

**INTERMEDIATED SECURITIES
UNIDROIT DRAFT CONVENTION AS A SOLUTION FOR
SLOVAKIAN SECURITIES LAW**

by

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ABSTRACT

In order to conduct business operations, issuers need to raise capital and this is typically achieved by issuing securities. Today, the investors do not physically hold their securities anymore. Securities are held and transferred through a complex system of financial intermediaries. As the interconnection of capital markets proceeds, numerous legal issues arise. It is the goal of this thesis to examine intermediated securities and holding system in Slovakia. This thesis assesses to evaluate Slovakian legal solutions for intermediated securities in comparison with the law of Germany and the United States. These two jurisdictions have been chosen due to their global importance and mutual difference. Moreover, this thesis aims to describe the most recent harmonizing instrument, the UNIDROIT Convention on Substantive Rules regarding Intermediated Securities and examine its compatibility with Slovakian legal system. It will be shown that Slovakian regulation on intermediated securities is adequate and effective, as it responds to the essential legal issues connected with holding of intermediated securities. Nevertheless, the adoption of the UNIDROIT Convention is recommended.

Keywords: central securities depository; direct holding system; immobilization; indirect holding system; intermediary; securities; securities account; security interest.

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LIST OF ABBREVIATIONS

BGB	German Civil Code (<i>Bürgerliches Gesetzbuch</i>)
CDCP	Central Depository of Securities of the Slovak Republic (<i>Centrálny Depozitár Cenných Papierov</i>)
EC	European Community
ECB	European Central Bank
ECJ	Court of Justice of the European Union (Initially the European Court of Justice)
EU	The European Union
FSAP	Financial Services Action Plan 1999 (EU)
GmbH	German Code on Private Limited Company (<i>Gesellschaft mit beschränkter Haftung</i>)
NBS	National Bank of Slovakia (<i>Národná Banka Slovenska</i>)
SEC	Securities and Exchange Commission (USA)
SIPA	Securities Investor Protection Act (USA)
TEU	Treaty of the European Union
TFEU	Treaty of the Functioning of the European Union
UCC	Uniform Commercial Code (USA)
UNIDROIT	International Institute for the Unification of Private Law
US	The United States of America

INTRODUCTION

Securities market being part of the capital market is one of the most vital areas of a market economy as it provides companies – the issuers with access to capital by issuing securities and investors with either a slice of ownership in the company or other financial instruments having the potential of future valorization. In today's global economy, issuers often require large amounts of capital in order to finance their business and therefore to minimize the risk they employ financial intermediaries who specialize in this field and provide the service for them. It is therefore crucial to any economy to create a market which is able to efficiently allocate free investment resources and provide capital where needed.

The first issuance of shares (officially) appeared in 1602 by the United Netherlands Chartered East India Company, thus being the beginning of the securities trade.¹ Subsequently, the trade with shares evolved and expanded, new security instruments were introduced and customized but the trade was not fast and efficient enough due to the necessity of physical delivery of securities certificates. Later on, the practice of holding and disposition of investment securities has radically changed and today investors do not physically hold the certificates of their securities anymore but rather employ financial intermediaries which manage their securities for them. Thus, the holding system through financial intermediaries has developed and so did the intermediated securities. The word “intermediated” refers to the holding of securities by financial intermediaries, as central banks, investment banks and broker institutions. There two types of holding system, the direct and indirect which qualify the relation between the issuer and the investor.

¹ See, e.g. GRUNDMANN- VAN DE KROL (2002), 3 and the further references provided therein. However, the French city of Toulouse could also claim to be the very first one on the ground of issuing 96 shares by the *Société des Moulins du Bazacle* in 1250; see <www.euronext.com> It has even been argued that a lively trade in corporate shares existed in ancient Rome; MALMENDIER (2005) in MATTHIAS HAENTJENS, HARMONISATION OF SECURITIES LAW: CUSTODY AND TRANSFER OF SECURITIES IN EUROPEAN PRIVATE LAW 30 (Kluwer Law International, 2007).

As the securities markets expand and develop worldwide and the number of domestic and cross-border securities transactions enormously increases, all legal systems face the task to create an effective and secure legal environment. Such securities regulation should provide the investors with sufficient legal protection and should lead to motivation of investors to invest in different types of securities and hence help and revive financial markets. It is assumed by several scholars that the most of current laws do not determine in advance with sufficient legal certainty and predictability the substantive law that will govern the rights and obligations of investment intermediaries, investors or issuers nor in the case of cross-border situations.²

To promote legal certainty in securities trade, the Hague Conference on International Private Law facilitated the recent adoption of conflict of laws treaty which aims to harmonize conflicts of laws rules regarding securities which are held and transferred through a securities account.³ Other important global harmonization initiative was introduced by the International Institute for the Unification of Private Law (UNIDROIT) which on 9 October 2009 adopted a Convention on Substantive Rules for Intermediated Securities.⁴ Also on the regional level, the European Union undertook several steps to provide harmonization in the field of intermediated securities. Although, due to the hesitation of the EU and other countries the concerns connected to intermediated securities are still not settled.

² See e.g. Luc Thévenoz, *Intermediated Securities, Legal Risk, and the International Harmonization of Commercial Law*, 13 Stan. J.L. BUS. & FIN. 384 (2008), Charles W. Mooney, Jr., *Law and Systems for Intermediated Securities and Relationship of Private Property Law to Securities Clearance and Settlement: United States, Japan, and the UNIDROIT Draft Convention in IMES Discussion Paper Series*, 15 (Institute for Monetary and Economic Studies, Bank of Japan 2008). Available at <http://www.imes.boj.or.jp> or JOANNA BENJAMIN, *INTERESTS IN SECURITIES: A PROPRIETARY LAW ANALYSIS OF THE INTERNATIONAL SECURITIES MARKETS*, 4 (Oxford University Press, 2000).

³ The 'Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary' was adopted on 13 December 2002, available at <www.hcch.net>/lastly visited 12th March 2011, [Hereinafter Hague Convention].

⁴ The 'Convention on Substantive Rules for Intermediated Securities', available at <www.unidroit.org>/lastly visited 12th March 2011, [Hereinafter UNIDROIT Convention or Convention].

Slovakia, once called “black hole in the middle of Europe” by Madeleine Albright (at that time US secretary of state) is not that black hole anymore.⁵ Since the time of representing a smaller and weaker brother of Czech Republic many had changed. Slovakia undertook significant reforms which helped to consolidate its budget and economy and enter the European Union in 2004 and to adopt euro in January 2009. Such progress was not predicted 20 years ago. Despite numerous victories in economic and legal areas, the Slovakian capital market, the smallest market of the European Union, still inadequately fulfills its role.

It is the aim of this thesis to analyze and examine the Slovakian securities law, in particular the regulation of intermediated securities. In order to provide a solid legal analysis it is necessary to explore and compare other legal systems and their solutions for the holding system of intermediated securities. Germany and the United States represent the selected jurisdictions since they provide two fundamentally different legal approaches. Moreover, as the UNIDROIT Convention was recently adopted and is of a significant international importance, its description and its possible applicability in Slovakia will be provided.

Concerning the thesis’s structure, the Chapter 1 clarifies the legal character of intermediated securities and illustrates different types of securities holding systems. Afterwards, chapter 2 analyzes and compares the current legal infrastructure of the intermediated securities in Germany and the United States. Subsequently, in chapter 3 the UNIDROIT Convention will be presented, its purpose and character will be defined. Finally, the last chapter is devoted to the Slovakian securities system, particularly the current regulation and the nature of Slovakian holding system. A general comparison between

⁵ *Bratislava’s plan B: Slovakia believes in the euro zone’s rules. Not a popular stance*, THE ECONOMIST, December 29, 2010, http://www.economist.com/node/17805663?story_id=17805663.

Slovakian and other given systems will be provided, as well as the reflexion on possible implementation of the UNIDROIT Convention.

1. EMERGENCE AND LEGAL NATURE OF INTERMEDIATED SECURITIES

As all securities markets expand and develop, the number of domestic and cross-border securities transactions increases and therefore all legal systems face the task to create an effective and secure legal environment. This chapter aims to introduce the topic of intermediated securities, as it is crucial to understand how the intermediated securities came into existence, what their features are and as well how and through what instruments they are traded. Moreover, the regional and international harmonization instruments on this issue will be brought up.

1.1. *Legal Nature of Securities*

Possibly all jurisdictions have a definition of the term “security”⁶, either a statutory definition or one given by a court. These definitions may slightly differ from each other, but the key is to understand the function and the economic content of this term while capital markets evolve incredibly fast and it is highly probable that new type of security was invented just right now. Security is an instrument representing ownership, rights to ownership or future payment based on a debt agreement. Security is a type of a transferable financial asset which is generally divided into two types: debt security & equity security.

⁶ “The term [security] refers to 1. Collateral given or pledged to guarantee the fulfillment of an obligation; esp. the assurance that a creditor will be repaid (usu. With interest) any money or credit extended to a debtor. 2. A person who is bound by some type of guaranty; Surety. 3. The state of being secure, esp. from danger or attack. 4. An instrument that evidences the holder’s ownership rights in a firm (e.g., a stock), the holder’s creditor relationship with a firm or government (e.g. bond), or the holder’s other rights (e.g., an option). A security indicates an interest based on an investment in a common enterprise rather than direct participation in the enterprise. Under an important statutory definition, a security is any interest or instrument relating to finances, including a note, stock, treasure stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in a profit-sharing agreement, collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of these things. A security also includes any put, call, straddle, option, or privilege on any security, certificate of deposit, group or index of securities, or any such device entered into on a national securities exchange, relating to foreign currency.” See BLACK’S LAW DICTIONARY (West, abridged 9th ed. St. Paul, Minn. 1991).

A debt security constitutes an acknowledgement by the issuer of the security that it owes money to the security holder, where the holder is entitled to a repayment with interest at the time specified under the terms of the security.⁷ Equity security is de facto an ordinary share. The holder of an equity security is a shareholder of a corporation which issued the shares –the securities.

Furthermore, there are other relevant categories of securities that are necessary to identify to be able to elaborate later on different types of holding systems:

- certificated securities & uncertificated securities

Certificated securities are securities for which an issuer issued one or more certificates. It is possible to issue separate certificates for each of the investment security or just issue one for all securities – global certificates, which nowadays prevail. A certificated security might be either a document of title or just an evidence of title which requires additional documents in order to transfer the property rights. On the other hand, uncertificated securities are securities for which no certificate was issued.⁸

- bearer securities & registered securities

Bearer securities are those that award proprietary rights to their holder due to the fact of a possession (holder “bears” a security). A security is in registered form if it specifies the person entitled to it and the rights it evidences are in favor of the person recorded on a register and the possession of that security is not required anymore.

