

The UNIDROIT Project on Intermediated Securities: Direct and Indirect Holding Systems

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1. *The concepts of directly and indirectly held securities*

1. This paper tackles the contrast between the so-called direct and indirect systems of holding securities in the context of the UNIDROIT Project on a Convention on Intermediated Securities¹. It is true that the pertinence of both concepts have been questioned². The reality is very heterogeneous. In comparative terms, the supra-concept of “book entry securities” encompasses a wide range of legal options each of them with its own peculiarities. That makes it very difficult to divide all national systems in two big categories. For many lawmakers it would be very difficult to offer a simple answer to the question: On which side are you playing? Direct or Indirect holding?

2. Nevertheless, my intuition is that if we agree to a common understanding of those two categories, they can be helpful to analyze certain comparative-law problems. To reach that common understanding we have to start from a very simple assumption: in principle, *all book-entry securities systems are de facto intermediated, and in this sense de facto indirectly held*. There is always somebody between the issuer and the account holder that has control over the books or the registry. The difference, therefore, does not relate to the fact that the investor does or does not physically possess the securities, but to the way in which the legal system copes with the “intermediated securities challenge”, *i.e.* how to prevent the custody risk and to facilitate investors the exercise of corporate rights in the case of intermediated securities.

3. *Direct holding*. In very broad terms, one group of systems considers that the intermediation does not call for the creation of a new legal product: “*intermediaries only have the function of a book-keeper and have no interest at all in the underlying securities*”. This implies that *ex lege* investors maintain a direct legal relationship with the issuer. Investors are the direct owners of all the rights arising from the securities, though they may need the collaboration of the intermediaries to exercise those rights. This is the case in Spain. Some countries, like Spain, have considered that they can protect the proprietary and the corporate rights of investors without the need for creating a new kind of property, and without breaking the legal link between the issuer and the investor.

4. *Indirect holding*. Another group of states considers that the intermediation process requires the legal creation of a new kind of property: An entitlement over the securities different from the underlying securities *and derived from the position of the intermediary*. In colloquial terms, their option is “we have to bite the bullet and admit that in the case of intermediated securities the investor does not have the securities any more, rather he is always in the hands of the

¹ See the text of the last draft of the convention in www.unidroit.org

² See, *i.a.* *Explanatory Notes to the Preliminary Draft UNIDROIT Convention on Harmonized Substantive Rules regarding Securities*, in *Unif. L. Rev.*, 2005-1/2, p. 36 and ff., footnote 2; AFRELL/WALLIN-NORMAN, “Direct or Indirect Holding – A Nordic Perspective”, *Ibid.*, p. 277 and ff., p. 283.

intermediary". The best way to provide him with a sound protection is through the legal creation of a new type of property. This is the case of the US or Switzerland (project)³.

5. When faced with the "intermediated securities challenge" States are free to choose. They may accept that the creation of a new type of property "...avoids many difficult legal constructions and fictions"⁴. Or they may not. The *reasons* for opting in favor of one or the other are varied, one of the most important being the "legal path dependence": the institutional framework under which each lawmaker was placed when it decided to design a new legal framework for intermediated securities. I am not going to elaborate on this here, but it is important to keep the "legal path dependence" element always in mind.

6. The UNIDROIT Preliminary Draft "...is intended to address both models"⁵. It seems to be based on the assumption that the difference between direct and indirect holding is most of the time a question of terminology (different conceptual frameworks) but not much else. Accordingly, the neutral and functional approach adopted can easily fit both systems of holding⁶.

The Preliminary Draft and the Explanatory Notes of the Conventions convey the impression that the direct/indirect issue is mainly a question of corporate law. One could argue that it is for the *lex societatis* to determine whether the account holder has a direct right *vis à vis* the issuer or not. The Convention does not interfere with that possibility (see Art. 2.1. (e) and 2.2.b of the Preliminary Draft and 4.1.e and 4.3.b of the 2005 Draft) and therefore can be accepted without too many difficulties by the direct holding model. As we will see hereafter, this is not necessarily true. The difference between direct and indirect holding is not only a question of corporate law.

7. The main purpose of this contribution is to check the validity of that assumption. That is, to check whether we can design a set of common rules, touching upon the core elements of the problem, that could be comfortably accepted by both systems; and whether the UNIDROIT project is oriented in the right direction. Obviously, my analysis should not be seen as an exhaustive report, but as mere "food for thought"

³ See, GOODE, "The Nature and Transfer of Rights in Dematerialised and Immobilised Securities", *B.J.I.L.F.*, 1996, p. 167 and ff. (arguing that dematerialisation does not by itself affect the direct relationship between investor and issuer, while immobilization necessarily does. This may explain why countries like France or Spain, where dematerialisation is the rule, have maintained the former approach). About the "new kind of property" introduced by the indirectly holding pattern, see i.a. REITZ, "Reflection on the Drafting of the 1994 Revision of Article 8 of the US Uniform Commercial Code", *Unif.L.Rev.*, 2005-1/2, p. 357 and ff., p. 361 ("The key legal relationship must be between an investor or holder and its intermediary"); ROGERS, "Policy Perspective on Revised U.C.C. Article 8", *UCLA L.Rev.*, 1996, p. 1431 and ff., p. 1455 ("...an entitlement holder's property interest is a bundle of rights that can be asserted directly only against the entitlement holder's own intermediary"); or FMLC Report on Property Interest in Indirectly Held Investment Securities, in www.fmlc.org ("... an account holder's rights are solely against its own intermediary"). The best place to trace the origins of this construction, MOONEY, "Beyond Negotiability: A New Model for Transfer and Pledge of interests in Securities Controlled by Intermediaries", *Cardozo L. Rev.*, 1990, p. 305 and following. From a civil law perspective, see THÉVENOZ, "The Legal Concepts regarding the Holding of Investment Securities for a Civil Law Jurisdiction - The Swiss Draft Act", *Unif.L.Rev.*, 2005-1/2, p. 301 and ff.

