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978-0-521-83265-6 - Property in Securities: A Comparative Study

Eva Micheler

Excerpt

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## Introduction

This book contains an analysis of the English, German and Austrian law of securities. The term ‘securities’ is used in the context of this book to refer to shares, bonds and other financial instruments which are issued to the capital market with a view for them to circulate among market participants. The analysis presented in the book addresses the rules governing transfers of securities, including unauthorised transfers, equities arising out of defective issues and the holding of securities through intermediaries. The book does not contain an examination of the regulatory regime associated with securities and their issue. It does not, for example, provide an analysis of the disclosure requirements that apply to securities on their being first issued, or throughout the period during which they are listed on a public market.

The boundaries of this area of the law can be defined by reference to the two steps that are taken when securities are bought and sold. The first step is the conclusion of a contract for the sale of securities. Such contracts can be made on the stock exchange, through an electronic trading system, or directly between buyer and seller. The conclusion of a sales contract is referred to in the financial markets industry as ‘trading’.<sup>1</sup> This book is not concerned with this first step.

The second step, and the focus of this book, is the performance of the contract for the sale of securities. This step is referred to in the financial markets industry as ‘settlement’. The analysis presented in the book concerns the rules governing the completion of transactions relating to securities and also the rules that regulate the relationship between

<sup>1</sup> P. Moles and N. Terry *The Handbook of International Financial Terms* (Oxford: Oxford University Press, 1997) define trade at 558 as ‘colloquial term for a transaction’ and transaction at 560 as ‘a purchase or sale made in the markets’.

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intermediaries who hold securities on behalf of investors and their clients. This involves complicated questions of company and property law which have been the subject of significant academic work in the past few years.<sup>2</sup>

Several approaches to settlement exist, which differ in legal as well as in institutional terms. In this book, two approaches will be analysed. The first is the system adopted by English law; the second is that adopted by German and Austrian law. The jurisdictions which have adopted the respective approaches are members of the European Union (EU) and represent equally advanced economies. There nevertheless exist significant differences between them: England is a common law jurisdiction, Germany and Austria are civil law countries.

In England, securities are almost exclusively issued in the form of *registered instruments*. Their transfer involves an amendment of a register of holders: the name of the transferor on the register is replaced by the name of the transferee. The register is maintained by or on behalf of the issuer; as a result, issuers frequently know the names and particulars of their investors.<sup>3</sup> If paper certificates are issued for securities, these certificates are documents of evidence only and do not constitute negotiable instruments. The financial service providers operating in this context in England are registrars who maintain registers on behalf of companies. To eliminate paper from the transfer process, England has opted for *dematerialisation*. Instead of issuing paper certificates, issuers are able to issue uncertificated securities that are transferred electronically through a central service provider named CRESTCo Ltd. English law will be analysed in part I of the book.

In Germany and in Austria, securities are almost exclusively issued in the form of *bearer instruments*. These instruments are classified as tangible movables: Transfers are effected by the physical delivery of the paper documents. Issuers are, traditionally, not involved in the administration of transfers and do not know the identity of their investors.

<sup>2</sup> See in particular: A. O. Austen-Peters, *Custody of Investments, Law and Practice* (Oxford: Oxford University Press 2000); Joanna Benjamin, *Interests in Securities* (Oxford: Oxford University Press 2000); Joanna Benjamin and Madelaine Yates, *The Law of Global Custody* (London: Butterworth 2003); Maisie Ooi, *Shares and Other Securities in the Conflict of Laws* (Oxford: Oxford University Press 2003); Arianna Pretto, *Boundaries of Personal Property Law: Shares and Sub-Shares* (Oxford: Hart Publishing 2005).

<sup>3</sup> This is, however, only the case if the investor chooses to hold the securities directly. An investor may also choose to hold securities indirectly, in which case the name of a nominee appears on the register and the nominee receives issuer information on behalf of the investor.

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The financial service providers operating in this context in Germany and in Austria are banks with whom securities are deposited and a central depository which stores most of the certificates relating to listed securities. To eliminate paper from the transfer process, Germany and Austria have opted for *immobilisation*. Certificates continue to exist; they are, however, put out of circulation and stored in a central depository. Transfers are effected by way of book entry on client accounts and without the need physically to move paper certificates. German law and Austrian law will be examined in part II of the book.

The book has three aims. The first is to present an account of the current English, German and Austrian legal regime governing the transfer and holding of securities and to compare the two approaches adopted by English law, on the one hand, and German and Austrian law, on the other. The book has been written with a view to explaining the English regime to readers with a civil law background and to explaining the German and Austrian regime to readers with a common law background. In order to enhance the understanding of the respective legal frameworks, the two approaches will be compared throughout the book.