⁷ See JOANNA BENJAMIN, *INTERESTS IN SECURITIES: A PROPRIETARY LAW ANALYSIS OF THE INTERNATIONAL SECURITIES MARKETS*, 4 (Oxford University Press, 2000).

⁸ The holder of the security might or might not be entitled to demand issuance of certificates. If he has no possibility to obtain a certificate it is wholly uncertificated security, if there is a possibility then it is a partially uncertificated security, cited in Christophe Bernasconi, *The law applicable to dispositions of securities held through indirect holding systems* 9 (Preliminary document no. 1 to the Hague Conference on Private International Law, November, 2000) available at <www.hcch.net>/lastly visited on 14th March 2011.

1.1.1. Distinction Between Securities and Interests in Securities

In holding systems, where between an issuer and investor an intermediary steps in, the confusion between a security and interest in securities may upraise. Interests in securities are the assets of an investor for whom an investment intermediary holds securities (or interests in securities, in the case of several intermediaries) on an unallocated basis, (in indirect holding systems the securities are usually mixed with the securities of other clients).⁹ It is necessary to differ one from another. The difference between securities and interests in securities and their position within the system of the trade with securities via financial intermediaries can be understood from the given figure.

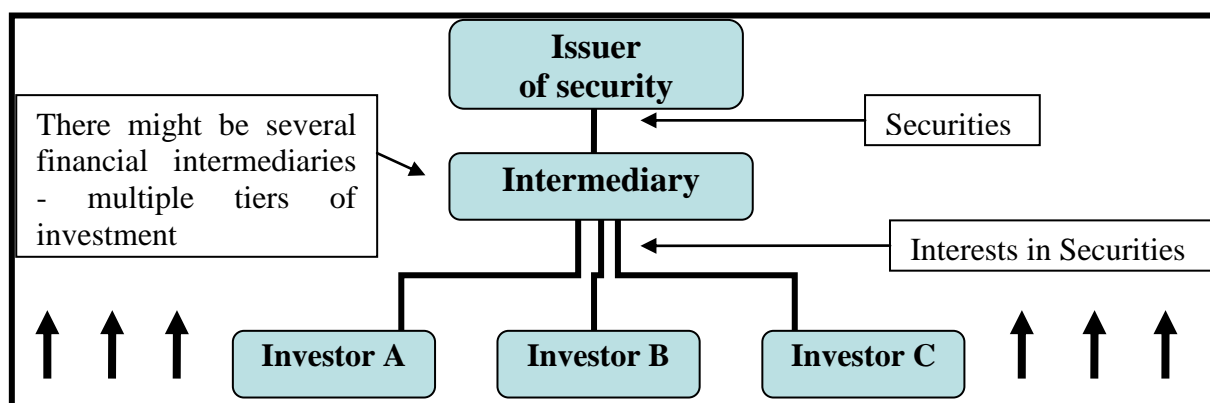


Figure 1

1.2. Emergence of Intermediated Securities

To understand the evolvement of the holding systems and the differences between the direct and indirect holding system, firstly it is necessary to describe the two core concepts which led to the creation of holding systems.

⁹See BENJAMIN, *supra* note 7, at 5.

1.2.1. The Concept of Immobilization and Dematerialization

In the United States, the immobilization of securities was introduced after the “paper crunch” in the 1960s. With immobilization, paper instruments or certificates can still exist, but they no longer move from investor to investor or from intermediary to intermediary. If securities are immobilized it means that certificates of securities are permanently held by a depository and thus physical transport of certificates is unnecessary. Nowadays, the largest immobilizers of securities in the world are the Depository Trust Company in New York and the Clearstream Banking and Euroclear in Luxembourg. If securities are immobilized and they are deposited in one or more depositories, the entitlement to them is recorded in accounts kept by the depository, so that any disposition of rights on the securities are performed through debits and credits in the respective accounts kept by the depositories on behalf of participants.¹⁰

In dematerialized systems, securities exist only as electronic records. If securities are dematerialized they take form of a book entry on a securities account, which is opened either with a financial intermediary responsible for opening and managing accounts for its investors, or the account is opened directly in the books of the issuer.¹¹ It is a process by which all physical certificates are replaced by electronic securities accounts.¹²

1.2.2. Direct Holding System & Indirect Holding System

As the volume of business in securities markets increased, the material trading of securities became impossible and a new trade practice was sought.¹³ Under the traditional

¹⁰ See Michael D. Diathesopoulos, *Interests in Securities Under a Comparative Law Approach*, 2010 PFESR ANNUAL REVIEW 7.

¹¹ *Id.*

¹² See MATTHIAS HAENTJENS, *HARMONISATION OF SECURITIES LAW: CUSTODY AND TRANSFER OF SECURITIES IN EUROPEAN PRIVATE LAW* 33 (Kluwer Law International, 2007).

¹³ In 1989, the Group of Thirty (G30) a New York based non-profit organization published its first report on this issue, making recommendations for more efficient settlement and emphasized the electronic rather physical

system for direct holding of securities, individual securities were issued to investors that subsequently had the right to trade those securities to other investors, by simply handing over the certificate of security (bearer security) or being recorded in the issuer's register (registered security).¹⁴ Following the improvement of banking institutions' services, more investors placed their securities in bank's custody. Especially because the law at that time attributed the ownership of the security to the person who physically held the certificates, the need to reduce the risk of loss and theft emerged.¹⁵ Hence, the main issue which the operation of the indirect holding system raises is to the existence and determination of proprietary rights.

In the indirect holding system, typical for the United States, the investor's securities account is not credited with a security, but with a right on securities (in the UCC it is a securities entitlement). The security is issued and exists through a registration in the issuer's register, but that register does not contain the identity of the investor but the identity of the intermediary who maintains the securities account of the investor in his name.¹⁶ Therefore is this indirect, while *de iure*, the securities entitlement holder (investor) does not hold the security and has no relation with the securities' issuer.¹⁷

transfer of paper. In Mohamed F. Khimji, *Intermediary Credit Risk – A Comparative Law Analysis of Property Rights in Indirectly held securities*, 3 J. BUS L. 287, 291 (2005).

¹⁴ See Steven L. Schwarcz, *Indirectly Held Securities and Intermediary Risk*, 2001 UNIF. L. REV. 283, 284.

¹⁵ See Randall L. Guynn et al., *Modernizing Securities Ownership, Transfer and Pledging Laws*, CAPITAL MARKETS FORUM, INTERNATIONAL BAR ASSOCIATION (Mar 11, 2011), <<http://www.davispolk.com/iba.modernization.pdf>>. It was after the IWW when the banks of Berlin used so called *Kassenverein* (A central securities depository that cleared and settled transactions on German stock exchanges), originally established in 1850 for money transfers, as a central securities depository for security transfers in Ulrich Drobning, *Dokumentloser Effektenverkehr, ABSCHIED VOM WERTPAPIER? DOKUMENTELOSER WERTBEWEGUNGEN IM EFEKTEN-, GÜTERTRANSPORT- UND ZAHLUNGSVERKEHR* 17 (K. Kreuzer, 1988).

¹⁶ See Thiebald Cremers, *Reflexions on "Intermediated Securities" in the Geneva Securities Convention*, 1 EUREDIA, 93, 97 (2010).

¹⁷ See SANDRA M. ROCKS & CARL S. BJERRE, *THE ABCS OF THE UCC, ARTICLE 8: INVESTMENT SECURITIES* 33 (American Bar Association, 1997).

In both holding systems, investment intermediaries¹⁸ play a key role, while they provide access for investors and capital seekers to the securities market.¹⁹ Investment intermediaries connect investors who hold capital and wish to invest (but do not know how) with the world of diverse investment products while providing them services such as investment advice, financial planning, investment portfolio management or brokerage services.

Moreover, it is important to realize that in indirect holding system the investment intermediaries – “securities intermediaries”²⁰ – not only hold the securities on behalf of investors but usually own the beneficial rights in the securities as well. Hence, the securities today are generally held indirectly through multiple tiers of investment intermediaries and due to the world’s financial interconnection the cross-border investments require not only the tiering of intermediaries, but also involvement by intermediaries in different countries, with each tier being subject to different national law.²¹

1.3. Legal Nature of Intermediated Securities

As it was described above, there is a certain difference between securities and interests in securities. Another important distinction is between directly held securities and intermediated securities, which are securities, hold by financial intermediaries and are frequently referred to as “indirectly held securities”.

Intermediated securities can be described as securities of which the physical certificates (if any) are deposited with an investment intermediary. Investment intermediaries

¹⁸ For the purpose of this thesis terms investment intermediaries, financial intermediaries, securities intermediaries and intermediaries are to be used interchangeable.

¹⁹ See Robert C. Clark, *The Four Stages of Capitalism*, 94 HARV. L. REV. 561 (1981) on the importance of financial intermediaries and their influence in economy).

²⁰ See UCC §8 – 102(a) which uses the same definition.

²¹ See *Morgan Guaranty Trust Co. of N.Y., Brussels Office as operator of Euroclear, Cross-Border Clearance, Settlement and Custody: Beyond the G30 Recommendation* (1993) (referring to legal ambiguities regarding intermediary risk), in Schwarcz, *supra* note 14, at 284.

and investors deal only with the rights which the paper represents and which were introduced into the intermediary system through the immobilization of the certificate with an intermediary. The container (the certificate) retreats into the wings while the content (the rights against the issuer) comes to center stage; while it can be transferred or charged to another – third party without the container-certificate being moved or affected in the least.²²

It is without any doubt, that once an investor places his funds on the security market he faces certain amount of diverse types of risks.²³ However, if he trades via investment intermediaries he faces one more – the intermediary risk. Schwarz in his article evolved on the subject of the intermediary risk and emphasized its several features:

- Investors want to know that their interests in securities held by failed securities intermediaries are not subject to the claims of creditors of those intermediaries;
- Other investment intermediaries within the multiple tier system (e.g. brokers) owning by themselves interests in securities held by failed intermediaries want to know that those interests are not subject to the claims of creditors of the failed intermediaries; or
- Other involved parties, such as lenders, that extend secured credit to investors where the intermediated security serves as collateral are as well afraid not to lose their rights in those intermediated securities.²⁴

²² See Luc Thévenoz, *New Legal Concepts regarding the Holding of Investment Securities for a Civil Law Jurisdiction – The Swiss Draft Act*, 2005 UNIF. L. REV. 301, 306.

²³ The risks associated with a particular investment can be classified as: *Uncertainty of income* (sometimes referred to as project or business risk); *Default risk* (this risk arises in respect of debt securities and is the risk that a loan will be not repaid at the due date); *Interest rate risk* (The valuation of investment is sensitive to the prevailing level of interest rates and therefore changes in interest rates cause changes in market values) and *Inflation risk*. For more see JANETTE RUTTERFORD, *INTRODUCTION TO STOCK EXCHANGE INVESTMENT* (Palgrave Macmillan, 2nd ed. 1993) where the author describes trading on capital markets, in particular on stock markets. On the other hand, legal risk refers to the possibility that the reason for losing the capital is the applicable law which is unable to clearly lay down the rules and specify the outcomes.