⁴ THÉVENOZ, *loc.cit.*, p. 308.

⁵ *Explanatory Notes*, footnote 2.

⁶ *Explanatory Notes*, para. 2.2.

8. To illustrate my explanations I am going to use the Spanish system, not only because it is the one I am more familiar with but also because it can be seen as a paradigm of the direct holding model. I guess, however, that most of the following considerations can be applied to other legal systems sharing the same model. Moreover, I will focus my speech on domestic situations. (*i.e.* Spanish securities held in accounts located in Spain)⁷.

I will leave outside my analysis the case of foreign securities held by investors in Spain but outside the Spanish CSD. This kind of holding can be characterized as indirect holding and the legal Spanish system should not have any problem in accepting the indirect holding conceptual framework for these type of cases.

2. Securities under Spanish law

9. From the point of view of the investor, a security operates in two capacities: on the one hand, it constitutes personal rights against the issuer, and on the other, it is an asset. The former is a matter of company law and the latter is a matter of property law. The interest of the *issuer* is to have clear and transparent rules regarding in favor of whom it must fulfill its obligations and to prevent the inflation of securities⁸. The interest of the *investor* is to have a sound protection of his property against the issuer (= *issuer risk*) but also, in the case of intermediated securities, against other creditors of the intermediary (= *custody risk*). The way to protect this second risk depends on the way the security is represented. So, for instance, if it is incorporated into a document, investors can prevent that custody risk by keeping the paper themselves.

10. Under Spanish law, securities can be represented in two ways: by means of a physical document (certificate) and by means of an electronic book entry. In the first case, the security, *i.e.* the contractual claim *vis à vis* the issuer, is incorporated into a piece of paper and transferable by physical delivery (or by endorsement and physical delivery in the case of registered securities⁹). In the second case, the security is represented by a bite of information recorded in an electronic registry. In principle, the issuer may choose the means of representation. Nevertheless, when securities are going to be listed in a regulated market, they must be represented by book-entries. This means that, for these types of securities, Spain, like other countries, has opted for a fully dematerialized scheme (not for an immobilization scheme)¹⁰. In quantitative terms, the vast

⁷ My personal intuition is that in cross border cases, once we have accepted the PRIMA principle (see, *i.a.*, PAZ-ARES/GARCIMARTÍN, "Conflictos de leyes y garantías sobre valores anotados en intermediarios financieros", *R.D.M.*, n° 238, 2000, pp. 1479 and ff.), whatever type we finally choose, it seems rather difficult to keep on using the directly held securities conceptual framework. PRIMA compartmentalized the law at each national level generating layers of rights. I am almost convinced that the appropriate analytical framework to cope with that scenario is provided by the indirectly holding model. See also, SPINK/PARÉ, "The Uniform Security Transfer Act: Globalized Commercial Law for Canada", *19 Banking and Finance Law Review*, p. 321 and following, p. 360.

⁸ Inflation of securities is a problem for investors but also for issuers who are confronted with contradictory obligations.

⁹ Under Spanish law, registered securities are transferable by endorsement. The modification in the registry of the issuer is not a condition for the transfer of the rights over the security, it only has a legitimizing effect *vis à vis* the issuer.

¹⁰ See, articles 51-52, D.A. 1^a of the Ley de Sociedades Anónimas and 5-12 of the Ley del Mercado de Valores.

majority of Spanish securities (listed companies, government securities,...) are evidence *only* by electronic means.

As it has been suggested, this may have some bearing on the option for a direct or indirect holding model. Fully dematerialization does not by itself affect the direct relationship between investors and issuers, while mere immobilization does¹¹.

11. To prevent any misunderstanding, it is important to know what we mean by the word “*representation*”. That is, what do we mean when we say that something (a piece of paper or a book entry) “*represents*” the security? A look at this concept will allow us to understand many of the traits of a directly held securities model. When a security is represented in form of a physical document, it means that all the rights and obligations *vis à vis* the issuer are now attached to the document, *i.e.* “*incorporated*” into a document. The main function of this reification is to facilitate the circulation and the exercise of the contractual rights incorporated into the paper. The incorporation of an intangible (the contractual rights) into a piece of paper permits the application of the rules of circulation laid down for tangible assets, in particular, the publicity linked to the physical possession of an asset. For instance, the good faith acquiror is protected to the extent that he has relied on the appearance offered by physical possession.

12. The conversion of an intangible in a tangible is obviously a fiction. But a legal fiction (somewhere between a *fictio iuris* and a *fictio juristae*) and therefore it has a fundamental consequence: *according to the law, the creation, the transfer, and the exercise of the rights can only take place as a consequence of the creation, the delivery and the presentation of the document.*

13. When the legal system recognizes that a security can also be represented by means of an electronic record (book-entry) is also a fiction. But, again, it may be a legal fiction with legal consequences. The legal system can foresee that in cases of book-entry securities, the rights arising from the security are now attached to inscriptions in a registry. And it can take this idea with all its consequences: the legal system may lay down the principle that *the creation, the transfer, and the exercise of the rights can only take place as a consequence of entries in an electronic registry.* To the extent that this registry is “*centralized*” that principle would satisfy the interest of both issuers and investors alike. One fiction (the paper represents the rights) is replaced by another fiction (the electronic entry represents the rights).

14. Somehow that was the point of departure of the Spanish lawmaker in the late eighties when it decided to set forth a model of dematerialization of securities¹². The Spanish law is construed on

¹¹ GOODE, *supra* note 2.

