

THE ENGLISH MODEL COMPARED WITH THE GERMAN MODEL

1. In this note, the English and the German rules that govern how certain types of securities are held and transferred are analysed. Securities are a type of transferable financial assets such as shares, bonds or other financial instruments (but not cash) that are issued to the public for investment purposes. The note will not analyse securities that have been issued for the purpose of private placements. It also does not address shares in private limited companies in England or membership interests in German companies with limited liability.¹
2. The purpose of the note is to determine if crossborder transactions and holdings between the two countries are subject to the same legal regime as domestic transactions and holdings within each of the two jurisdictions respectively.
3. The first part of the analysis will give a brief overview on domestic securities held in the respective national markets. This overview briefly introduces the reader to each of the two systems. It is also helpful to draw a comparison between domestic and crossborder holdings and transfers. The second part will analyse foreign securities.

PART I – BRIEF INTRODUCTION TO THE DOMESTIC MARKET

4. This first part of the analysis addresses paper-based transfers as well as transfers effected without the physical delivery of a paper certificate. It shows that English and German law have adopted different approaches to the law of securities in general and to indirect holdings of securities in particular. Notwithstanding these differences, there are also significant similarities between the two systems. Paper based transfers are analysed first.

Paper based transfers

5. Both in English and in German law paper certificates are, traditionally, used to transfer securities. The legal nature of securities and the role performed by the certificates are, however, different. English and German law will be briefly analysed in turn in the following paragraphs.
6. In England, securities are issued in the form of registered instruments. They are considered to be intangibles and are also referred to as 'choses in action'. A register in which the name and other particulars of the owners of securities are entered is kept by or on behalf of the issuer. Traditionally, issuers would also issue paper certificates. An English securities certificate, however, does not

¹ The English term 'membership interest' is used here to refer to the German term 'Geschäftsanteil'. The English term 'company with limited liability' refers to the German term 'Gesellschaft mit beschränkter Haftung'.

constitute a negotiable instrument. It is a document of evidence made out in the name of the owner. It evidences the entire holding of a particular class of securities of that owner.

7. When English registered securities are transferred, the transferee acquires ownership to the securities upon entry of his name on the securities register.
8. In Germany, securities are issued in the form of negotiable instruments. Traditionally, a separate certificate would be issued for every securities unit. The prevailing view is that the entitlement materialises in the certificate relating to it. Securities for which certificates have been issued are transferred according to the same rules as tangibles.
9. When German securities are transferred, the transferee acquires ownership to the securities upon delivery of the certificates to him.

Eliminating paper

10. In both England and Germany, the type of securities which this note focuses on are normally transferred without the need for physical delivery of paper certificates through a central account provider and through chains of account providers which are connected with the central account provider/depository. In practical terms, ownership to securities is transferred by book-entry in both systems. In both system, clients of account providers enjoy a proprietary interest in the securities held for them by the account provider. The method through which paper was eliminated from the transfer process, the legal analysis of the respective account providers and the method through which property rights are conferred on clients are, however, different in the two systems. In the following paragraphs English and German law will be discussed in turn.
11. **English Law:** England has undergone a process of dematerialisation. In 1996, it introduced paperless securities transfers. Securities that can be transferred without paper certificates are referred to as uncertificated securities. Uncertificated securities are transferred by means of electronic instructions sent through a settlement system operated by CRESTCo.
12. CRESTCo is the central English account provider. Its role is different from the function performed by English account providers further up the chain. CRESTCo does not hold UK securities on behalf of clients.² It does not mediate property rights. It only keeps the register for uncertificated securities. Investors whose names are entered on that register are considered to be the owners of the securities. They have a direct relationship with the issuer. The issuer therefore knows the names and other particulars of the owners.
13. Ownership to uncertificated securities is transferred upon entry of the transferee's name on the books of CRESTCo.

² This analysis only applies to UK securities. CRESTCo operates an international service in the context of which CRESTCo acts as a custodian of foreign securities.

