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**REFLECTIONS ON THE SECURITIES HOLDING SYSTEM IN CROATIA
IN LIGHT OF THE UNIDROIT'S CONVENTION
ON INTERMEDIATED SECURITIES**

ABSTRACT

Securities holding systems are vital for the effective functioning of capital markets. They reduce the risks associated with transfer of securities between market participants; their smooth functioning depends from certainty as to the rights and obligations of different subjects. If there is no such certainty, the system is prone to legal risk and – in time of financial duress – to systemic risk as well. The purpose of this paper is twofold: first, to analyse the difference between various systems of holding securities and second (section 1 and 2), to assess the Croatian securities holding system (section 3). Our attention is especially focused on Croatian legislation governing securities, with emphasis on the national Central Clearing and Depository Agency. In section 4 we discuss the UNIDROIT's Convention on Intermediated Securities. Finally, section 5 discusses recent EU regulatory initiatives which are part of an overarching post-crisis reform agenda in the financial markets.

Key-words: *intermediated securities, securities holding system, Geneva Convention, central securities depository, Securities Law Directive*

1. INTRODUCTION

The purpose of this paper is twofold. First, we discuss the difference between various systems of holding securities and their development. We also point to the different legal options encompassed within the term of “book-entry securities”. Then our attention focuses on the efforts of the International Institute for the Unification of Private Law (hereinafter the UNIDROIT) with respect to changes in securities markets that have occurred over the last three decades – specifically the dematerialisation of securities and consequently their intermediated holding. We do this by discussing the result of such efforts, namely the UNIDROIT Convention on Intermediated Securities (hereinafter the Geneva Convention). Second, against this background we discuss the securities holding system in Croatia and we analyse how beneficial can the UNIDROIT's work in this area be for its future development. Regardless of the fact that the intermediary holding of securities is an accepted practice in Croatia, the issue received little attention by experts in the field; as a result relevant literature is almost non-existent. Thus, our goal is to assess the state of Croatian legislation governing securities holding system, with special consideration of the position of the Croatian Central Clearing and Depository Agency. In addition, we assess Croatia's preparedness to follow recent regulatory trends in this area, in order to enhance the stability of the national securities market and its cross-border compatibility (particularly important from the aspect of the EU accession).

2. DISTINGUISHING BETWEEN SECURITIES HOLDING SYSTEMS

In this section we discuss the difference between direct and indirect holding systems of securities. It is very difficult to divide national systems into these clear-cut categories. The reality is heterogeneous, with the two categories encompassing a wide range of legal options each of them with its own peculiarities. We begin our analysis with a historical background to the development of securities holding systems and the evolution of the form of securities.

One of the crucial innovations of securities markets was the incorporation of investors' intangible rights into certificates which represented negotiable instruments that could easily be transferred between subjects. By transforming intangible rights into a tangible property, investors were able to prove their ownership by holding certificates and to dispose their investment by delivering them to purchasers or lenders in a securities lending transaction (*e.g.* repurchase agreements). The sale and purchase or lending of securities could be carried out in a manner similar for any other moveable; one party delivered the certificate representing the underlying security to the other. The delivery also transferred the title in securities, thus constituting a settlement¹. Through the circulation of certificated securities, capital flows between investors. By mid-20th century the volume, number of issues, and turnover speed made the delivery of certificated securities impractical and costly. In addition, the level of operational risk connected with the physical handling of certificates was not acceptable anymore². These events induced a growing number of countries to transition from direct holdings of certificated securities to indirect holdings of uncertificated securities through one or more custodians, such as banks or other specialised financial institutions. *Dematerialisation* and *immobilisation* of securities were the innovative solutions. Physical securities that were certified became unnecessary, and thus replaced by an "issue account" against which dematerialised securities were credited (that is to accounts of market participants) and transferred by means of "book-entry". Dematerialised securities take the form of a book-entry on a securities account which are opened either with an intermediary responsible to open accounts for its clients' final investors or directly in the books of the issuer. Immobilisation means that securities are held in custody of reliable depositories and represented by entries in securities accounts which were maintained by financial intermediaries for the investors³.⁴We also point that these intermediaries are usually investment firms or credit institutions whose operations and obligations are governed by specific legislation⁵.

Nowadays, in almost all regulated markets worldwide, the securities issued and listed by different companies are dematerialised⁶. Furthermore, the relation existing between the substantial owner of securities to these securities and the issue of directness of this relation and of its interruption by the imposition of an intermediary determines the type of securities holding system in practice. There are two basic types of securities holding systems: direct and indirect. In this analysis we depart from a basic presumption; that all book-entry securities

¹ Kronke, H., (2008): "The Draft Unidroit Convention in Intermediated Securities: Transactional Certainty and Market Stability", *Current Developments in Monetary and Financial Law*, 5: 619-643.