²⁴ See Schwarcz, *supra* note 14, at 286-7.

1.4. *EU Harmonization Initiatives*

Since the common market has been established by the Treaty of Rome the area of securities law has evolved in several stages.²⁵ The European Community did not adopt directly binding regulations, but rather, enacted more politically convenient directives that mandated only general results which were to be achieved and provided each member state significant time and discretion in transposing the directives in their national laws.²⁶ The problem with these directives was that they only harmonized some general principles and rules, lacked coherency, and were implemented and enforced in different ways. However, the shift occurred with the Financial Services Action Plan 1999²⁷ (FSAP) which aimed to achieve an integrated internal market for financial services in general and led to the adoption of 42 Community instruments.

Later on, in 2001 the Committee of Wise Men, chaired by Baron Alexandre Lamfalussy produced a Lamfalussy Report which led to massive changes in the financial market law-making and policy formation process.²⁸ The result of the FSAP and the Lamfalussy process is that all major aspects of securities law are now regulated. Regulation regarding the infrastructure of capital markets can be found in the Markets in Financial Instruments Directive (MiFID)²⁹, the Investor Compensation Schemes Directive,³⁰ the

²⁵ For more on the history of the EU security market harmonization see NIAMH MOLONEY, *EC SECURITIES REGULATION* 11-16 (Oxford University Press, 2nd ed. 2008) and MANNING GILBER WARREN III, *EUROPEAN SECURITIES REGULATION* 1-8 (Kluwer Law International, 2003).

²⁶ See MANNING GILBER WARREN III, *EUROPEAN SECURITIES REGULATION* 2 (Kluwer Law International, 2003).

²⁷ Financial Services Action Plan, a Progress Report, available at <http://ec.europa.eu/internal_market/finances/docs/actionplan/index/progress1_en.pdf>/lastly visited 15th March 2011.

²⁸ See NIAMH MOLONEY, *EC SECURITIES REGULATION* 1010 (Oxford University Press, 2nd ed. 2008). The integration on European financial markets is now carried out in a four stage process which is in detail described and evaluated by in his article Mathias M. Siems, *The Foundations of Securities Law*, 20 EUR. BUS. L. REV., 141, 167-169 (2009).

²⁹ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directive 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC OJ L 145.

³⁰ Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes, OJ L 84/22.

Settlement Finality Directive³¹ and the Collateral Directive.³² Moreover, investment funds are to some extent harmonized in the Directives on undertaking for collective investment in transferable securities.³³

The investment-services regime is based ultimately on the objective of the Treaties³⁴ to create an internal market (Article 3 TEU and Article 26 TFEU), more specifically on the free movement rights granted under the TFEU to investment intermediaries in regard to the right of establishment and the freedom to provide services (Articles 49-55 TFEU and 56-66 EC, respectively). The approach to establish an internal market in the investment-services and securities sector is a similar one to that in other areas of financial services. The European Union lays down rules on harmonization of essential standards, mutual recognition by the national supervisory authorities and of laws and practices governing access to investment activity.³⁵

It is impossible to simply enumerate which directives are applicable to the investment intermediaries, while the intermediary services are provided by numerous institutions (mainly by investment funds), depending as well on the Member State's home legislation and control, so the regulation between banks and other financial institutions overlap. Directives regulate the initial and on-going conditions for service providers, establish requirements for the issuance of securities and co-operate the conditions applicable to investment funds.³⁶ The legislation on issuance of securities harmonizes minimum

³¹ Directive 1998/26/EC of the European Parliament and of the Council of 19 May 1998 on the finality in payment and securities settlement systems, OJ L 166/45.

³² Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168/43.

³³ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) OJ L 302/23 which is the recast of formal directive.

³⁴ Treaty on the Functioning of the European Union and the Treaty on European Union, OJ 2010 C 83/13.

³⁵ See CORNELIA GERSTER, EUROPEAN BANKING AND FINANCIAL SERVICES LAW 43 (Kluwer Law International in association with EAPB, 2004).

³⁶ For more see <http://ec.europa.eu/internal_market/top_layer/index_24_en.htm> /lastly visited 8th March 2011.

requirements for the information that must be disclosed to the public and facilitates the cross-border security issuance.

1.4.1. EU Regulation on Investment Intermediaries

The importance of the regulation of investment intermediaries was firstly recognized in 1995 by the Court of Justice of the European Union (earlier the European Court of Justice) in the *Alpine Investments*³⁷ case where it was found that “*the existence of professional regulations serving to ensure the competence and trustworthiness of the financial intermediaries on whom investors are particularly reliant’ was essential for investors’ confidence towards the securities markets.*”³⁸

There are two main rationales for regulation of investment intermediaries. The first one is the micro-protection of investors and the second one is the macro-protection of the financial system stability.³⁹ Both of them require different set of regulatory tools and strategies. Regarding the protection of investors, the regulation should include the disclosure mechanisms of potential risks, investor’s rights and obligations, necessary authorizations and licenses, scope of liability of intermediary and as well the duty to inform on regular basis. In terms of protection of financial system stability the principal aim of any regulation should be to banish such financial intermediaries, which are incompetent, fraudulent or unable to meet capital requirements or competency standards.⁴⁰

1.5. Other International Harmonization Efforts

International legal community during last few years undertook several efforts to promote legal certainty and economic efficiency with respect to the cross-border holding and

³⁷ See Case. C-384/93, *Alpine Investments v. Minister van Financiën*, 1995 ECR I-1141.

³⁸ See *id.* Para 42.

³⁹ See MOLONEY, *supra* note 28, at 340-341.

⁴⁰ See *id.* at 344.

disposition of securities held with an intermediary. The Hague Convention and the UNIDROIT Convention will be briefly introduced and described.

1.5.1. Hague Convention

In May 2000, Australia, the United Kingdom and the United States proposed to Hague Conference that it should facilitate a convention concerning private international law regarding indirectly held securities. In February 2004 the final text of Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary was published.⁴¹

The Hague Convention is a pure conflict-of-laws convention and has no effect on the substantive law that will be applied once the applicable law has been determined.⁴²

The basic principle of the Hague Convention (Article 4) is that where securities are held through a financial intermediary, the applicable law is determined solely by the express law agreement between the account holder and the relevant intermediary. If the applicable law cannot be determined in this way Article 5 lays down fall-back rules which result in the application of the law of the jurisdiction in which the intermediary is incorporated or has the principal place of business. The Hague Convention rejects any approach under which the law governing a transaction of indirectly-held securities is determined by reference to connecting factors affecting the underlying securities.⁴³

⁴¹ Available at <http://www.hcch.net/index_en.php?act=conventions.text&cid=72>/lastly visited 14th March 2011, hereinafter [Hague Convention].

⁴² UNIDROIT Secretariat, *Explanatory Notes to the Preliminary Draft UNIDROIT Convention on Harmonised Substantive Rules regarding Securities Held with and Intermediary*, 2005 UNIF. L. REV. 60.

⁴³ Roy Goode et al., *Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held With an Intermediary* 18-19 (HCCH 2005).

1.5.2. UNIDROIT Convention

The International Institute for the Unification of Private Law (UNIDROIT) has facilitated the creation of numerous harmonization instruments in the field of private and commercial laws. On 9 October 2009 UNIDROIT adopted a Convention on substantive rules on intermediated securities which aims to harmonize the substantive law of intermediated securities. Until now only Bangladesh signed the Convention. The UNIDROIT Convention will be described in greater detail later in chapter 3.

2. COMPARISON OF GERMAN & US REGULATION ON INTERMEDIATED SECURITIES

Germany and the United States represent two competitive market economies which stand on fundamentally different legal traditions and principles. In this chapter the analysis regarding the law of the intermediated securities will be made for two selected jurisdictions, Germany and the US. Both of them are commercially very important. The first one is Germany - one of the most influential EU Member States which is based on a bank-market system and the second chosen country is the United States which has established a modern, harmonized legal framework for intermediated securities and which continues to be the leading legislator in this field, as is stated by several scholars.⁴⁴

2.1. *The Legal Nature of Intermediated Securities in Germany*

This part of the thesis aims to outline the basic legal mechanisms of the German securities law, more specifically the legal framework of the intermediated securities, their transfer and the holding system. Moreover, the relationship between the financial intermediary and the investor will be described, in particular the investor's protection in the case of intermediary's insolvency.

2.1.1. Statutes Regulating Intermediated Securities in Germany

To understand the functioning of the German security market, it is necessary to specify the structure of the core legal framework. Although, the thesis does not specifically deal with all of them, they are necessary for the subsequent analysis. Hence, there are several

⁴⁴ See, e.g. GUY P. LANDER, *US SECURITIES LAW FOR INTERNATIONAL FINANCIAL TRANSACTIONS AND CAPITAL MARKETS* (West Publishing, 14th ed. 2000) and Charles W. Mooney Jr., *The Roles of Individuals in UCC Reform: Is The Uniform Law Process a Potted Plant, The Case of Revised UCC Article 8*, 27 OKLA. CITY U. L. REV. 553 (2002) (both sources analyze the current state of holding systems in the United States).

relevant acts which need to be briefly described within the context of intermediated securities:

- German Civil Code - BGB (*Bürgerliches Gesetzbuch*) is applicable concerning the transfer of intermediated securities.
- German Securities Trading Act (*Wertpapierhandelsgesetz*) governs the trading with securities, financial instruments, futures, derivatives and similar financial products.⁴⁵
- German Securities Deposit Act (*Depotgesetz*) regulates the relationship between investors, their securities and their intermediaries.
- German Banking Act (*Kreditwesengesetz*) forms the statutory framework for banking and financial services activities and protects their customers.

All German securities markets and providers of financial and securities trading services are subject to the national supervision of Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*), so called BaFin.⁴⁶

2.1.2. German Legal Doctrine on Securities

In Germany it was during the Napoleon wars when the securities were firstly issued with the purpose to raise finance for the war. They were freely traded in a liquid market.⁴⁷ Later, in the beginning of the 19th century as the railway industry evolved and securities were used to raise the capital, the Bavarian Ludwig Railway (*Bayerische*

⁴⁵ For more on the securities law in Germany see Marc-Oliver Kurth & Oliver Rothley, *Securities Law in Germany*, INTERNATIONAL SECURITIES LAW HANDBOOK (Mar 14, 2011) Available at <http://www.taylorwessing.com/uploads/tx_siruplawyermanagement/International_Securities_Law_Handbook_German_Chapter.pdf>.

⁴⁶ BaFin regulates around 2000 banks, 710 financial service providers, approximately 620 insurance companies and 28 pension funds as well as around 6000 domestic investment funds and 73 asset management companies in Germany. BaFin exercises solvency supervision, markets supervision and promotes investor protection. For more details, see <http://www.bafin.de/cln_179/nn_721608/EN/BaFin/Functions/functions__node.html?__nnn=true>/lastly visited 14th March 2011.