¹² It is very recommendable to read the article produced by one of the “*fathers*” of the new regulation, PAZ-ARES, “*La desincorporación de los títulos-valor*”, in *El nuevo mercado de valores*, p. 81 and following. See also RECALDE “*Los valores negociables*”, in ALONSO UREBA/MARTÍNEZ-SIMANCAS, *Derecho del mercado financiero*, I-2, pp. 265 and ff., p. 301. But this is not “*typical Spanish*”, see KHIMJI, “*Intermediary Credit Risk: A Comparative Law Analysis of Proprietary Rights in Indirectly Held Securities*”, *J.B.L.*, 2005, pp. 287 and following (arguing that under English, US and Canadian law, a perfectly adequate solution to intermediary risk is available under the traditional law of property).

the assumption that the new means of representation (book-entry) does not call for a radical change on the legal and conceptual framework traditionally applied to securities. Naturally, some modifications were necessary to adapt the legal regime to the technical and operational particularities of book-entry securities. Adaptation yes, but not radical changes. The lawmaker considered that the Spanish legal system offered enough tools to adapt the basic principle of the traditional law to the new way of representation without reducing the protection of investors. Basically, the technical adaptations required were to replace the physical possession of the certificate, as instrument of protection, for entries in an electronic registry. That is, the electronic registry could fulfill a function equivalent to the possession of the physical document. For instance, the obligation of custody of the documents in the case of materialized securities is replaced by the obligation of keeping the book-entry registry, the principle of good faith acquisition based on the appearance of physical possession is replaced by the acquisition based on the appearance of the electronic registry, the transmission by delivery of the document is replaced by entries in the registry, and so on.

As we will see in the next paragraph, to meet those objectives it was necessary to lay down some degree of centralization in the electronic registry *and to borrow certain principles from land-registry law* (see Art. 16 of the Royal Decree 116/1992)). We can discuss the correction of this option from a policy perspective, but even those who maintain a critical position recognized that those ideas were the point of departure of the Spanish law. This strongly contrasted, for example, with the position of the Swiss lawmaker who, if I am not mistaken, considered that the rules governing book entry securities can not be extracted from the traditional rules applicable to negotiable instruments¹³. The same holds for the US, where one of the basic choices was that “the legal platform for the intermediated sector of the securities market could not be merely an adaptation of the law in place for the older forms of securities holding”¹⁴. The Spanish lawmaker, on the contrary, considered that there was no need to change the essence and to create a new type of property. In the following paragraphs we are going to see how the Spanish legal system was *adapted* to the new means of representation without reducing the level of protection offered to investors.

3. *The central securities depository: the general structure of Iberclear*

15. The Spanish system is based on the idea of a single registry where entries take place (=central record-keeping based on accounting entries). The organisation of intermediaries involved in the maintenance of such a book-entry registry depends on whether the securities are listed in a Regulated Market or not.

16. For *non listed securities* (as foreseen in Chapter III of Title I of Royal Decree 116/1992) the book-entry registry will be maintained by a *sole financial entity* (credit entity or investment services firm authorised for the activity of securities custody and administration) that shall register, at all times, the amount of securities owned by each holder, *i.e.* registering the securities directly in the name of each holder. This requires for each holder to open a securities account in such an entity.

¹³ THÉVENOZ, cited *supra* footnote 2, p. 307-308.

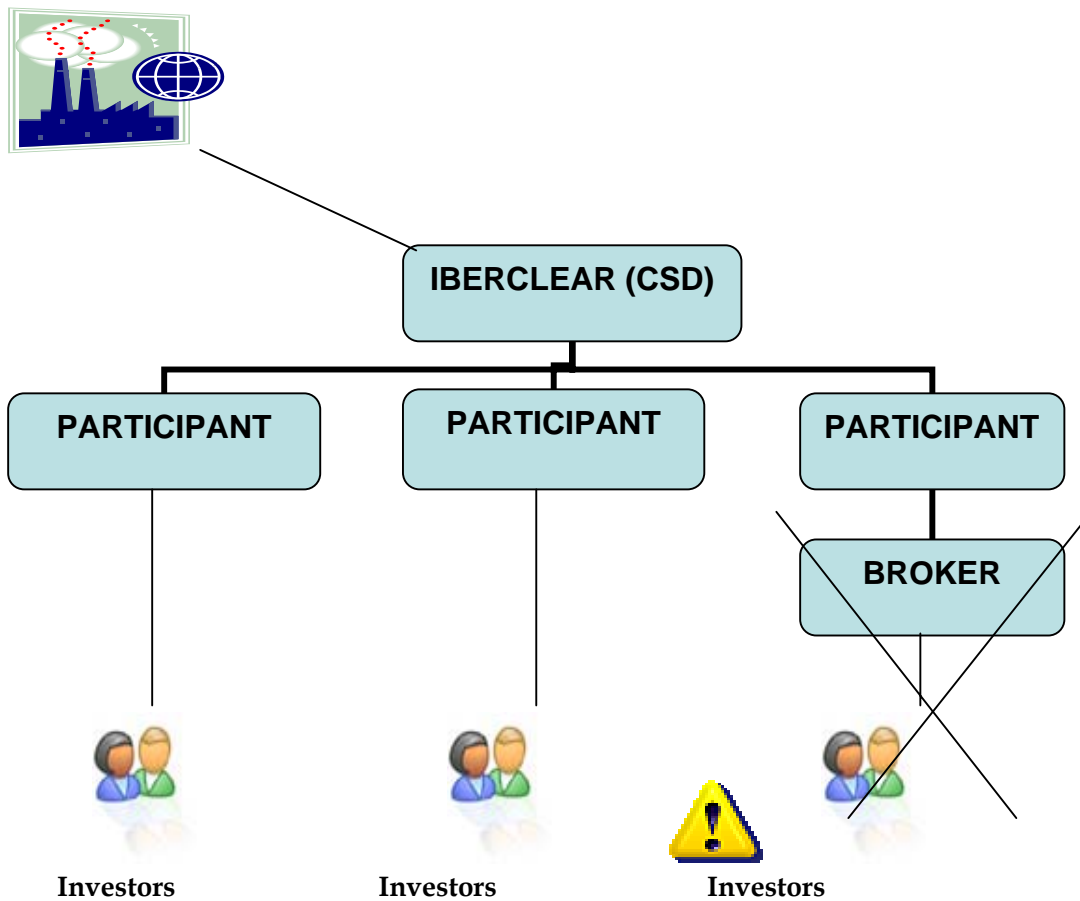
¹⁴ REITZ, cited *supra* footnote 2, p. 361.