14. Account providers other than CRESTCo are sometimes referred to as custodians. Custodians operate on a different legal basis than CRESTCo. They hold securities on trust for the benefit of their clients. This means that the account provider holds ownership of the securities and its name is entered on the securities register. The legal rights of the account provider are, however, limited by the beneficial ownership of its clients. As beneficiaries of a trust, clients hold what is termed ‘beneficial’ or ‘equitable’ ownership. Clients have a proprietary interest in the securities held by their immediate account provider and are able to enforce that interest in the account provider’s insolvency. They are also able to claim their securities from third parties to whom the securities may have been misappropriated by the account provider.
15. If securities are held in a chain of multiple account providers, an investor has a proprietary interest only in the securities or the interests in securities held by his immediate account provider. He cannot directly enforce proprietary rights against an account provider further up the chain.
16. In principle, the trust analysis also applies if securities are held by an account provider on an unallocated basis in an omnibus account. For a trust to arise, however, the subject matter to which the trust relates must be certain. English law has not yet developed a bright line rule as to how this requirement for certainty applies to assets kept on an unallocated basis. This means that the documentation setting up the arrangement between the account provider and the client needs to be carefully drafted for a property interest to arise if securities are kept by the account provider on an unallocated basis. England is in the process of clarifying the law in this respect to make it easier for parties to create property rights for securities kept in omnibus accounts.
17. **German law:** Germany did not generally abolish paper certificates through a process of dematerialisation. Most paper documents were put out of circulation by immobilisation. Almost all the securities which are the focus of this note are now stored in a central depository.³ The German legal term for this depository is ‘Wertpapiersammelbank’. In many cases, global certificates representing the whole issue have replaced certificates issued for every individual unit of the securities. Currently, Clearstream Banking AG is the only admitted central depository. Retail clients do not hold an account with Clearstream, but with an account provider which is directly or indirectly connected with Clearstream. An account provider other than a central depository is referred to in German as ‘Depotbank’ or, in terms of the Depotgesetz,⁴ as “Verwahrer”.
18. Unlike CRESTCo, Clearstream does not maintain an issuer register of members for all deposited securities. Unlike English custodians, Clearstream and other German account providers do not hold ownership of the securities. Clearstream stores the paper certificates relating to the securities on an unallocated basis. Clearstream and the account providers further up the chain are considered to be

³ No certificates are issued for German government bonds or ECB certificates. German government bonds may nevertheless be held through a central depository such as Clearstream if they are not held directly with the respective public debt office. If they are transferred within Clearstream, the position in German law is that such transfers are governed by the same legal rules as apply to other German domestic securities notwithstanding the fact that no certificates exist.

⁴ The Depotgesetz is a German statute on securities depositories.

bailees mediating joint possession of securities certificates to the ultimate owner (end investor). The clients on top of the chain (ultimate owners) are co-owners of the certificates kept with the central depository. They are therefore also co-owners of the rights represented by the certificates. The fact that investors are deemed to have co-ownership rights in the underlying certificates, protects them against in the insolvency of Clearstream or of other account providers.

19. Notwithstanding this, the central depository only keeps accounts of the entitlement of account providers immediately connected with it. These account providers in turn only keep accounts of the entitlement of account providers or clients immediately connected with them. The issuer does not normally know the identity of the account providers immediately connected with Clearstream, of any other account provider further up the chain, or of the ultimate owner of the securities.⁵
20. A transfer of ownership in securities is effected by means of a book entry. That book entry is, however, analysed as involving a change of the possession of the underlying certificates. The legal argument is that upon changing the book entry on the records of an account provider, the transferee acquires possession of the underlying physical certificate and thereby becomes a co-owner of the documents and the entitlement contained in them. This result was originally achieved by applying the German concepts of bailment and of co-ownership. It is backed up by the Depotgesetz, the already mentioned statute on securities depositories.
21. The position in German law that investors are presumed to be in possession of the certificates even if these certificates are held through a chain of multiple account providers contrast with the position in English law where the end investor has a proprietary interest in the entitlements held by his immediate account provider but does not have a direct interest in entitlements held by an account provider further up the chain.
22. The analysis presented above shows that both English and German law protect investors who hold and transfer domestic securities by giving them proprietary rights. English law achieves this through a trust law analysis. German law achieves this through its concepts of bailment and co-ownership respectively.
23. After this brief analysis of the respective domestic regimes, the regime for foreign securities in both English and German law will be examined in the second part of this note.