⁴⁷ See EVA MICHELER, PROPERTY IN SECURITY 149 (Cambridge University Press, 2007), [hereinafter MICHELER].

Ludwigseisenbahn/Ludwigsbahn) was the first one to issue them.⁴⁸ During the nineteenth century the German legal doctrine struggled to find a generally accepted theoretical explanation for the rules governing securities, while firstly securities were treated as intangibles and their transfers were considered to be governed by the law of assignment. Later, *Nikolaus T. Gönner*, at the time a leading German scholar, reclassified securities being a separate legal institution.⁴⁹ Afterwards, in late nineteenth century other novel theories evolved.⁵⁰

As German capital market continued to develop, the issuers created global certificates which replaced the individual certificates.⁵¹ Today most issues of debt securities are represented by a permanent global certificate and the issues of equity securities are represented by a temporary certificate, which gives right to request the issue of individual certificates.⁵² Following this transformation, it was impossible to connect individual certificate to its owners. Nevertheless, German law overcame the allocation problem and continued in the previous doctrinal solution and expanded the scope of application of the rules of possession – creating a joint possession of and joint co-ownership of the investor.⁵³

⁴⁸ See HELMUT COING, *EUROPÄISCHES PRIVATRECHT*, 19. JAHRHUNDERT 94-96 (Beck, 2nd ed. 1989).

⁴⁹ See NIKOLAUS THEODRE GÖNNER, *VON STAATSCHULDEN, DEREN TILGUNGSANSTALTEN UND VOM HANDELN MIT STAATSPAPIEREN* 194 (Fleischmannsche Buchhandlung, 1826). Gönner in his book describes why the securities should be treated as of a unique nature and what other specific rules should apply for them as well for their holders.

⁵⁰ For more details on the theories see MICHELER, *supra* note 47, at 159 – 160.

⁵¹ During the Second World War as the paper represented an expensive commodity it was uneconomical to print every single individual certificate, instead the issuers started to issue a global security which represented the individual ones.

⁵² EVA MICHELER, *WERTPAPIERRECHT ZWISCHEN SCHULD- UND SACHENRECHT: ZU EINER KAPITALMARKTRECHTLICHEN THEORIE DES WERTPAPIERRECHTS. EFFEKTEN NACH ÖSTERREICHISCHEM, DEUTSCHEM, ENGLISCHEM UND RUSSISCHEM RECHT* 252-260 (Springer, 2003) *cited in* MICHELER, *supra* note 49, at 188.

⁵³ See MICHELER, *supra* note 47, at 189. More on the issue of co-ownership rights in German securities system see Dorothe Einsele, *Modernising German Law: Can the UNIDROIT Project on Intermediated Securities Provide Guidance?* 2005 UNIF. L. REV. 251, 251-253 (where the author describes that according to German Securities Deposit Act, the investor is a co-owner of a fungible pool of securities held with intermediary and based on the fact, that usually the holder of the global certificate is not the direct intermediary, but the German Central Securities Depository – *Clearstream Banking AG*, the investor does not have a right to separate certificates. Consequently, problems arise with the transfer of co-ownership rights).

2.1.3. Transfer of Securities in Germany

Today in Germany, most securities (*Wertpapier*) are issued in the form of bearer security, rather than in the form of a registered security. The underlying theory in modern German law defines a security certificate as a paper document of a very special type. The right (the interest in securities) which is presented by this document materializes in the document and therefore can be transferred according to the rules governing tangible assets.⁵⁴ If the certificate is transferred, the buyer is entitled to the paper document and also to the right which is represented by the paper.

As it is stated above, the current German law applies the same rules to transfers of bearer securities as to transfers of any tangible assets. The applicable law is the German Civil Code - BGB, ss. 929-936. According to sec. 929 BGB, which lays down the general rule, the buyer becomes the owner if two requirements are satisfied. Firstly the buyer needs to acquire possession to the tangibles and secondly, seller and buyer agree that the ownership is to be transferred to the buyer. The BGB does not require any written sales contract as long as the parties agree that, upon transfer of possession to the buyer, the buyer is to become the owner. Thus, the buyer of securities is considered to become an owner in the moment of possessing the securities certificates.

However, it would be very impractical if all the transfers would have to be concluded in this way. Therefore, there are methods how the buyer gains the possession of securities without directly holding the certificate. Either buyer and seller agree that the securities remain with the seller, provided that the seller now holds them on behalf of the buyer or the securities are with a third party (usually financial intermediary) and the seller

⁵⁴ See MICHELER, *supra* note 47, at 145.

assigns the right to claim the tangibles from the third party to the buyer. Both of these options must be carried out contractually.

The German law system is characterized by the specific protection of a bona fide purchaser who is protected against adverse claims through provisions in the respective civil and commercial codes.⁵⁵ Hence, it is the issuer who is unable to raise equities against a good faith purchaser of securities and is therefore liable by the fact that the securities certificates contain a representation of the issuer who represents that the securities have been validly created and a good faith purchaser is able to rely on it and enforce the rights referred to in the securities documents against the issuer.⁵⁶ Therefore, German banks started to provide depository services for their clients.

2.1.4. Holding System in Germany

Given the fact that in Germany the transfer of securities from an unauthorized seller to a *bona fide* buyer is valid and the buyer becomes the owner in the moment of gaining the possession of the securities, it affects the whole system of indirect holding securities as to keep securities certificates out of circulation in order to prevent a third party from acquiring possession of-and, consequently, ownership of-bearer securities.⁵⁷ In Germany, financial intermediaries are usually banks and the ultimate holder/custodian of securities is the German Central Securities Depository – *Clearstream Banking AG*. The multi-layered intermediated holding structures are created through the following chain:

⁵⁵ The Roman law's basic principle is that no one can transfer a better title than he himself has (*nemo plus iuris transferre potest quam ipse habet*). This principle is not rigidly followed in German private law. Several rules in BGB or in GmbH (*Gesellschaft mit beschränkter Haftung*) enable *bona fide* purchaser to acquire ownership from an apparent owner. These rules oppose the rights of the true owner, who thus loses the right – the ownership of the security (or any other tangible asset) by the operation of law. For details on this issue see Christian Altgen, *The Acquisition of GmbH Shares in Good Faith*, 9 GERMAN L. J. 1141, 1142 (2008).

⁵⁶ See MICHELER, *supra* note 47, at 179.

⁵⁷ See MICHELER, *supra* note 47, at 183.

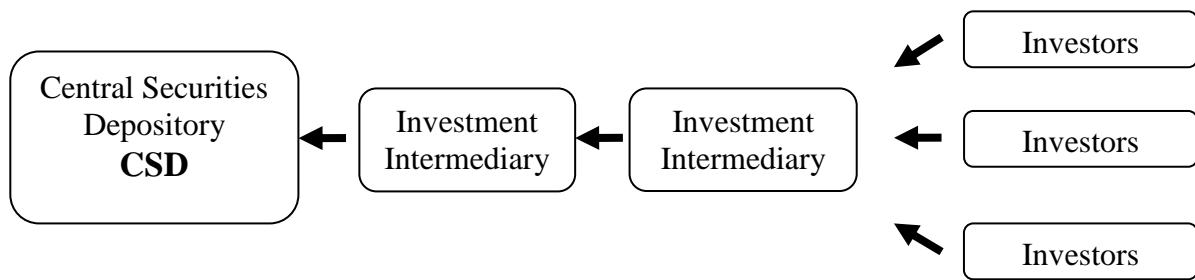


Figure 2

2.1.5. The Relationship Between Financial Intermediary and Investor in Germany

As it is stated in 2.1.1., it is the German Securities Deposit Act which regulates the relationship between financial intermediaries and investors. In addition, as the intermediated securities are governed by the law relating to tangible assets, so is the relationship between financial intermediaries and investors. Moreover, despite the fact that investors have a claim to the underlying securities, this claim is enforceable only indirectly through the chain of intermediaries that operates between the investor and the central securities depository.⁵⁸

Investor's position derives directly and only from the legal relationship with the issuer, not the intermediary. Intermediaries are neither legal nor beneficial owners of the securities on the investors' accounts. Hence, the insolvency of the intermediary will not affect the investor's rights which are under §35 Insolvency Act (*Insolvenzordnung*) excluded from insolvency proceedings.⁵⁹

2.2. The Legal Nature of Intermediated Securities in the United States

Federal government of the United States has the authority to regulate only very limited areas of law. The area of law of securities markets is very broad as it includes also

⁵⁸ See MICHELER, *supra* note 47, at 212.

⁵⁹ See Bernd Geire, *Comparison of the Electronic Securities Settlement Systems for the Securities Markets in Germany and England*, 23 J. INT'L BANKING L. & REG. 97, 104 (2008).

contract law, property law, commercial law or tax law, so the national regulation meets the federal which generally has the priority.

In this part, the legal framework of intermediated securities in the U.S. and the indirect holding system will be defined and the transfer of securities as well as the relationship between investment intermediaries and investors will be described and analyzed.

2.2.1. Statutes regulating intermediated securities in the United States

The core legal framework of intermediated securities comprises of these relevant statutes:

- Securities Act of 1933⁶⁰, often referred to as the “truth in securities law” which has two basic objectives:
 - It requires that investors receive financial and other significant information concerning securities being offered for public sale; and
 - It prohibits deceit, misrepresentations, and other fraud in the sale of securities.⁶¹
- Securities Exchange Act of 1934⁶² constituted the Securities and Exchange Commission (SEC) with broad authority over all aspects of the securities industry.
- Uniform Commercial Code (UCC)⁶³ which governs transactions involving investment securities through Article 8 titled “Investment Securities”.

⁶⁰ Available at < <http://www.sec.gov/about/laws/sa33.pdf>>/lastly visited 15th March 2011.

⁶¹ See <www.sec.gov/about/laws.shtml>/lastly visited 15th March 2011.

⁶² Available at < <http://www.sec.gov/about/laws/sea34.pdf>>/lastly visited 15th March 2011.

⁶³ The Uniform Commercial Code (UCC) is a comprehensive code addressing most aspects of commercial law in the United States. It was written by experts in commercial law and was submitted as drafts for approval to the National Conference of Commissioners on Uniform State Laws in collaboration with the American Law Institute. The UCC (in whole or in a part) is in force in all 50 states, the District of Columbia and the Virgin Islands.

- Securities Investor Protection Act of 1970⁶⁴ with the state bankruptcy law covers insolvencies of financial intermediaries.⁶⁵

All US securities markets as well as providers of financial and securities trading are subject to the US Securities and Exchange Commission (SEC) regulation and supervision.