17. For securities listed in Spanish Regulated Markets, *i.e.* the Public Debt Market, Stock Exchanges and AIAF Fixed Rate Market, the book-entry registry is structured in a *two-tier system* (as foreseen in articles 29 *et seq.* of Royal Decree 116/1992). In such a system the registry is entrusted jointly to Iberclear and to its participant entities (the “participants”). The latter are financial entities that have a contractual arrangement with the manager of the system, *i.e.* the Central Securities Depository (CSD), Iberclear.

18. This book-entry two-tier registry system, is structured in *two levels*. First, a *central registry*, managed by Iberclear, containing the aggregate balances of securities issued in two types of accounts opened by Iberclear for each participant: (i) An account in which the securities owned by each participant are held; and (ii) Another account, different and entirely segregated from the latter, that reflects the total amount of securities held by each participant on behalf of its clients. Second, a so called *detailed registry*, managed by the participants in which each of them maintains in its own books the accounts opened by each investor, and in which the details of securities recorded in the name of each client is held.

SPANISH HOLDING MODEL

Issuer



Two-tier centralized system:

First tier → Iberclear

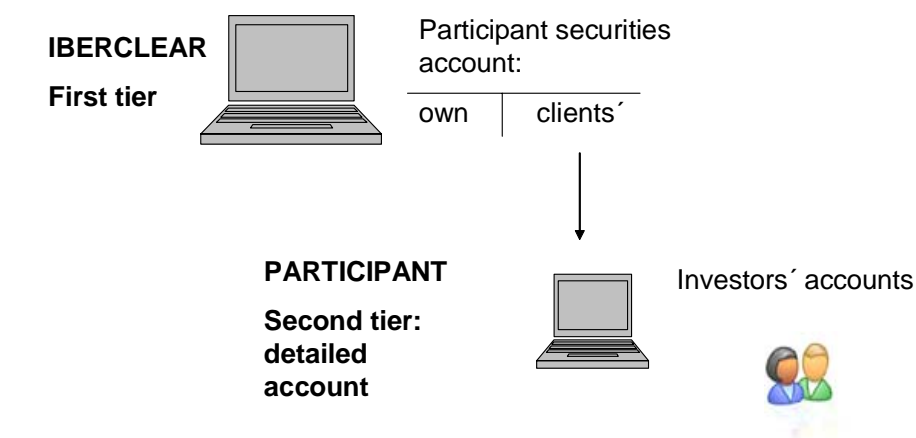
Second tier → Participants

19. Nevertheless, the law considers both levels as parts of the same registry (see Royal Decree 119/1996, "...a system of two tiers which is not contrary to the idea of a single electronic registry even though it is articulated through a central registry and detailed registries...")¹⁵. The system guarantees the *connexion* between those two levels by a code: the so-called *register references* ("referencias de registro"). This allows the system to keep a historical register of all operations and account entries. All operations are numbered, and Iberclear communicates this number to the participants who, in turn, file it away in order to facilitate later enquiries about a given operation or to resolve incidents.

As explained in the web page of Iberclear (www.iberclear.es/Iberclear/home/home.hatm): "All operations are numbered,... The operation number consists of 15 digits, and in the case of Stock Market trade is supplied by the Stock Exchanges, as they are the source of that operation. When, as a result of a purchase or other type of change of ownership, securities are credited to new holders (or at the moment of the initial registration of the issue), the operation number becomes what is known as the Register References (RR). This RR number is entered into the register when the participant, by means of a sale, changes ownership or cancels it from the system. This results in the cancellation of the original ownership by replacing it by the RR. With the maintenance of these RR numbers and the rules for keeping them up to date, the aim is to strengthen the synchronisation between the central and the individual registers. This will avoid authorising the settlement of a sale trade against the overall balance of a participant whilst the participant is unable to identify the securities trade and their original owner."

¹⁵ The account on behalf of its clients that each participant has in Iberclear, though it reflects the total sum of all of its clients' securities, cannot be considered an *omnibus* account. The Spanish legal system only foresees *omnibus* accounts "outside Spain", when they are indispensable for conducting activities in foreign markets (see, article 2 of the Order of 7 October 1999).

REGISTRY AND ACCOUNTS




Key idea: “two-tier centralized registry” (RD 116/1992).
The interconnection between the two tiers is guaranteed
by a system of register reference (RR) numbers

20. To summarise, an entry at the lower level formally can only be made when the corresponding register reference number has been assigned at the upper level, and accordingly any transfer at the lower level is reflected by a number at the upper level. As we are going to see in the next paragraphs, this has several consequences: (a) it prevents that a credit could take place without a corresponding debit, and therefore prevent situations of shortfall, (b) it allows to trace back operations, (c) or it may even give way to the application of the conceptual framework of the doctrine of appearance to the electronic entries¹⁶.