The second aim is to analyse the law of securities against the background of a recent debate in the area of comparative law. In recent years, comparative legal scholars have focused on studying the effect of globalisation on legal systems. The focus of the debate is corporate governance, in particular the question whether globalisation will cause the corporate governance regimes represented around the globe to become more like each other. Some scholars predict that global competition will lead to the emergence of a single model of corporate governance. Others propound the view that there exist significant obstacles in the way of any convergence of legal rules: politics, economics, culture, social and commercial norms and legal mentalities.

The book contributes to this debate. Like corporate governance, the law of securities has been subject to the pressures created by a globalised economy. The book contains an analysis of how English, German and Austrian law have historically responded to change. It will be shown that, historically, all three jurisdictions have adapted to new challenges by refining the legal doctrinal concepts already in place. Whenever they have been faced with a need for reform, neither of the legal systems analysed in the book has created law from scratch, drafted to suit the requirements dictated by politics, economics, culture, or other forces, and it is likely that this pattern of legal change will continue in the face

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of globalisation. This leads to the conclusion that globalisation is unlikely to cause jurisdictions across the globe to adopt rules with identical wording, or of identical doctrinal background. Convergence will occur only at a functional rather than at a formal level, leaving the underlying doctrinal rules already in place largely intact.

Another conclusion presented in the book is that the institutional framework of a particular jurisdiction is determined by legal doctrine. The book does not claim that legal doctrine is the only factor explaining why certain institutions are present in certain markets. Nevertheless, it will be shown that the type of market infrastructure currently in place in England, Germany and Austria can be explained as a function of the legal rules that govern securities and their transfers.

The third aim of the book is related to the second. The book also intends to make a contribution to the question whether it is possible to harmonise the law governing securities. This harmonisation is currently being discussed by two international organisations. The UNIDROIT, an international organisation promoting the harmonisation of laws across the globe, presented in March 2006 a draft for a Convention on the substantive rules regarding intermediated securities. The EU is in the process of determining whether there exists a need to harmonise securities law across its member states (the EU Legal Certainty Project, see chapter 17). A group of legal experts has been appointed to give advice on whether the differences currently existing between the securities laws of the member states of the EU provide an obstacle capable of preventing the emergence of a single European financial market. If differences in the law are to be found to operate as a hindrance to a single market, the members of the group have been instructed to make suggestions for the harmonisation of this area of the law.

The book also aims to contribute to the question of what form a harmonised law of securities should take. The conclusion from the analysis contained in the book is that no attempt should be made to harmonise the legal doctrinal rules governing securities across Europe: harmonisation is possible, but only consistent with incumbent legal doctrine. The analysis presented in the book shows that notwithstanding the different legal tools applied in the different legal systems, the underlying explanation for these legal rules and the practical outcomes produced by them are similar. The legal systems share a common understanding of the theory underlying the law of securities; rather than interfering with domestic legal doctrine, law can be most effectively

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harmonised across Europe at a functional level by determining the outcomes which are to be achieved by the different jurisdictions.

Chapter 1 of the book contains an analysis of the arguments advanced in the current debate on convergence and path-dependence of legal development. English law will be examined in part I of the book, and German and Austrian law in part II. Part III of the book contains the conclusions following from the analysis presented. It will also examine the implications of these conclusions for the convergence and path dependence-debate and for the current plan to harmonise securities law across Europe.

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## 1 Convergence and path-dependence

Modern comparative law scholarship has been concerned with determining the effects of globalisation on legal development. One of the current discussion topics in the field is whether, with globalising economies, legal systems converge. The focus of this discussion is corporate governance.

The debate starts from the premise that there currently exist, roughly speaking, two types of corporate governance models. The two models differ in the way in which firms are owned and in the way in which the law allocates influence between shareholders, the board of directors, employees, creditors and the general public.

Scholars distinguish between jurisdictions with relative dispersion of ownership of public companies (such as the US and the UK) and jurisdictions with relative concentrated ownership of public companies (such as Germany). In the US and UK, public companies have a large number of shareholders who each hold small fractions of the company's capital. Company law tends to favour shareholder interests. In Germany, public companies have one shareholder (or a small group of shareholders) who holds a significant stake in the company.<sup>1</sup> German company law looks after shareholders, but also protects the interests of employees, creditors and the general public.

The question that scholars are trying to solve is whether globalisation has an effect on these governance models. The starting point of the analysis is the assumption that the regime under which companies are governed is a cost factor in production: the assumption is that companies

<sup>1</sup> Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', (1999) 52 *Stan. L. Rev.* 127 at 133.