2.2.2. UCC Article 8

The drafting of the Article 8 began in the 1940s and 1950s with the purpose to enable trading with securities for the broad public. At that time, whenever the securities were traded, by phone or by person, it was required to deliver the physical certificate from the seller to the purchaser. In the case of securities in registered form (as opposed to bearer form used in Germany), securities had to be enclosed by an executed stock or bond power (giving the purchaser authority to re-register the security) or registered in purchaser's name on the issuer's book.⁶⁶

In 1994 the UCC Article 8 and related provision in Article 9 were revised after several years of preparation⁶⁷ and subsequently implemented in all states of US. The 1994 revisions represent an effort to overhaul commercial law rules for securities transfers so as to reflect the realities of modern securities direct and indirect holding and trading practices.

⁶⁴ Available at < <http://www.sipc.org/pdf/SIPA.pdf>>/ lastly visited 15th March 2011.

⁶⁵ Of course this list is not exhaustive and there are other relevant statutes which govern the security industry, as Trust Indenture Act of 1939, Investment Company Act of 1940, Investment Advisers Act of 1940, Sarbanes-Oxley Act of 2002, plus the Rules and Regulations for the Securities and Exchange Commission and Major Securities Laws; all available at < <http://www.sec.gov/about/laws.shtml>>/lastly visited 15th March 2011.

⁶⁶ See ROCKS *supra* note 17, at 1-2.

⁶⁷ On the historical overview and the background process of the UCC revision in 1994, see Charles W. Mooney Jr., *The Roles of Individuals in UCC Reform: Is The Uniform Law Process a Potted Plant? The Case of Revised UCC Article 8*, 27 Okla.City U. L. Rev. 553 (2002). In this article author describes in detail the history of the UCC, reminds the successes as well as the failures and leads the reader through all the revisions of the Article 8, their motives and justifications.

Sandra M. Rocks and *Carl S. Bjerre* describe in their book the principal objectives of this revision and ways to achieving them in a greater detail.⁶⁸

The UCC Article 8 now regulates the direct holding of both certificated and uncertificated securities, but also the indirect holding of immobilized securities. The Article 8 is generally considered to provide a systemic terminology and highly effective legal framework for the custody and transfer of securities.⁶⁹

There are two main features of the UCC Article 8 which have to be pointed out and which evidence great applicability of this Article:

- It recognizes a concept of indirect holding that is unlimited in terms of participants and the number of potential intermediaries within the chain;
- The definition of financial asset is very broad as it includes any property an intermediary agrees to treat as a financial asset and hence there are no limits what might be treated as a security.⁷⁰

2.2.3. Holding System in the US

The United States UCC Article 8 applies both the direct as well as the indirect holding system of securities. In this part the indirect holding system will be described. It is a pattern of securities ownership and transfer in which investors, the owners of securities, have no direct relationship with the issuer, and instead they hold securities entitlements through financial intermediaries.⁷¹ When an investor decides to hold securities through an

⁶⁸ See ROCKS *supra* note 17, at 4-5.

⁶⁹ Eric T. Spink & Maxime A. Paré, *The Uniform Securities Transfer Act: Globalized Commercial Law for Canada*, 19 BANKING & FIN. L. REV. 321, 321-329 (2004).

⁷⁰ See Sandra M. Rocks, U.S. Commercial Law Response to Intermediary Holding, in 5 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW, 556, 557-558 (International Monetary Fund 2008).

⁷¹ See ROCKS *supra* note 17, at 39.

intermediary, he transfers the legal title to the intermediary and the only thing he holds is the security entitlement.

The conceptual foundation for the US indirect holding system is the “securities account”.⁷² The person that maintains a securities account for entitlement holders in the regular course of business is a “securities intermediary.”⁷³ The account holder is an “entitlement holder” and the entitlement holder’s rights and interest in respect of a securities account is a “security entitlement”.⁷⁴

A security entitlement is actually a *sui generis* form of property interest, a combination of property rights and contract rights resulting from an undertaking by a person to provide to another person the rights that constitute a security or certain other assets.⁷⁵ A security entitlement is acquired the moment when a securities account relationship has been created, i.e. when accredit-entry has been made in an accountholder’s securities account.⁷⁶

2.2.4. The Relationship between Financial Intermediary and Investor in the United States

Once a security entitlement has been established, a financial intermediary is subject to certain obligations toward an investor – entitlement holder. These obligations constitute the core of the intermediary – investor relationship and, if breached, they give rise to *in personam* liability of the financial intermediary.⁷⁷ In general, an intermediary satisfies these duties if it acts in accordance with its agreement with the investor or if, in absence of such an

⁷² UCC § 8-501(a) defines “securities account” as “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.”

⁷³ UCC § 8-102(a)(14) defining “securities intermediary”.

⁷⁴ UCC § 8-102(a)(7) defining “entitlement holder”.

⁷⁵ See ROCKS *supra* note 17, at 40.

⁷⁶ Cf. UCC § 8-102 official cmt. 7 and UCC § 8-501(b).

⁷⁷ See ROCKS *supra* note 17, at 48.

agreement, the intermediary acts with “due care in accordance with reasonable commercial standards, described below.”⁷⁸

Pursuant to Article 8, a financial intermediary is obliged to maintain financial assets to cover its entitlement holders’ security entitlements (1),⁷⁹ obtain payments or distributions (2),⁸⁰ exercise rights with respect to financial assets if directed by the entitlement holder (3),⁸¹ comply with entitlement orders (4)⁸² and to change position to other form of holding, meaning the right of an investor to terminate the intermediary relationship either by changing the financial intermediary or by terminating the indirect form of holding and obtaining the direct ownership of the financial asset (5).⁸³

However, the UCC Article 8 governs the investor-intermediary relationship as described it does not do so exhaustively. Firstly, an investment intermediary may perform many services that do not fall within the scope of Article 8 (investment advices, portfolio management, etc.) and are subject to other branches of law, such as the law of contract, the law of agency which in that case supplement Article 8.⁸⁴ Secondly, different set of rules and laws apply depending on the type of financial intermediary (bank or broker).

In the case of insolvency of a non-bank intermediary, generally the Securities Investor Protection Act of 1970⁸⁵ applies providing that a non-bank intermediary is a subject to the registration requirement of the Security Exchange Act (an interstate broker). SIPA

⁷⁸ See Charles W. Mooney, Jr., Law and Systems for Intermediated Securities and Relationship of Private Property Law to Securities Clearance and Settlement: United States, Japan, and the UNIDROIT Draft Convention in IMES Discussion Paper Series, 15 (Institute for Monetary and Economic Studies, Bank of Japan 2008). Available at <<http://www.imes.boj.or.jp>>/lastly visited 15th March 2011 [hereinafter Mooney].

⁷⁹ See UCC § 8-504(a).

⁸⁰ See UCC § 8-505(a).

⁸¹ See UCC § 8-506.

⁸² See UCC § 8-507(a).

⁸³ See UCC § 8-508. The UCC Article 8 expresses all these duties in a very general form without specifying any standards to permit a degree of flexibility. For in-depth description See ROCKS *supra* note 17, at 50-57.

⁸⁴ See HAENTJENS, *supra* note 12, at 199.

⁸⁵ The Securities Investor Protection Act specifically protects eligible non-institutional account holders of insolvent registered broker-dealers against losses up to \$ 500,000 (see 15 U.S.C. § 78fff-3(a)).

specifies the distribution rules for securities account holders. On the other hand, in the case of insolvency of a bank intermediary, there are no special distributional rules applicable to securities account holders and only applicable property law would apply to the claims of entitlement holders.⁸⁶

2.2.5. Transfer of Securities in the US

While the vast majority of security trade occurs in the indirect holding system, the UCC Article 8 attempts to control systemic risk in securities markets by facilitating the finality of settlement through the rules protecting purchaser.⁸⁷ Prior to the enactment of the Uniform Commercial Code, securities transfers were governed by the Uniform Stock Transfer Act. Both of these statutes have been built on the principle of negotiability, i.e. a protection of transferees against competing third party claims. Thus, before describing the transfer of securities, the principle of negotiability will be introduced.

As it was described in the German part of this chapter, the general principle of the Roman as well as the Anglo-American property law is that a purchaser can only acquire the rights which his seller has to transfer (*nemo dat quod non habet*). Contrary to this principle Article 8 as well as the Article 9 aims to protect innocent purchasers of securities against the adverse claims of third parties that might have been involuntarily dispossessed of their assets.⁸⁸ The UCC Article 8 codifies this principle and protects a *bona fide* purchaser in case of direct as well as indirect transfer.⁸⁹ Hence the same principle applies in the US as in the Germany.

⁸⁶ See Mooney, *supra* note 78, at 16.

⁸⁷ See Russell A Hakes, *UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day?* 35 LOY. L.A. L. REV. 661, 710 (2002).

⁸⁸ See HAENTJENS, *supra* note 12, at 211.

⁸⁹ UCC §§8-502(a) and (b) and §§8-510 (a) and (b) respectively and §8-503(e). More on the protection of *bona fide* purchaser and the immunity from liability to an entitlement holder see Mooney, *supra* note 78, at 19.

The effectiveness of the transfer differs depending on the types of securities. Transfer of directly held bearer securities is effective in the moment a transferee obtains a possession of the certificate.⁹⁰ In case of directly held registered securities a transfer is effective after the registration of the transferee's name in the issuer's books, or the endorsement of the certificate in the transferee's name and the transferee's possession of that certificate. Transfers of directly held, uncertificated securities can only have proprietary effect through the registration of the transfer in the issuer's book.⁹¹

In the case of indirectly held securities, a transfer has proprietary effect, i.e. it can be asserted against third parties, when the transferee acquires a security entitlement, resulting in a credit-entry in his securities account.⁹² Hence, a securities transfer is effective when the securities entitlement of the transferor has been extinguished, and the transferee has acquired a corresponding entitlement through a credit-entry in his securities account.⁹³ Consequently, transfers can only be initiated by an entitlement order from the entitlement holder to his account provider.⁹⁴

2.3. *Germany or the US – Which is better?*

In this chapter, two different legal systems of intermediated securities, Germany and the US, were described and briefly analyzed. Giving the limitation of scope of this thesis the analysis was basic and did not cover all the relevant issues. Nevertheless, several conclusions can be drawn.

In Germany, the securities are classified as tangibles and so does the legal doctrine govern the trade with them. In the case of registered securities which are deposited by the

⁹⁰ See UCC § 8-301(a).

⁹¹ See UCC § 8-301(b).

⁹² See UCC § 8-301 official cmt. 1 and UCC § 8-501(b).

⁹³ See UCC § 8-501 official cmt. 5. See also Rocks, *supra* note 17, at 35-36.

⁹⁴ See UCC § 8-501 official cmt. 8.