PART 2 – FOREIGN SECURITIES

24. This second part of the note addresses foreign securities of the type which the note focuses on under both the English and the German legal regimes. The analysis is presented in the form of case studies.

⁵ A relatively small number of issuers issue name securities. Unlike English registered securities, German name securities are negotiable instruments. If name securities are held within Clearstream, they are normally endorsed to the bearer and are, therefore, transferred according to the same rules as bearer securities. There also exists an issuer register of name securities, but an entry on that register does not cause the transferee to acquire title.

There are several ways in which a German investor can buy and hold English securities. There are also several ways in which an English investors can buy and hold German securities. The author of this note is aware that this is the case. For the purpose of focussing the discussion process, however, this note will, for the time being, only address two frequent scenarios.

25. The first case study concerns an English investor who holds securities issued by German plc through an English custodian but not in the form of CREST Depository Interests.
26. The second case study concerns a German investor who holds securities issued by an English plc through a German bank. It examines a method of holding securities in German law which is commonly referred to in German as 'Wertpapierrechnung'.
27. These two case studies are examined in turn below. The analysis of the two case studies shows that in English law the rights of an investor who holds foreign securities are identical to the rights of an investor who holds domestic securities. This is not the case in German law.
28. The respective foreign securities are held in both the first and the second case study in the form of a trust. In the first case study, the trust arrangement is governed by English law. In the second case study, the trust arrangement is governed by German law. The difference between English and German trusts is that under English law the investor has a proprietary interest in the securities, under German law the investor has a preferred contractual claim against the account provider. This does not affect the legal position in the insolvency of the respective account providers. In both cases, the investor has a right to claim the securities in the account holder's insolvency. If, however, the account provider misappropriates the securities, an English investors can trace them with a third party, a German investor cannot.
29. Both in English and German law, the investor is not protected against adverse claims by the rules governing priorities or good faith acquisition of title respectively.
30. In both English and German law, the investor acquires the interest upon credit of the securities to his account.
31. The first case study will be analysed in the next section.

English Investor holds German securities through English Custodian but not in the form of CREST DEPOSITORY INTERESTS

32. In that case, English Custodian holds the foreign securities on trust for the benefit of English Investor. The same rules that apply to English domestic securities that are held indirectly also apply to foreign securities that are held indirectly.
33. It has already been mentioned that English Investor as the beneficiary of an English trust has a property right called 'equitable or beneficial ownership' in the securities held on trust. Like with English domestic securities this means that English Investor is protected against the insolvency of English Custodian.

34. Beneficial ownership usually arises upon appropriation of the securities to the trust. In most cases that will occur when the securities are credited to the account of English Investor. English Investor therefore acquires title to the securities upon credit of the securities to his account.
35. If the securities are misappropriated, English conflict of law rules determine the position of English Custodian. Assuming that neither the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 nor the Financial Collateral Arrangements (No.2) Regulations 2003 apply, English law will revert to the common law as stated in the rule in *Macmillan v Bishopsgate*.⁶ That case applies the *lex situs*. It does, however, not give an satisfactory answer on how the *situs* is determined.
36. It is possible that a judge would in the circumstances apply German law to determine whether or not there has been a change in ownership. If ownership has changed under German law, English Investor would loose his entitlement. A change of ownership occurs under German law if the securities are credited to a different account for value and if the transferee acts in good faith. If ownership has not changed under German law, English Investor would remain entitled.
37. If English law applies, the beneficial ownership will remain in-tact if the securities are misappropriated by English Custodian. The interest of English Investor will only cease to exist if a third party acquires legal title to the securities for value and in good faith. This would occur when English Custodian holds the securities as a co-owner with a German depository and transfers them for value to a third party which acts in good faith and becomes a co-owner of the securities. English Investor would, in principle, retain beneficial ownership if English Custodian misappropriates the securities to another investor which holds these securities also as a beneficial owner with English Custodian. Whether or not English Investor is able to enforce his proprietary interest, however, depends on the rules on tracing which are notoriously complex. Difficulties arise particularly if assets are transferred through mixed funds.
38. Adverse claims are governed by the rules on priorities, which are notoriously complex. If English Custodian held the securities on trust for another investor and transferred them to English Investor in breach of that trust, English Investor will not acquire beneficial ownership and might therefore not be able to claim protection against an adverse claim by the previous beneficial owner. The apparent beneficial ownership of English Investor also does not trump an earlier legal interest of a third party.
39. As regards the exercise of voting rights and rights under other types of corporate actions, the default rule is that English Custodian as a trustee is obliged to exercise rights according to the instructions of English Investor. A trustee under English law is also obliged to account for profits to English Investor.
40. This default rule can, however, be modified by an agreement between English Investor and English Custodian. Standard documentation obliges English Custodian to forward proxies for voting rights to clients to the extent this is reasonable practicable.