21. In order to present a clear picture of the Spanish system two more clarifications may be helpful.

22. First. Under Spanish law, the recording of the issue in the central registry (Iberclear for listed securities) determines that the securities are duly constituted as book-entry securities (Art. 8 of the Securities Market Act: “securities represented by book entry shall be classified as such by virtue of their entry in the relevant book entry records...”). Therefore (and for listed securities): *only securities recorded in securities account that are opened in the CSD and its participants are considered under Spanish law as authentic securities that generate a valid direct legal relationship between the issuer and the investor.* In this sense, it is very eloquent that the lawmaker has laid down an “exclusive denomination rule”: The expression book-entry securities (“valores anotados en

¹⁶ PAZ-ARES, *loc.cit. supra* footnote 11, at p. 100.

cuenta”) can only be used in relation to securities registered in the CSD and its participants (Art. 5 of the Royal Decree 116/1992). This implies that all the Spanish legal system is construed on the idea of a “two-tier centralized registry” where “sub-tier intermediaries” (in Spain) are not acceptable (see first picture ¹⁷).

23. Second. The fungibility of the securities cannot be invoked as an argument against those principles. Under Spanish law, the fungibility character is only applicable for operational purposes, that is for clearing and settlement operations and implies that any unit is interchangeable for the purpose of delivery (art. 8 *in fine* of the Ley del Mercado de Valores). As has been pointed out “Though intangibles may not be capable of identification in the physical sense, they are capable of allocation, and this facilitates tracing”¹⁸. The RR number is electronically linked to a certain and traceable amount of fungible securities. That number is also used for corporate law purposes¹⁹. To the extent that there is a central registry with a historical record of all transactions over the securities, we can consider that investors are owners of an identifiable property (=direct holders of a certain amount of securities *vis à vis* the issuer and also *vis à vis* third parties).

24. This organizational and legal framework has relevant consequences for our analysis.

4. Legal consequences

4.1. First: no “new kind of property”

25. Under Spanish law the model of a “central record-keeping based on formal accounting entries” permits to maintain the conceptual framework of direct holding. The name of the owners of the securities (=investors) must appear in the detailed registries of the participants in Iberclear, and those owners have a *direct right vis à vis* the issuer and *vis à vis* third parties, including the right to receive and enjoy the fruits of ownership of the securities, the right to dispose of the securities, the right to cause the securities to be placed in the accounts of another participant in Iberclear, and so on. Accordingly, if the issuer does not fulfill its obligation, the investor is the only person authorized to sue the issuer, he therefore must act as plaintiff action on his own capacity. In cases of insolvency of the participant that manages the investor’s account, his securities are moved by the National Stock Exchange Commission *ex officio* to another participant (with more detail *infra* § 4.5). On the contrary, if the securities have not been credited according to the corresponding process to the account of the investor, in principle the investor is not going to

¹⁷ RECALDE, *loc.cit.*, *supra* footnote 11, at p. 301.

¹⁸ BENJAMIN, *apud* GOODE, *loc.cit.* *supra* footnote 2, at p. 170.

¹⁹ For example, only securities acquired before five days prior to the date of the General Shareholder’s Meeting may attend the meeting. As 6 out of the 15 digits of the RR number represents the date in which the securities were acquired (i.e. **905091**541234567, the bold digits meaning 15 September 2005), only securities with the appropriate RR may attend and vote in the GSM. This is controlled through electronic means, as issuers receive on demand from IBERCLEAR a full list of all the RRs that are “alive” of a given issue when a GSM is called.

be considered as holder of the securities (see Art. 11 of the Ley del Mercado de Valores)²⁰. Spanish law is based on the principle that the real owner must appear in the books, and therefore whoever appears in the book is legally presumed to be the owner.

Of course, to exercise the rights arising out of the securities, the investor may need the assistance of the intermediary, but in doing so, the intermediary exercises *rights of the investor* in the capacity of an attorney or of an agent.

26. According to this approach, the Spanish lawmaker has not considered it necessary to create a “new type of property/asset” to cope with the book-entry securities world. There is no division of entitlements “in tiers”, nor any sort of split ownership between investors and intermediaries. There is no difference between legal and beneficial owners either (*i.e.*, there is no “*nominee accounts*”). And there is no room for any kind of legal entitlement different from the underlying security, not even for any kind of co-ownership over a pool of securities. It is important to insist on this point: under Spanish law (corporate or property law), neither the CSD nor its participants have any proprietary or personal right or interest over the securities of investors. *Intermediaries are mere record-keeping institutions.*

It may be the case that *de facto*, and contrary to the foresights of the Spanish lawmaker, an intermediary places himself between the participant in Iberclear and the final investor (see, in the diagram Broker). The position of the investor in this situation is not expressly contemplated by Spanish law. It could be argued that he only has a contractual right *vis à vis* his intermediary, or it could also be argued that under general rules of civil law he has a proprietary right to the extent that he can offer fully evidence that Broker was a mere fiduciary owner. The second understanding seems to be, *prima facie*, more sensible. However, this result can be achieved through the application of traditional principles of civil law, without reinventing the legal framework or creating a new type of entitlement.

4.2. Second: transmission of property by means of credits and debits. Excursus

27. Under Spanish law, the transmission of ownership over securities requires two elements: (a) the existence of a valid agreement and (b) the delivery of the security. In the case of “dematerialised securities”, the law has substituted physical delivery of the document by book-entry in the corresponding registry. This means that recording or crediting the securities in the securities account of the buyer has legally the same effects that are afforded to the delivery of physical securities. In this sense, article 9 of the Ley del Mercado de Valores states that “*Transfer of book-entry securities takes place by means of account transfer. The inscription of the transfer in favour of the acquirer will produce the same legal effects as the delivery of the physical securities*”. The same applies to the creation of a security interest, which is only perfected and binding *erga omnes* when recorded in the relevant securities account.