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with better governance are more likely to operate at lower cost and therefore more able to succeed in global competition. This will lead to a change in the governance of companies world wide. The pressure of a global world economy will force jurisdictions and companies to reform their governance models to become more efficient. Will this cause differences between existing governance models to disappear, with the result that a global corporate governance model will emerge? Different scholars have given different answers.

Some argue that the existing corporate governance models will converge; they predict that different jurisdictions will adopt similar rules of company law and corporate practice. Others propound the view that there are significant obstacles that stand in the way of such convergence: politics, economics, culture, social and commercial norms and legal mentality. There is also a point of view which predicts that functional convergence will occur prior to formal convergence. In sections 1.1–1.3 the views advanced in this debate will be analysed; the arguments in favour of convergence will be presented first.

## 1.1 Convergence

Henry Hansmann and Reinier Kraakman predict the end of history for corporate law.<sup>2</sup> They observe convergence of corporate law towards an Anglo-Saxon style model of corporate law caused by ‘a widespread normative consensus that corporate managers should act exclusively in the interests of shareholders, including non-controlling shareholders’.<sup>3</sup> Hansmann and Kraakman believe that all jurisdictions will move to similar rules of corporate law and practice. Differences may persist as a result of institutional and historical contingencies, but the bulk of

<sup>2</sup> Henry Hansmann and Reinier Kraakman, ‘The End of History for Corporate Law’, (2001) *Geo. L. J.* 439; John C. Coffee, Jr., ‘The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications’, (1998–1999) 93 *Nw. U. L. Rev.* 641, Columbia University. Center for Law and Economics Working Paper 144 (November 11, 1998); see also Klaus J. Hopt, ‘Common Principles of Corporate Governance in Europe?’, in Joseph A. McCahery, Piet Moerland, Theo Raaijmakers and Luc Renneboog, *Corporate Governance Regimes, Convergence and Diversity* (Oxford: Oxford University Press 2002) 175, who concedes that there are path-dependent differences between corporate governance regimes. These differences are deeply embedded in a country’s tradition, history and culture. Hopt concludes, however, that market forces can be expected to be stronger in the long run (at 193).

<sup>3</sup> In the abstract to Hansmann and Kraakman, ‘The End of History’.

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legal development worldwide will be towards a standard model of the corporation.

A view also exists that convergence of corporate laws will occur because cross-border mergers, which have increased in recent years, will bring investors insisting that companies should promote shareholder interests to countries that are stakeholder oriented. This will cause stakeholder oriented jurisdictions to adopt a more shareholder-friendly approach.<sup>4</sup>

Another argument supporting the prediction for convergence is that there is an increase in listings of foreign companies on the New York and London stock exchanges. Listings of this type cause firms to adopt the Anglo-American legal model. To attract investors, firms opt to become subject to higher regulatory and disclosure standards,<sup>5</sup> bringing firms around the globe under the head of the same law and thus achieving convergence of legal rules.

Moreover, even without formal convergence of corporate law, securities law will become global either because of harmonisation or because of migration towards the US and the UK. Securities law will take over the role of protecting shareholders, and there will be a set of securities law rules that apply globally.<sup>6</sup>

All proponents of convergence share the vision that global competition is a strong enough force to trigger change in the laws that govern companies around the globe. In reaching this conclusion, they assume that it is possible for a jurisdiction to amend existing legal norms to any desired degree: there is no mention of limitations to such change. These scholars base their work on the assumption that legal systems are able to choose from an open-ended menu of legal rules.

<sup>4</sup> Jeffrey N. Gordon, 'Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany: Deutsche Telekom and DaimlerChrysler', (1999) 5 *Colum. J. Eur. L.* 219.

<sup>5</sup> Coffee, Jr., 'The Future as History' 673–679; see also Bernard S. Black, 'The Legal and Institutional Preconditions for Strong Securities Markets', (2001) 48 *UCLA L. Rev.* 781, 816; for a critical view, see Amir N. Licht, 'Cross-Listing and Corporate Governance: Bonding or Avoiding?', (2003) 4 *Chi. J. Int'l L.* 1.

<sup>6</sup> Coffee, Jr., 'The Future as History' 699–704; for a view that securities regulation has proven more susceptible to convergence, see also Amir N. Licht, 'International Diversity in Securities Regulation: Roadblocks on the Way to Convergence', (1998) 20 *Cardozo L. Rev.* 227. It will be shown later in this chapter that listings in the US and the UK can cause change in the jurisdictions from which foreign companies originate. This change is, however, subject to the constraints imposed by the legal doctrine prevailing in the foreign jurisdiction concerned. See chapter 15.