² See Thèvenoz, L., (2007): "Intermediated Securities, Legal Risk, and the International Harmonization of Commercial Law", *Duke Law School Legal Studies Research Paper No. 170*; available at: www.ssrn.com

³ See Garcimartín Alférez, F. J., (2006): "The UNIDROIT Project on Intermediated Securities: Direct and Indirect Holding Systems", *Revista para el análisis del derecho*, 324: 3.

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⁵ In the EU these are the Markets in Financial Instruments Directive and the Second Banking Directive.

⁶ Diathesopoulos (2010) notes that in the UK and USA paper securities still constitute an important ratio of overall traded securities. The rationale for this may be found in their legal tradition, and their long-standing trading infrastructure concerning paper securities. See Diathesopoulos, M. D., (2010): "Interests in Securities Under a Comparative Law Approach", *PFESR Annual Review*; available at: www.ssrn.com

systems are *de facto* intermediated and in this sense indirectly held⁷. In other words, a third party that exerts control over the books or the registry comes between the issuer and the holder of the security. However, one must be careful in distinguishing between securities holding systems upon this presumption; the difference between direct and indirect holding systems is not practical and does not depend on whether the investor physically possesses the security, but rather it is legal and it depends on the way in which a legal system prevents custody risk and facilitates the exercise of investors' corporate rights in the case of intermediated securities. Does the intermediary act as a mere agent or a facilitator for the investor or does the intermediary appear as the owner of the securities in the issuer's registry?

In direct holding systems intermediaries only have the function of a book-keeper and have no legal interest in the underlying securities, while in indirect holding systems a number of intermediaries comes between the end-investor and the issuer of securities. In discussing direct holding systems one has to keep in mind that there is a difference between their earlier versions⁸ and the "modern direct holding system". We will focus solely on the latter type. In a modern direct holding system investors maintain a direct legal relationship with the security's issuer. As investors are direct owners of all the rights incorporated in the security, their interests in the intermediary is limited to the exercise of these rights. The central securities depository (hereinafter the CSD) operates thousands of investors' accounts. These accounts are opened directly with the investor and as such are known as "owner accounts". In a modern direct holding system the legal framework ensures that account holders at the CSD are the owners of shareholder rights against the issuer of securities. To this aim, the intermediary – or the CSD – holds the accounts without having any right to the securities. The CSDs have the ability to access the identity of investors in real time irrespective of the complexity of the mediation chain. Furthermore, all positions of beneficial owners are registered, meaning that their identity is known to the issuer or the central securities depository. These systems are considered to be transparent, "direct holding" systems⁹.

Certain jurisdictions (most notably the US) consider that the process of intermediation requires creation of new legal concepts: *an entitlement over the securities different from the underlying securities and derived from the position of the intermediary*¹⁰. In this way, they create a new form of proprietary rights better suited for investor protection with respect to intermediated securities. The term "indirectly held securities" has lately been described as referring to securities held on account by an intermediary, therefore differentiating them from securities held by owners in paper form. The existence of an account being administered by someone with whom the holder has an agreement – following certain regulation – is the fact that necessitates special attention. If the person, responsible in relation to the account holder for the administration of the account, is called an intermediary then all intermediaries are CSDs and all securities held on CSD accounts are indirectly held. This system is also known as a "multi-tiered holding system" as it usually consists of one or more tiers of intermediaries between the issuer and investor. In this case, the interests of investors are recorded in the files of the intermediary, who in turn records these securities in the files of another intermediary, and so on until an intermediary appears as the owner of the securities in the issuer's registry.

⁷ See Garcimartín Alférez, F. J., (2006): "The UNIDROIT Project on Intermediated Securities: Direct and Indirect Holding Systems", *Revista para el análisis del derecho*, 324: 3.

⁸ An early direct securities holding system is associated with paper securities, and was exercised before the era of immobilization and dematerialisation. In this system transfer of the interest in securities (ownership) was executed through physical delivery of certificates from the seller to the buyer.

⁹ According to the Report of the UNIDROIT, transparent systems are divided into three categories. In the first there is no mediation chain and intermediaries settle their transactions directly through the management of their accounts by the CSD. In the second category, on upper level of chain in CSD accounts are maintained in the name of the intermediary, but are divided into several sub-accounts for each account-holder client of the intermediary reflecting the number of shares that each client owns. The third category covers systems where there is an account at the level of CSD in the name of the intermediary reflecting the total amount of securities held by the intermediary on behalf of its clients. See UNIDROIT Committee of Governmental Experts of a Draft Convention on Substantive rules regarding intermediated securities, *Report of the Transparent Systems Working Group – Study LXXVIII*, Doc. 88 (Rome: 2007); available at: www.unidroit.org

¹⁰ *Ibidem*.