⁶ [1996] 1 WLR 387.

41. The second case study will be analysed in the next section.

German Investor buys and holds securities issued by English plc through German Bank but not in the form of German depository receipts or DTZs ('Wertpapierrechnung')

42. This second case study refers to a scenario where the securities are kept in England and German Bank acquires legal or beneficial title to them. Other than with German securities, German Bank is not a bailee of the English securities. It rather holds title to the securities in its own name and acts as a trustee for German Investor. This trust arrangement is referred to in German as 'Treuhand'. The arrangement is governed by German law. This means that German Investor is not does not hold an ownership right in the securities, but rather has a contractual claim against German Bank.⁷ Notwithstanding the fact that the claim is contractual, the securities which German Bank holds as a trustee are not available to the general creditors of German Bank in German Bank's insolvency or otherwise. This is why the rights against German Bank in this context are also referred to as 'rights akin to ownership'.⁸
43. The most important difference between a 'right akin to ownership' under a German trust arrangement and beneficial ownership under an English trust is that a German rightholder cannot, in the case of an unauthorised transfer, trace the securities into the assets of the recipient. This means that if German Bank transfers the securities without the authority of German Investor, the transferee will acquire title even if he did not acquire for value.
44. Like the English investor in the first case study, German Investor as the holder of a 'right akin to ownership' is not protected against adverse claims by the German rules governing good faith acquisition of title. The German rules on good faith acquisition only apply to ownership rights and do not apply to 'rights akin to ownership'. This is because the rules on good faith acquisition of title apply to proprietary rights [Sachenrechte] but do not apply to contractual rights [schuldrechtliche Ansprüche]. The means that German Investor is protected against adverse claims if he acquires domestic securities, but not if he acquires English securities under Wertpapierrechnung.
45. Like an English trust interest, the 'right akin to ownership' against German Bank arises when the securities are credited to account of German Investor with German Bank.
46. According to sec 16 of the German Standard Terms for Securities Transactions (Standard Terms),⁹ German Bank is obliged to pass on any information it receives from the issuer or a foreign account provider to German Investor provided that the information received has significant impact on the

⁷ This view is not only confirmed by academic authority, but also appears in client information put together by German banks. For example, on the website of Deutsche Bank the system of 'Wertpapierrechnung' is defined in English as a '*Special form of safekeeping for securities, whereby the buyer or depositor only has a claim, under the law of obligations, to the return of similar, but not identical, securities. [Wertpapierrechnung] is used with foreign securities, for example. The depositor receives from his domestic bank a credit note in security accounting for his securities which were acquired and are stored abroad.*' In the German original the phrase 'only a claim, under the law of obligations' reads in German as 'nur einen schuldrechtlichlen Anspruch' (website of Deutsche Bank [<http://www.db.com/lexikon/1925.html>] last visited 29 September 2005).

⁸ The German term is 'eigentumsähnliche Rechte'.

⁹ Available at <http://www.rws-verlag.de/zbbdat/DOKUMENT/wp_sond_bed.pdf> last visited 26 January 2006.

legal position of German Investor and provided the notification is necessary in the interest of German Investor. In particular, German Investor must be notified about purchase and conversion offers, and corporate rescues. German Bank does not have to notify German Investor if it has not received the information in time, or if the cost of measures available to German Investor significantly outweigh the benefits of these measures.

47. The case study shows that English Investor has an ownership interest in securities held through English Custodian irrespective of whether the securities are domestic or foreign.
48. In German law, German Investor holds ownership if he holds domestic securities. German Investor does not hold ownership rights if he holds foreign securities in “Wertpapierrechnung”.