CDS and maintained through intermediary or chain of intermediaries, there are two relationships. One between the investor and the central depository, where they are both considered to be co-owners and co-possessioners of the securities and one between the investor and the intermediary where no co-ownership arises.⁹⁵ Even in the case that the intermediary keeps the securities on one account and pools them together and the form of ownership is modified, it does not change the identity of the owners, who are and remain the investors themselves.⁹⁶ This direct ownership of securities is viewed as well as the justification for the protection of investors and their investments in the case of intermediary's insolvency: securities held on behalf of the customers cannot be reached by intermediary's creditors while he has never been their owner.⁹⁷

In comparison to the German "direct ownership" system, the United States legal concept of intermediated securities takes precisely the opposite approach. In the United States, in the moment the investor signs a contract with an intermediary to hold securities for them or/and provide additional services, the investor transfers the legal title to the intermediary and thus terminates any direct relationship with the issuer. What the investor holds from then on is the securities entitlement which "entitles" him to pro rata property interest in the financial assets held by the intermediary. In the case there is a chain of intermediaries and every intermediary holds some property interest in the financial assets of the other intermediary for the benefit of its own customers-investors, the investor has to require its own intermediary to extinguish his property interest.⁹⁸

Concerning the transfer of securities in both systems, the procedure is similar and the transfer is generally effective in the moment of either obtaining the possession of the

⁹⁵ See Micheler, *supra* note 47, at 221

⁹⁶ See Luc Thévenoz, *Intermediated Securities, Legal Risk, and the International Harmonization of Commercial Law*, 13 Stan. J.L. BUS. & FIN. 384, 405 (2008).

⁹⁷ *Id.*

⁹⁸ See *id.* at 408.

security or in the moment of the valid book entry on the security account. It was not the ambition of this thesis to analyze in detail the registration and clearance systems. More importantly analyzing the transfer of securities, both systems are providing protection for the *bona fide* purchaser as well as a special insolvency protection.

It has been shown that however different the legal concepts are, both systems provide sufficient protection and legal certainty in the case of domestic transaction, since they specify the legal title of securities, protect the investors and regulate the duties of intermediaries. Nevertheless, the question in today globalized world is, what will happen if these two fundamentally different systems encounter. Hague Convention wanted to specify which law will apply but in the case of a chain of intermediaries and different types and origins of contracts it might be difficult to specify the applicable law. Therefore, as far as countries continue to keep their legal tradition and concepts it might be helpful to adopt an instrument which would be binding as to the result but would leave the choice of methods for the national regulators. The UNIDROIT Convention is such an instrument.

3. UNIDROIT CONVENTION

In 2002, UNIDROIT⁹⁹ started a project which represented an international effort to harmonize substantive law regarding securities held with an intermediary. UNIDROIT undertook this project in order to form an internationally recognized instrument for improving the legal framework for securities holding system, collateral transactions and the rights of account holders. The adoption of the Convention took seven years of negotiation, four negotiation sessions of national experts and two diplomatic sessions. This chapter is devoted to describe this international instrument and outline the purpose, the key features and the structure of the UNIDROIT Convention.

3.1. *Purpose of the UNIDROIT Convention*

The UNIDROIT Convention on Substantive Rules for Intermediated Securities¹⁰⁰ intends to enhance the internal stability of national financial markets and their cross-border compatibility and, as such, promote capital formation.¹⁰¹

Due to the fact, that in last decades the practice of holding and disposition of investment securities changed significantly and not all of the countries revised their applicable legal framework the situation on capital markets enhances legal uncertainty and cross-border incompatibility. Several international institutions and initiatives have addressed this problem and call for a solution.¹⁰² They identified the need for a reliable and functioning

⁹⁹ The International Institute for the Unification of Private Law (UNIDROIT) is an independent intergovernmental organization which was established in 1926 as an auxiliary organ of the League of Nations. Today UNIDROIT has 63 member states from all five continents which represent a variety of different legal, economic and political systems as well as different cultural backgrounds. See <<http://www.unidroit.org>>/lastly visited 17th March 2011.

¹⁰⁰ UNIDROIT Convention on Substantive Rules for Intermediated Securities, Geneva, 9th October 2009 [Hereinafter UNIDROIT Convention or Convention]. Background to the UNIDROIT Convention *available at* <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/overview.htm>/lastly visited 17th March 2011.

¹⁰¹ See José Angelo Estrella Faria, *The Unidroit Convention on Substantive Rules Regarding Intermediated Securities: an Introduction*, 2010 UNIF. L. REV 196, 196.

¹⁰² There are several reports which define the problems and make recommendation for the system, e.g. International Organization of Securities Commissions (IOSCO) together with the Bank for International

legal framework adapted to the modern system of holding securities through financial intermediaries, especially in cross-border situation which is crucial to all participants in the modern capital markets.¹⁰³

However, there are already several international or regional legal instruments they are not sufficiently exhaustive. The Hague Convention provides now legal certainty as to the conflict-of-laws issues but there are accepted weaknesses deriving from the limitation of its scope.¹⁰⁴ EU harmonization effort provide just regional solution and therefore their effectiveness is limited. Hence, there are still numerous legal issues which remained untouched and the UNIDROIT Convention is designed to provide a general legal framework for substantive rules governing the indirect holding system and so complement the Hague Convention and EU harmonization efforts.¹⁰⁵

3.2. *Key Features of the UNIDROIT Convention*

When drafting a convention it is important to define its scope and desired goals, the UNIDROIT Study Group specified several policy goals of UNIDROIT Convention which were aimed to be achieved.

The first policy goal of the UNIDROIT Convention was the internal soundness and compatibility of systems, which means that each system should be given a sound legal framework for the holding and transfer of securities through financial intermediaries, taking into account in particular objectives of investor protection and efficiency.¹⁰⁶ Investors should

Settlements (BIS) published *Recommendations for Securities Settlement Systems*, November 2001; The Group of Thirty, *Global Clearing and Settlement – A Plan of Action* (2003).

¹⁰³ See Faria, *supra* note 101, at 198-202

¹⁰⁴ See Herbert Kronke, The Draft Unidroit Convention in Intermediated Securities: Transactional Certainty and Market Stability in 5 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW, 627-28 (International Monetary Fund, 2008). The author in his paper defines some of the weaknesses of the Hague Convention mainly the determination of applicable insolvency law (*lex concursus*) in a case where the relevant intermediary is a financial institution which operates globally.

¹⁰⁵ See *id.* at 629.

¹⁰⁶ See Explanatory notes, *supra* note 42, at 68.

be confident, for example, that their interests are enforceable and the system of transfer is subject to simple and efficient rules and procedures.¹⁰⁷

At the same time the internal soundness in today's globalized and interconnected financial world is not sufficient. It is necessary to ensure the ability of different legal systems to connect successfully in cross-border situations. Since both the internal soundness and compatibility of systems were aimed, the UNIDROIT Convention does not distinguish between domestic and cross-border transactions.¹⁰⁸

The second proclaimed policy goal was a neutral and functional approach of the Convention. Since the UNIDROIT Convention aims to be applicable all over the world and thus cope with several different legal traditions and conceptual frameworks of the different systems of laws it adopts a functional approach – using neutral language and leaving the technical and legal implementation to the participating states.¹⁰⁹ The functional approach was adopted while the creating of harmonized rules for the intermediated securities could not possibly include the choice between the two holding systems. This approach responds to the need for sound uniform rules compatible with and capable of implementation in all jurisdictions independent from the legal characterization of an investor's rights in securities held with an intermediary.¹¹⁰

Thirdly, the minimalist approach of the UNIDROIT Convention means, that it offers harmonized rules only where clearly required for the purpose of reducing legal or systemic

¹⁰⁷ See Faria, *supra* note 101, at 208.

¹⁰⁸ *Id.*

¹⁰⁹ See Explanatory notes, *supra* note 42, at 70.

¹¹⁰ See Thévenoz, *supra* note 96, at 414.

risk or promoting market efficiency.¹¹¹ The objective of this approach is to create as unintrusive an instrument as possible by employing fact-based rules.¹¹²

Finally, the key element of the UNIDROIT Convention is the recognition of the central position of book entry accounts in indirect holding and transfer systems so all parties to be aware that securities on accounts represent interests that are effective against its intermediary and third parties, even in the event of insolvency of the intermediary.¹¹³

3.3. *Structure of the UNIDROIT Convention*

The UNIDROIT Convention is divided into seven Chapters. Chapter I (Articles 1-8) is devoted to definitions, scope of application, principles of interpretation and other general provisions. Chapter II (Articles 9, 10) contains provisions on the rights of an account holder and on measure to enable the exercise of those rights. Chapter III (Articles 11-20) deals with methods of acquiring and disposing of intermediated securities by credit and debit to the account holder's securities account, including good-faith acquisition by an innocent person (Article 18). Afterwards, the Chapter III deals with the priority among competing interests (Article 19). Chapter IV (Articles 21-30) lays down rules on insolvency of relevant intermediary, prohibition of upper-tier attachment, on the instructions to the intermediary by the account holder and other essential issues that arise in intermediary systems. Chapter V (Articles 31- 38) provides a special set of rules with respect to collateral transaction. Chapter VI (Article 39) deals with the priority of security interests before and after the entry into the force of the UNIDROIT Convention. Finally Chapter VII contains the final provisions.

¹¹¹ See Faria, *supra* note 101, at 210.

¹¹² See Kronke, *supra* note 104, at 630.

¹¹³ These aspects are addressed in several articles of the Convention: Articles 1(d), 2(2)a, 5, 11,14 and 15.

4. CURRENT SITUATION IN SLOVAKIA AND THE APPLICABILITY OF UNIDROIT CONVENTION

Since the establishment of the Slovak Republic in January 1993, Slovakia has undergone a transition from a centrally planned economy to a free market economy. In 2007 Slovakia reached the highest economic growth among the members of OECD and the EU. Today, despite the world economic crisis it is still considered to be developed and competitive market. Nevertheless, nothing is perfect and there are certain deficiencies in the framework of Slovakian securities market which need to be identified and removed, so the capital market could serve properly to the issuers as well as the investors.

This part of the thesis will present the Slovakian securities law. Firstly, the history of the Slovakian capital market and current securities law and situation concerning the law of intermediated securities will be described and analyzed. Furthermore, the Slovakian securities law system will be compared to the German and US systems to see which system is closer and which provides better protection of investors. Afterwards without any pretense at exhaustiveness, it will go on and discuss the applicability of the UNIDROIT Convention in Slovakia and the challenges for the European Union.