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## 1.2 Path-dependence

The prediction of convergence has been challenged by a number of academic contributors who, as we have seen, point to obstacles that stand in the way of a global model for corporate law. Subsections 1.2.1–1.2.5 will analyse these barriers in turn.

### 1.2.1 Politics

Prominent legal scholars have propounded the view that political forces cause legal systems to develop path-dependently. Mark Roe points out that there are still significant differences between the corporate governance in different jurisdictions, caused by differences in their political orientation. He shows that there is a correlation between a social democratic form of government and certain corporate governance patterns.<sup>7</sup> Roe's view is, in principle, also endorsed by Peter Gourevitch, who refines it by pointing to the fact that it is not so much the form of present government, but the type of government that was in place when corporate governance structures established themselves, that matters. Gourevitch also stresses the fact that a distinction between left- and right-wing politics is too simplistic to account for the relevant political forces, in particular the influence of political interest groups that cut across the left/right political divide on corporate governance patterns.<sup>8</sup>

<sup>7</sup> For a comprehensive statement of this theory, see Mark J. Roe, *Political Determinants of Corporate Governance* (Oxford: Oxford University Press, 2003); for a discussion of Roe's central political thesis of corporate governance, see Peter A. Gourevitch, 'The Politics of Corporate Governance Regulation', (2003) 112 *Yale L. J.* 1864; for an international relations perspective, see Jeffrey N. Gordon, 'An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990–2000' (February 2003), European Corporate Governance Institute (ECGI), Finance Research Paper Series, <http://ssrn.com/abstract=374620>.

<sup>8</sup> The same point was made by Otto Kahn-Freund in the mid-1970s (Otto Kahn-Freund, 'On Uses and Misuses of Comparative Law', [1974] *MLR* 1–27). Notwithstanding differences in the terminology used, Kahn-Freund's view is similar to that put forward by Roe and Gourevitch, in that all three think that politics determines if convergence is possible. Otto Kahn-Freund argues that differences in the respective political systems determine whether or not legal rules can be transplanted from one legal system into another. Unlike Roe, Kahn-Freund does not point to a path-dependent form of legal development. He nevertheless stresses the importance of political factors. Kahn-Freund also anticipates the refinement of Roe's theory suggested by Gourevitch, pointing to the division of power between different interest groups as an influential factor which operates as a determinant of whether the transplantation of legal rules will be successful.

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Having identified the political orientation of a jurisdiction as a factor that influences corporate governance Roe, in an article written jointly with Lucian Bebchuk, criticises the convergence thesis.<sup>9</sup> Bebchuk and Roe do not say that convergence is impossible; they also do not say that convergence will occur. They point out only that there is one important obstacle that global forces driving towards convergence need to overcome: path-dependence. They distinguish between structure-driven and rule-driven path-dependence.

Structure-driven path-dependence occurs because the present relative distribution of power is a function of the distribution of power that existed at earlier times. To give an example, a jurisdiction in which companies were originally dominated by large shareholders has a tendency to continue to have concentrated ownership structures. There are two reasons for this. The first is that it may be cost-efficient to maintain a division of power; change costs money and, assuming that efficiency is what drives development, change will occur only when its benefit outweighs its cost. The other reason is politics. Incumbent power holders tend to have the ability to influence the political process in their favour. By influencing the political process, large German stakeholders, for example, are able to prevent a change to a structure with dispersed ownership even if such a change were efficient.

The concept of rule-driven path-dependence assumes that law influences ownership structures. If the law succeeds in effectively preventing majority shareholders from taking advantage of their influence, for example, concentrated ownership structures will not arise. Bebchuk and Roe refer to law as 'an additional, indirect (but important) channel through which the initial corporate structure might affect subsequent structures'.<sup>10</sup> Again, change will occur only when lawmakers conclude that the benefits of the change outweigh its cost. Moreover, the political pressure exercised by interest groups who disproportionately benefit from the current legal regime may prevent changes of legal rules, even if these changes were efficient and therefore in the public interest.<sup>11</sup>

It is important to note that in Bebchuk and Roe's analysis, ownership structure comes first and is in itself a function of politics or even 'historical accidents'.<sup>12</sup> Ownership structure then influences the

<sup>9</sup> Bebchuk and Roe, 'A Theory of Path Dependence' 127.

<sup>10</sup> Bebchuk and Roe, 'A Theory of Path Dependence' 138, 153–154.

<sup>11</sup> Bebchuk and Roe, 'A Theory of Path Dependence' 154–162.

<sup>12</sup> Bebchuk and Roe, 'A Theory of Path Dependence' 129.