28. In relation to this, it is important to emphasize two other points. *First*, that a book entry is not in itself enough to transfer property. If there is no title (typically a contract) or the title is null and

²⁰ As in the case of land registries, where the person whose name appears in the registry is considered to be the owner of the land.

void, the mere credit of securities to a securities account does not create a valid proprietary right in favor of the account holder (see, for instance, Art. 9 I *in fine* of the Ley del Mercado de Valores and Art. 12.5 of the Royal Decree 116/1992)²¹.

Apparently, the Spanish legal model does not fit well within the model of the UNIDROIT project, where a “principle of abstraction” of the transmission of property seems to be laid down (see, arts. 3, 4 and 5).

29. *Second*, that the terms “book-entry”, “credit” and “debit” have a particular technical meaning. Though questioned by some legal scholars, Spanish law seems to turn around the idea that the transmission of property rights over the securities only takes place by means of credits and debits *made according to the rules of the system, that is, in the case of listed securities, under the rules aforementioned (supra § 3)*. So, for instance, a participant can only make a valid credit to a securities account of one of its clients, with proprietary effects, if the central system has assigned that participant the corresponding RR number²². In this sense, the “book-entry registry” is conformed as an ownership-in-securities *formal* registry made up not with paper books (as the Real Estate Registry), but with several securities accounts on which securities are inscribed and held in the name of their owners. Colloquially it can be said that, under Spanish law, “in order to determine the ownership we have to look into the computers of the intermediaries”.

Excursus. Under Spanish law, credits and debits imply more than a mere legal relationship. They require a record in the registry, and in a particular way: through the iberclear scheme (for listed securities). So, unlike in other countries where a credit takes place by a mere confirmation to the account holder or by any form that identifies the security as belonging to the purchaser²³, under Spanish law an investor only acquires a proprietary right when the inscription in the “two-tier central registry” takes place. The investor may have paid and may have received a confirmation by his intermediary, but if a formal credit under the rules of the central system has not taken place, the investor does not have a proprietary right over the securities (naturally, he may have a contractual claim against his intermediary or may get the benefits of a public or private insurance). This may be good or bad policy, but it is a corollary of a model of book-entry securities based on a two-tier centralized registry.

In his well-known article in the UCLA Law Review, professor ROGERS put the following example: “Suppose that at Time 1, Broker acquires 10.000 shares of XYZ Co. common stock for its own property account at a time when none of Broker’s customers are holding XYZ Co. common stock through it. Thereafter Customer places a buy order for 10.000 shares of XYZ Co. common stock through broker, to be credited to Customer’s securities account with Broker. Broker takes Customer’s money and falsely reports to Customer that it has purchased 10.000 shares for Customer’s account, but in fact, Broker does not do so. If Broker fails...Under revised Article 8, the answer is clear Customer wins”²⁴. This paragraph is very useful to illustrate the different approach to the concept of “credit” and “debit”. Under a fully-regulated and centralized book-entry system, the fact that Broker reports Customer the acquisition of the securities does not imply the acquisition of the ownership over the securities, so Customer would not have any proprietary right over the securities. Nothing has been credited. For the same reasons, ideas like “the creation of a security entitlement is not dependant upon whether an intermediary actually

²¹ *I.a.*, PAZ-ARES, *loc.cit. supra* footnote 11, at p. 100.

²² As pointed out, this understanding is questioned by some scholars, nevertheless most of the rules issued by the competent authorities seem to be based on that assumption.

²³ “Identification requirements”, see MOONEY, *loc.cit. supra* footnote 2, p. 331.

²⁴ ROGERS, *loc.cit. supra* footnote , at p. 1515.

holds or acquires a financial asset"²⁵ are conceptually very difficult to accept in the cases of centralized registries.

This difference in the understanding of those two terms makes me think whether it would not be advisable to include a definition of credits and debits in the UNIDROIT Convention, or at least a definition of *the requirements under which a "credit and a debit" can take place*. Otherwise, in countries like Spain it would not be easy to interpret that a credit in a securities account takes place by a mere "report" to the investor.

30. *Mutatis mutandi*, the same approach holds for security rights. The creation of a security interest calls for an electronic entry which implies a sort of dispossession. A pledge, for example, implies an electronic entry in the registry of the intermediary which blocks the concrete RRs corresponding to the specific securities being pledged. It is a full "earmarking" inside the account.

This contrasts again with the text of article 2 of the 2004 UNIDROIT project according to which a security interest can be created by mere "designation", without any sort of electronic entry in the corresponding registry. Again, a system based on a fully-regulated "two-tier centralized book-entry registry" would usually require some form of electronic entry in the registry to perfect the security interest.

4.3. Third legal consequence: Credits and corresponding debits. Traceability

31. In the typical indirect holding system an investor has a security entitlement. A security entitlement can be defined as the package of rights that a person has against the person's own intermediary with respect to the positions carried in the person's securities account. That package of rights is not, as such, something that is traded. In most cases, settlement of securities trade will involve termination of one person's security entitlement and acquisition of a new security entitlement by another person. That transaction is not, however, a transfer of the same entitlement from one person to another²⁶. The model is based on the idea of extinction and creation of rights. Therefore, there is no conceptual problem in accepting that there can be a credit without a debit. For the same reason, the rules of traceability have no place in this context (see also Art. 3 of the 2004 UNIDROIT Project, and in particular the Explanatory Notes accompanying that article).