4.1. *Slovakian Securities Law*

First of all, it is necessary to realize that the capital market in Slovakia was created in a different way than in the other parts of the world. It did not arise from the demand of capital of investors and issuers, but as a byproduct of the coupon privatization of 1990.¹¹⁴ Hence, the capital market in Slovakia started to form since 1990 with the onset of the stock

¹¹⁴ The voucher privatization began in the time when Slovakia was still a part of Czechoslovakia. In Slovakia, 2,579,327 people registered in the coupon privatization. The shares were exchanged for the investment coupons, which were received within electronic auctions. State published a list of companies and size of their assets and divided them into shares. In this way 504 companies in a nominal value of almost 80 billion Slovakian crowns (around 3 billion Euros /trillion in US) were sold.

companies. Slovakian government tried to build a similar system to the advanced market economies, especially establish the preconditions for the implementation of basic capital market functions (ownership restructuring and efficient allocation of free investment resources).¹¹⁵

Securities trade became in the nineties the domain of three entities: Bratislava Stock Exchange (*Burza cenných papierov v Bratislave*), Bratislava Option Exchange – until 1996 (*Bratislavská opčná burza*) and Slovakian Stock Exchange – until 2003 (*Slovenská burza cenných papierov*). At this time the trading with securities was uncertain, dangerous and fraudulent.

After the adoption of Securities Act in 2001, the system of issuance and registration of book-entered (dematerialized) securities has been modified. Securities Act gives powers to register the issuance of book-entered securities (shares, bonds, etc.) to the Central Depositary of Securities of the Slovak Republic (*Centrálny Depozitár Cenných Papierov*).¹¹⁶ The CDCP is a private joint stock company licensed by the National Bank of Slovakia, responsible for the issuance of book-entered securities, for the clearing and settlement of transactions and for the administration of securities accounts.

4.1.1. Statutes Regulating Intermediated Securities in Slovakia

To understand the functioning of the Slovakian security market, it is necessary to specify the structure of the core legal framework. Although, the thesis will not assess them in a great detail, they are essential for understanding the whole concept of intermediated securities and functioning of the securities market.

¹¹⁵ See Radoslav Bajus, *Vývoj kapitálového trhu v SR [Development of Capital Market in Slovakia]*, 16 Biatec 15, 15 (2008).

¹¹⁶ Available at < <http://www.cdcp.sk/english/> >/lastly visited 19th March 2011.

- Banking Act (Act No. 428/2001 Coll. on Banks and on changes and the amendment of certain acts, as amended) governs some relations associated with the establishment, organization, management business operations and termination of banks in the territory of the Slovak Republic.¹¹⁷
- Securities Act (Act No. 566/2001 Coll. on Securities and Investment Services and amending and supplementing certain other acts, as amended) regulates securities, investment services, some contractual relations involving securities, some relations associated with activities of persons providing investment services, the business of the central depository of securities and capital market supervision.¹¹⁸
- Stock Exchange Act (Act No. 429/2002 Coll. on the stock exchange, as amended) regulates the admission of securities to trading on a regulated market and the obligations of issuers of securities, regarding information obligations.¹¹⁹
- Financial Intermediation Act (Act No. 186/2009 Coll. on Financial Intermediation and Financial Counseling and on amendments and supplements to certain laws) amends financial intermediation and financial counseling.¹²⁰
- Collective Investment Act (Act No. 594/2003 Coll. on collective investment, as amended) governs e.g. collective investment, activities of management companies, establishment and management of mutual funds or activities of depositories.¹²¹

¹¹⁷ Available in English version <http://www.nbs.sk/_img/Documents/_Legislativa/_BasicActs/A483_2001.pdf>/lastly visited 19th March 2011.

¹¹⁸ Available in English version <http://www.nbs.sk/_img/Documents/_Legislativa/_BasicActs/A566-2001.pdf>/lastly visited 19th March 2011.

¹¹⁹ Available in English version <http://www.nbs.sk/_img/Documents/_Legislativa/_BasicActs/A429-2002.pdf>/lastly visited 19th March 2011.

¹²⁰ Available in English version <http://www.nbs.sk/_img/Documents/_Legislativa/_BasicActs/A1862009.pdf>/lastly visited 19th March 2011.

¹²¹ Available in English version <http://www.nbs.sk/_img/Documents/_Legislativa/_BasicActs/A594-2003.pdf>/lastly visited 19th March 2011.

- Commercial Code (Act No. 513/1993 Coll. the Commercial Code, as amended) regulates the contractual relations between financial intermediaries and investors.

Since 1st January 2006, the entire financial market supervision covering banking, capital market, insurance and pension is performed by the National Bank of Slovakia (NBS).¹²²

4.2. *Holding System in Slovakia*

Since 1993 Slovakia has undergone three stages of the indirect holding system development. In the first stage, from 1993 until 2001 only one-tier system was accessible. The ownership of book-entry securities had been registered in Centre of Securities Depository of Slovak Republic, Bratislava which opened for investors a holder's account. The ownership to the securities was connected to the ownership of the account. In the case, a financial intermediary was the owner of the account and at the same time provided intermediary services for an investor, this investor would not hold a title to the securities, only a right to claim.¹²³

From 2002 until 30th April 2006 the second stage took place. During this period, the registry system in Slovakia decentralized and some types of securities were registered by the National Bank of Slovakia, other by custodians and some by the CDCP. This decentralization led to legal uncertainty and confusion within the registry system. In the final stage which has begun on 1st May 2006 and still continues, the multiple-tier system of intermediaries was introduced.

¹²² Before 1st January 2006 the supervision was performed by several institutions (e.g. the Financial Market Authority, specific supervisory division of Ministry of Finance of Slovak Republic) which were dissolved by law (Act No. 747/2004 Coll. on financial market supervision and amending and supplementing certain other acts, as amended) and the whole supervision was integrated. The objective of this action was to contribute to the stability to the financial market as a whole, as well as to secure and sound operation of the financial market in the interest of maintaining credibility of the market, protecting investors and consumers, and respecting the competition rules.

¹²³ See Peter Baláž, *Sprostredkované vlastníenie cenných papierov na Slovensku a v zahraničí* [Intermediated Ownership of Securities in Slovakia and Abroad], 15 Biatec 17, 19 (2007).

Slovakian holding system could be described as a direct holding system with some discrepancies which are to be described later. It is the CDCP which is responsible for registration of issues of book-entry securities as well as all types of immobilized securities and administration of securities accounts.

Firstly, upon the registration of first issue, the CDCP opens for an issuer an issuer's register that contains information on the issuer and on individual securities. Afterwards, an issue is registered in the issuer's register upon the issuance of book-entry securities. On the other hand, concerning the purchaser, the CDCP uses two types of securities accounts in the system of securities registration. They are the owner's account (one-tier system) and the client account of a member (multiple-tier system).¹²⁴ The member – investment intermediary is a legal entity admitted by the Central Depository to provide investment services, investment activities and ancillary services defined in the Article 6 of the Securities Act.

The members of the CDCP – investment intermediaries may open two types of accounts, one for themselves and one for their clients – the investors. Directly in its registration, the central depository opens an owner's account for a member (its own account) where information is kept on the securities owned by the member itself.¹²⁵ In the member's client account, the CDCP registers data on securities which owners are registered by the member – investors. The member itself does not own the securities kept in its client account; the owners of such securities are the clients and are recorded in the member's registration, which is held separately by the CDCP.¹²⁶

In the situation that the intermediary chain would comprise of several financial intermediaries, the Securities Act compels the intermediary to keep the investor's securities

¹²⁴ Concerning the one-tier system, the owner's account contains primarily data on the owner - investor and on securities kept in this account. The account owner is at the same time the owner of securities registered in this account.

¹²⁵ See Article 105 of Securities Act.

¹²⁶ See Article 105a and 106 of Securities Act.

separately. Moreover, for the purposes of safeguarding clients' rights in relation to financial instruments and funds belonging to them, the intermediary shall keep records and accounts in a way that enable in any time and without delay to distinguish assets held for one client from assets held for any other client, and from their own assets.¹²⁷

4.2.1. The Relationship Between Financial Intermediary and Investor

The contractual relationship between the financial intermediary and investor is governed by the Commercial Code and the Securities Act.¹²⁸ The Part Two of the Securities Act, titled "Contracts of Securities" defines and regulates different types of contracts, their character and rights and duties of the contractual parties.¹²⁹ All the investors should be aware of the type of contract they sign while their legal title to securities may differ.

Furthermore, the Securities Act distinguishes between two main types of investment intermediaries: Stock Brokerage Firm and Investment Broker and lays down different license requirements and different registry duties for them. In addition, the Securities Act regulates the foreign securities dealers whereas it treats more favorably those having registered office in a Member State of the EU.

Generally, Slovakian legislators sought to create a direct holding system where the investor would have a direct relationship with the issuer and would be the only owner of securities. However, in the case of a further safekeeping of securities of one investor together with other fungible securities of other investors on an omnibus account (bulk safekeeping/pooling)¹³⁰ the fungible securities are the joint property of the investors and the

¹²⁷ See Article 71h of Securities Act.

¹²⁸ See Article 30 of Securities Act.

¹²⁹ See e.g. Commission agent contract (Articles 31-35), Mandate contract (Article 36), Contract on the loan of a security (Article 38), Contract of safekeeping of paper securities (Articles 39,40), Contract on administration of securities (Article 41), Contract on portfolio management (Article 43) etc.

¹³⁰ If an intermediary holds securities of the same issue for all of its account holders in a single fungible "omnibus account" the securities are "pooled"(mixed) without any attribution of specific securities to identified account holders.

share of any investor in this joint property is determined by the ratio of the sum of nominal values of the fungible securities.¹³¹ Nevertheless, the safekeeper is obliged to keep records of securities and take due professional care to protect the security against loss, destruction, damage or depreciation.¹³² Hence, the question arises whether the ownership is joint or individual. In the case of individual ownership, there is a risk of missing securities and in the case of joint ownership there is a risk of possible competition between investors (or intermediaries) at various levels.¹³³

Concerning the applicable law, in most cases it is the Slovakian law which is applicable. However, in the case that the CDCP opened an account for a member being a foreign bank or foreign securities dealer (foreign member), the applicable law for this account shall be that under which the foreign member was founded. The applicable law for keeping data on the owner of the security shall be that of the Slovak Republic.¹³⁴

The Securities Act as such does not specify any special procedures in the case of the intermediary's insolvency, so the general insolvency regulation applies and the investor is sufficiently protected by *rei vindication* claim while he is the only owner of the security. From the perspective of a material protection of investors, the Securities Act lays down specific provision on creation and Investment Guarantee Fund. All financial intermediaries (members) are obliged to contribute, although foreign members do not have to participate provided their home legislation offers at least the same level of investor protection and the reciprocity is guaranteed.¹³⁵ The Investment Guarantee Fund provides compensation for investments only up to 90%, and only to certain investors.¹³⁶

¹³¹ See Article 39 (3) of Securities Act.

¹³² See Article 39 (4) and (5) of Securities Act.

¹³³ See Baláž, *supra* note 123, at 22.

¹³⁴ See Article 99 (4) of Securities Act.

¹³⁵ See Article 83 (3) of Securities Act.

¹³⁶ See Article 87 (2) and 81 (1,5) of Securities Act.

4.2.2. Transfer of Securities

Based on the Articles 18 and 19, the Securities Act distinguishes between transmission of securities and transfer of securities. A transmission of a security means a change of its owner based on a valid inheritance decision, a valid decision by another state authority, a company sale agreement or based on legal facts defined by law, specified in Commercial Code.¹³⁷ A transfer of a security means a change in the owner of the security based on an agreement defined by the Security Act (in the second part of the Act).

General presumption is that the transfer of a paper security is valid in the moment of the delivery, unless otherwise provided by the Security Act, a separate law or a contract.¹³⁸ In the case, where an intermediary procures the purchase or sale of a book-entry security, it shall, without undue delay, submit a transfer registration order to the CDCP, otherwise the intermediary is liable.¹³⁹ Thus, in the case of a book-entry security the investor becomes the owner in the moment of the recording by the intermediary.

Slovakian Securities Act specifically protects a bona fide purchaser in the event he acquires the security even in the case a transferor did not have the right to transfer the security, except if the transferee knew or ought to have known at the time of transfer that the transferor did not have the right to transfer the security.¹⁴⁰

4.3. *Germany v. US – which is closer?*

As already described, Germany and the US represent two types of holding system. The UCC Article 8 represents the indirect holding system where the investor holding securities through an intermediary transfers legal title to that intermediary and loses a direct

¹³⁷ See Article 18 (1) and (3) of the Securities Act.

¹³⁸ See Article 20 of the Securities Act.

¹³⁹ See Article 24 of the Securities Act.

¹⁴⁰ See Article 19 (3) of the Securities Act.

relationship with the issuer.¹⁴¹ On the contrary, Germany relies on the notion that the deposit of securities with a financial intermediary does not disrupt the investor's direct legal title to the securities nor his rights or claims against the issuer despite the number of tiers of intermediaries or the pooling of securities. Number of civil law jurisdiction considers that investors maintain a direct relationship with securities issuer even though they depend on intermediaries to exercise their rights, Slovakia being one of them.¹⁴²

When considering different models of holding systems, Slovakia would be considered as a "direct ownership" jurisdiction and would represent so-called "transparent system", where the central securities depository – the CDCP maintains individual sub-account for every individual investor, while the financial intermediaries provide mostly the management services and act solely on behalf of the investor. However, as it has been shown, first of all it depends on the type of a contractual relationship between the intermediary and the investor and second of all the number of intermediaries in the chain may cause some defects which leads to legal risks and uncertainty considering the legal title and the protection in the case of intermediary's insolvency.

4.4. *UNIDROIT Convention –Solution for Slovakia?*

In the continental legal systems, the nature of the legal title plays a key role. The investment in securities may have the nature of an individual ownership, a joint ownership or a right to claim. Despite the fact that the current Slovakian securities law contains several elements that are likely to boost its effectiveness it does not respond to the full range of problems associated with the legal nature of the rights of investors as outlined above. Since the regulation on intermediated securities is technically complex area it is not appropriate to

¹⁴¹ See Thévenoz, *supra* note 96, at 407.

¹⁴² See Thévenoz, *supra* note 96, at 406.

wait for a case law to patch the holes, rather it would be more appropriate to undertake further legislative initiatives – UNIDROIT Convention being one of them.

First of all, the UNIDROIT Convention is not trying to achieve the international unification of the law governing securities through an intermediary. Its aim is to promote a degree of international harmonization which would be compatible for both holding systems and would reduce the overall legal risk and would simplify and clarify the cross-border trading. This part of thesis aims to define the sphere of application of the UNIDROIT Convention and comment on the compatibility of with Slovakian Securities law.

4.4.1. Sphere of Application of the UNIDROIT Convention

Article 2 of the Convention determines that the Convention is intended to be part of the substantive law of a Contracting State.¹⁴³ Therefore, the Convention will be applied in respect of the matters dealt with in the Convention to the extent that the substantive law of the Contracting State is the applicable law for such matters.¹⁴⁴ The Convention deals primarily with four issues.

Firstly, the Convention considers the rights of the account holder¹⁴⁵ in respect of intermediated securities and their effect as regards to third parties, and the means for acquiring, transferring and pledging rights in intermediated securities.¹⁴⁶ Convention does not attempt to characterize the legal nature of the rights and interests arising from the credit of securities to securities accounts, it simply treats intermediated securities as a set of rights

¹⁴³ Within this thesis the phrase “Member State” and “Contracting State” are used interchangeably, except when referring to the member states of the European Union.

¹⁴⁴ See UNIDROIT Convention, art. 2.

¹⁴⁵ It has to be pointed out that the Convention focuses on account holder, not on investors to avoid any unnecessary interference with company law and law of financial markets in Draft Official Commentary on the draft Convention on Substantive Rules regarding Intermediated Securities, Article 9, UNIDROIT 2009 p.39.

¹⁴⁶ See UNIDROIT Convention, articles 9 – 13.

accruing to account holders.¹⁴⁷ Therefore, the Convention is applicable both to the direct as well as the indirect holding system. The Convention defines basic rights of the account holder (as the right to receive and exercise any rights attached to the securities, e.g. dividends) and leaves the space for the non-Convention law (the law of Contracting State). Concerning the transfer of intermediated securities, the Convention provides four internationally recognised methods, one mandatory and the other three optional, without precluding additional methods under non-Conventional law.¹⁴⁸

Secondly, it determines the priority between competing interests in the same intermediated securities, provided that the interests in securities became effective against third parties.¹⁴⁹ The Convention applies the basic, traditional first-in-time priority rule. Such competing interests rank according to the time when they have been made effective against third parties.¹⁵⁰ Furthermore, the Article 20 of the Convention lays down priority rules in the case of insolvency of the intermediary.

Thirdly, the Convention specifies the duties of securities intermediaries vis-à-vis the account holders and other intermediaries. Article 10 of the Convention provides for the most basic obligation that an intermediary owes to its account holders.¹⁵¹ The intermediary must take appropriate measures so that the account holders enjoy their rights provided in Article 9(1) of the Convention. The obligations are not absolute and must be interpreted and applied by taking into account the provisions of Article 28 which define the obligations and possible liability of intermediaries.

¹⁴⁷ See *Draft Official Commentary on the draft Convention on Substantive Rules regarding Intermediated Securities* 39, Article 9, UNIDROIT (2009).

¹⁴⁸ See *id.*, at 47, regarding chapter III of the UNIDROIT Convention.

¹⁴⁹ See UNIDROIT Convention, article 19.

¹⁵⁰ See Draft, *supra* note 147, at 88 regarding article 19 of the UNIDROIT Convention.

¹⁵¹ See UNIDROIT Convention, articles 10.

The final interest of the UNIDROIT Convention is to ensure the integrity of the intermediated holding systems. Such protection is provided by prohibition of upper-tier attachment, holding or availability of sufficient securities, allocation of securities to account holder' rights, loss sharing in case of insolvency of the intermediary or obligations and liability of intermediaries.¹⁵²

In conclusion, the UNIDROIT Convention gives a good example of the most fundamental rules necessary for the proper functioning of securities held with an intermediary. It addresses all important issues giving the discretion to the Contracting States to decide upon the method while implementing the objectives. This approach responds to the need for discrete uniform rules compatible with and capable of implementation in all types of jurisdictions including Slovakia.

¹⁵² José Angelo Estrella Faria, *Sphere of Application of the UNIDROIT Convention on Substantive Rules for Intermediated Securities and Future Work by UNIDROIT on a Legislative Guide for Emerging Financial Markets* 2010 UNIF. L. REV. 357, 358.

CONCLUSION

When analyzing the current legal diversity of intermediated securities, in particular the holding systems and transfer laws, it is clear that despite the number of differences and discrepancies, the market itself pushes the legislators more or less the same direction. Comparison of the holding systems of Germany and the US in chapter 2 showed that the law concepts and legal doctrines fundamentally distinguish. However, their aim is generally the same as they attempt to create an investment-friendly environment by sufficiently protecting the investor and diminishing the legal risks in domestic as well as in international situations.

Each legal system has over time created its own framework on holding systems of securities. Some of them continue and modernize their systems and try to promptly follow the developments of securities market. It is generally believed that the UCC Article 8 is flexible and applicable to various situations and therefore the best solution. The present work has shown that both, Germany as well as the US address the same issues but in different ways. Nevertheless, it is for further research to examine both jurisdictions in different situations in order to objectively state which one is more accurate and efficient.

Concerning the harmonization efforts the Hague Convention addresses conflicts of laws by substantially promoting the choice of the applicable law by the account holder-investor and the relevant intermediary in their contract. The Hague Convention departs from the traditional and widely supported *lex rei sitae* in favor of unlimited freedom of contract, thus following the US conflicts of laws approach and creating several discrepancies with the EU private international law.¹⁵³ Despite the conflicts of laws rules, the necessity of harmonization the substantive law remains while several material issues have to be brought together in order to promote the soundness of national laws and reduce the legal risk resulting

¹⁵³ See HAENTJENS, *supra* note 12, at 314.

from their incompatibility. With respect to the EU securities law, as it was outlined by this thesis, the EU has undertaken several harmonization efforts and aims to harmonize the whole financial market. However, the question is whether the EU intends to create a unified securities market or rather lay down regulation on interoperability of the member states systems with regard to the protection of investors which would rather lead to competition than cooperation thus advancing the economy. Following the general principles of EU law, especially subsidiarity and proportionality, the restrictive and functional approach should be chosen and therefore the minimum harmonization should be concluded.

The UNIDROIT Convention aims to improve the legal certainty in cross-border security trading by focusing on the functional equivalence rather than the harmonization of legal concepts. The UNIDROIT Convention (as it was pointed out) is not exhaustive and its aim is not to redefine or rewrite the securities laws of the contracting states but rather reveal the weak issues of the securities trading and offer the contracting states solution. In the Convention itself, there are number of articles in which the reference to the “non-Convention law” is made which proves the supplementary character of this Convention.

In conclusion, since the Slovakian securities law is still evolving, mostly in the way of EU harmonization, there is a need to specify its future direction. The legal framework for securities transactions has to be flexible enough to enable all market participants to trade and transfer capital market products according to the needs of issuers as well as investors. It is of a great importance to provide a system where investors would be protected against loss or impairment of their investments. The purpose of this thesis was to assess the Slovakian system on intermediated securities and reflect upon it through the UNIDROIT Convention, rather than address in any depth the numerous features of the UNIDROIT Convention. It has been shown that the current system in Slovakia is effective and it does address all necessary legal issues. Hence, the question why the securities market in Slovakia is not effectively used

remains unanswered and thus represents an open topic for a future research. Nevertheless, it has been shown that the Unidroit Convention due its functional approach is highly applicable to any system. Therefore, if Slovakia adopts it, it might improve the quality of the Slovakian securities law, particularly in cross-border situations.

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