32. In direct holding systems, the transfer is the transfer of the same asset: the securities and the rights arising thereof. That is why, in these systems, it is not conceptually easy to understand the idea of "credits without corresponding debits". One can only acquire a thing if there is somebody elsewhere who has lost it. The introduction of the *fungibility* element does not necessarily call for a reconsideration of this principle to the extent that the system is able *to allocate portions of fungible securities* (see *supra* n. 29).

²⁵ SPINK/PARÉ, *loc.cit. supra* footnote 6, p. 363.

²⁶ See para 5 of the Official Comment to Rev. Art. 8-501 UCC

33. Precisely, this is what happens under Spanish law. As we have already seen, all transferors and transferees are directly or indirectly connected with a central program. The system assigns portions of securities to account holders. Each portion corresponds to a number, which is also reflected in the central registry. When a transfer takes place, one register reference (RR) is cancelled (the one corresponding to the debit) and a new one is issued (the one corresponding to the credit). This guarantees the exactness in the matching of credits and debits, and therefore explains why the basic principle of the Spanish law, unlike the UNIDROIT project, is that there cannot be credits without corresponding debits (see Arts. 16 and 32.2 of the Royal Decree 116/1992 “no credit or debit can be undertaken if the corresponding reference registry number has not been cancelled and issued”).

34. A corollary of this operational system is that theoretically it allows for traceability. The system stores the information of all transactions at least for five years (see Art. 28 of the Royal Decree 116/1992). This information permits the historical reconstruction of entries (credits and debits), and accordingly, if there is a mistake, the program can trace where it comes from.

Because of the operational rules of the system, the need to trace back a succession of entries would be very rare (and, naturally, without disturbing the principle of finality). But it does not affect the theoretical underpinning principle: traceability is factual and legally feasible. This contrasts, again, with the UNIDROIT Project (see *Explanatory Notes* corresponding to Art. 3).

4.4. Fourth consequence: loss allocation. My securities belong to me!

35. The basic principle, either in the *direct* holding systems or in the *indirect* holding systems, is the duty of the intermediary to hold sufficient securities of a given description with respect to the number of securities of that description that are booked to its clients' accounts. This is the rule in the UNIDROIT Project (see Art. 14 of the 2004 Project and 16 of the 2005 Project) and it is also the rule under Spanish law. In order to implement this principle, under the rules of the Spanish “two-tier centralized system”, a participant cannot credit a security to one of its client's account without the corresponding credit in its account in the CSD. This is guaranteed by the register reference number (RR). A participant cannot make a credit to one of its client's account until it has received the corresponding RR number from the CSD. This number ensures the matching, *i.e.* that an equivalent amount of the same type of securities has been debited in the account of the transferor. This centralized control makes cases of shortfall very rare. It is important to keep this in mind to understand the following considerations.

36. The immediate obligation of the intermediary to eliminate an imbalance is also the rule under the UNIDROIT Project (see Art. 14.2 of the 2004 Project and 16.2 of the 2005 Project). An equivalent obligation is foreseen under Spanish law. If, for whatever reason, a credit in the client's account has not been effectively made, the intermediary must proceed to acquire the corresponding amount of securities and credit them to that client's account (see Art. 27.4 of the

Royal Decree 116/1992)²⁷. In principle, it does not make any difference whether a system is characterized as direct or indirect holding to lay down this obligation.

37. Cases of shortfall call for a more precise analysis. A shortfall may happen when the intermediary goes bankrupt or when there are no securities available in the market to cover the imbalance. In these situations, a provision for the allocation of the shortfall is needed. *Indirect holding systems* have no problem in accepting a rule of mutuality of losses: the remaining securities "...shall be allocated among the account holders to whose securities accounts securities of the relevant description are credited, in proportion to the respective numbers or amounts of securities so credited" (see Art. 16.1 of the 2004 UNIDROIT project and Art. 18.1 of the 2005 UNIDROIT project).

This solution does not pose any problem to the extent that, in indirect holding systems, the investor holds an entitlement over the pool of securities held by his intermediary. The only open question is the rule of distribution. The pro-rata assignation can be carried out "security by security" ("...among the account holders to whose securities accounts *securities of the relevant description* are credited", see Art. 16.1.b of the 2004 UNIDROIT project and 18.1.b of the 2005 UNIDROIT project), or by creating a "customer pool fund", *i.e.* spreading the shortfall evenly among *all customers* (not just among those whose entitlement relates to the particular financial assets in which the shortfall occurs)²⁸.

38. For some *direct holding systems* the adoption of that rule does not present difficulties, but for others, like the Spanish system, it does. Some direct holding systems establish that the account holder is the *direct co-owner* of a pro-rata portion of the securities held with his intermediary. For these systems, in cases of shortfall, the rule of distribution adopted in the UNIDROIT project does not present too many difficulties²⁹.

39. On the contrary, in those systems based on a centralized registry with particular allocations of securities among account holders, that rule of distribution does not fit well. As we have explained, under the Spanish "two-tier centralized registry" each account holder has the guarantee that if the securities have been credited to his account, there will be a corresponding amount in the CSD to match that credit. The basic rule of "no credit without the corresponding debit" and the regulated process of crediting and debiting make situations of shortfall extremely rare. In fact, the Spanish law does not foresee a specific rule for shortfall cases. This can also be explained as a technical point: as in the case of traceability, by looking into the system it is possible to assign specific amounts of securities (in the CSD) to specific account holders (in the detailed registries of the participant).

²⁷ The rules of the systems allow the very CSD (Iberclear) to buy the corresponding securities in the market on behalf of the participant (see Circular 1/2002 of Iberclear).

²⁸ This seems to be the rule adopted in Canadian insolvency law, see SPINK/PARÉ, *loc.cit. supra* footnote 6, at p. 375.

²⁹ I presume that for these systems it would be more difficult to accept the "Canadian solution" (though I personally think that this solution is the most consistent within the indirect holding systems framework)

One could argue: but what happens if the participant (intermediary) lies to the customer and falsely reports to him that a certain amount of securities have been credited to his account? Is it not a case of shortfall? (see Example given by professor ROGERS, *supra* § 29).

This question brings us back to the concept of “credits and debits” (*supra* § 29). Under Spanish law, a “credit” means a real credit in a two-tier centralized registry and according to certain operational rules. This makes it very difficult to imagine cases in which the same amount of securities are credited to two different account holders. In order to legally affirm that a security has been credited to a client’s account it is not enough, for instance, a report –confirmation- of the intermediary to that client. Therefore if the intermediary falsely reports to his client that a security has been credited to his account, but actually it has not (according to the rules of the system), that client will have a contractual claim against that intermediary (which by law is obliged to buy the corresponding securities, see *supra* § 36), will get benefit from investment guarantee schemes or any other kind of insurance, but he will not have a proprietary right over the securities duly credited to other account holders’s securities accounts. These other account holders will argue: “my securities, duly credited to my account, belong to me” This results can be fair or unfair but, again, it is consistent within a model of book-entry based on a fully-regulated two-tier centralized registry.

4.5. Insolvency

40. The former explanations pave the way to understand the solution adopted by the Spanish lawmaker in cases of insolvency of an intermediary (*i.e.* a participant in the Spanish CSD). The basic principle is common to other legal systems. In the case of securities credited in the securities accounts, the insolvency of the intermediary will not affect the investor’s rights, since they are not contractual rights against the intermediary, but property rights recorded in the securities account held by the intermediary. Therefore, these rights recorded in the accounts are never commingled or otherwise mixed with the intermediary’s assets.

41. One of the advantage of the Spanish “two-tier centralized system” is that it facilitates the exercises of the rights of *separatio ex iure dominii* from the insolvency estate. In the case of securities listed for quotation in official secondary markets, according to article 44 bis 9 of the Ley del Mercado de Valores, should an insolvency proceeding be opened against a participant in the Spanish CSD, the Stock Exchange Commission (CNMV) shall, immediately and at no cost to the investor, transfer the securities credited in his securities account to another firm authorised to perform this activity. In the same way, the owners of such securities may request for them to be transferred to another firm. If no firm is in a position to take on the responsibility for the aforementioned records, this activity shall provisionally be undertaken by the CDS itself until the owners request that the registration of their securities be transferred. This system is less cumbersome for investors than other options to the extent that they do not have to lodge any claim in the insolvency proceedings to implement his rights of *separatio*.

This rule can only be understood under the strict concept of “credits and debits” laid down by Spanish law (*supra* § 29). Only those account holders who have their securities duly credited under the rules of the system can be identified and therefore get the benefits from this *separatio ex officio* carried out by public authorities.

4.6. Upper tier attachment

42. In an indirect holding scheme a debtor's securities entitlement exists only against the debtor's own intermediary. That debtor has no rights against any other upper-tier intermediary or even against the issuer. That explains why it is legally impossible any upper-tier attachment in those systems. In fact, it could be argued that in those systems a rule prohibiting an upper-tier attachment would not really be necessary. It fulfills a mere function of clarification. As has been said "It is therefore impossible to draft a rule prohibiting the attachment of property within a legal framework where that property does not exist"³⁰.

43. In a direct holding scheme an upper-tier attachment is conceptually feasible. The fact that the investor is the direct owner of the securities necessarily implies that the asset is the same all along the chain and therefore that an attachment at the upper-tier should be conceptual acceptable. The only problem is of a *technical nature*: when at the upper-tier level it is not possible to segregate an amount of securities as pertaining to a particular investor, the attachment cannot be executed. However, if there is a technical way to identify the securities at an upper level, the upper-tier attachment should be accepted. What is more, it could be the only way to adequately protect the beneficiary of the attachment against abuses or fraudulent disposition by the debtor.

44. The "two-tier centralized model" underpinning the Spanish system may allow for that identification. In practice, credits, debits and attachments take place in the registry either in the central tier (kept by Iberclear) or in the detailed tier (maintained by its participants) of the registry. But in this latter case, Iberclear, as the upper-tier intermediary, records all transactions (credits and debits, and for debt securities also other kind of dispositions like security interest). Accordingly, with the pertinent information, nothing precludes an attachment at this upper level. In fact, this is what usually happens in certain cases: blockings or attachments of debt securities listed in the Public Debt Market or in AIAF Market, both of which are maintained and settled in a special platform (CADE), do produce a simultaneous attachment on either tiers or levels.

In this sense, the absolute prohibition of upper-tier attachment laid down by the UNIDROIT project (see Art. 8 of 2004 project and Art. 9 of 2005 project) should be revised. In cases of direct holding systems, where, at the upper-level, the operational rules permit the identification of a certain amount of securities as belonging to a particular investor, upper-tier attachment should be accepted.

5. Conclusion

45. There are two main conclusions that can be drawn from the former analysis.

First. In principle, the functional approach underpinning the UNIDROIT project is feasible. Most of the practical rules can be designed to fit both conceptual models: direct or indirect holding

³⁰ SPINK/PARÉ, *loc.cit. supra* footnote , at p. 369.

systems. However, there are certain issues where the two systems may be irreconcilable and, if this is the case, the only way out is to foresee an exception to the general rules.

Second. As we have seen, this irreconcilability derives not so much from the “conceptual framework” (direct vs indirect holding) but from the characteristics of the operational and technical rules governing certain systems. System, like the Spanish, based on a “two-tier centralized registry” (a “hub and spokes scheme”) may call for certain exception to the general rules laid down by the UNIDROIT project.

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