Schwarcz (2001) describes indirect holding systems as those where investors generally record ownership of their securities as belonging to one or more depositories. Although securities held with a depository are often evidenced by physical certificates these certificates remain in the possession of the depository and are never delivered to third parties. The depositories in turn, record the identities of other intermediaries, such as brokers or banks that purchase interests in these securities. And those other intermediaries record the identities of investors that purchase interests in the intermediaries' interests¹¹. In short, the indirect holding system functions as a chain where various intermediaries are the links between the issuer and the original investor. The transfer of interests in securities is performed through book-entries and no physical delivery of securities is required.

In order to perform a credit or a debit (depending whether there is a purchase or sale of securities) on the individual securities account the end-investor must hold a securities account with a custodian in the system, which is usually kept in the form of Collective Securities Accounts. This is in fact a chain of sub-custodians, starting from the CSD authorized with respect to the place of the transaction to the end-investor's custodian, who has their individual securities and monetary account (either themselves or through a credit institution) and a dematerialised movement of securities with entries in accounts kept in more tiers (Diathesopoulos, 2010, 24). In the first tier the CSD registered in the books of the issuing company keeps securities accounts for its members (*e.g.* brokers, custodians) to whom it is contractually bind. Typically the CSD has to provide a final file with information related to people who act as owners of securities kept and that are entitled to securities rights. In the next tier members either hold accounts for other intermediaries or individual accounts for their customers' end-investor. Therefore, unlike in direct holding systems, the end-investor may exercise their rights deriving from securities (and against the issuer) either through their custodian (who may exercise such rights either directly or by authorising another intermediary in case there is more than one intermediary in the system) and they cannot directly claim securities entered in a Collective Securities Account kept by an intermediary of a next tier¹². Therefore, end-investors may exercise their rights only indirectly.

The two securities holding systems are obviously very different from a legal aspect, but how does their nature relate to an economic context? Diathesopoulos (2010) argues that one of the main advantages of an indirect holding system is the reduction of the investors' total cost, which is not required to open individual securities accounts in each clearance and settlement system operating in every market he invests in. More specifically, this type of system organisation is appropriate for well developed securities markets opened to international activities. In fact, it allows international and institutional investors a certain relation to a custodian, typically an international one, who undertakes to further organise the investor's equity participations in each country and their custody, through local custodians (usually brokers, credit institutions, Units for Collective investments in Transferable Securities or mutual funds, acting on behalf of end-investors and not as end-investors themselves¹³). Furthermore, the indirect holding system reduces the risks associated with transfer of securities as it allows rapid disposition of the interests nationally and internationally through the system of book-entries by one or more intermediaries¹⁴.

¹¹ See Schwarcz, S. L., (2001): "Intermediary Risk in a Global Economy", *Duke Law Journal*, 50(6): 6.

¹² See *supra* note 5, p. 24.

¹³ More on the legal nature and economic strategies of these investors can be found at: http://ec.europa.eu/internal_market/investment/index_en.htm

¹⁴ Nevertheless, it cannot be argued that the indirect holding system is completely immune from certain vulnerabilities. An obvious one is that in such a system the issuers do not know the identity of their securities' beneficial owners; they typically know only the identity of the intermediary.

3. SECURITIES REGULATION AND THE SECURITIES HOLDING SYSTEM IN CROATIA

Although Croatian securities regulation follows the European and thus, international regulatory trends and specifications (and in doing this Croatia is very well prepared) what is striking is that there is virtually no information or relevant studies regarding the type of the securities holding system exercised or adopted regulation. Hence, an analysis of this issue is long overdue, especially when considering its evidenced economic impact. Before entering the merit of the discussion in this section let us first briefly explain the economic nature of securities. Securities are a type of financial assets. They are created through the interaction of two persons, which are bound together either by statutory provisions or contract, from which the asset derives its value. Securities are intangible assets whose financial value is dependent from the future business performance of its issuer¹⁵. From the investor's point of view securities operate in two capacities: (i) they constitute personal rights against the issuer, and (ii) they represent an asset. The interest of the *issuer* is to follow clear and transparent rules regarding in favour of whom it must fulfil the obligations incorporated in the security. 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)¹⁶. The way in which the latter risk is mitigated depends on the way the security is represented within a legal system (whether it is a direct or indirect holding system).

Regulation of securities in Croatia owes its speedy development to the harmonisation requirements with the European *acquis*. Croatia's political choice to become an EU Member State and its negotiation toward accession has greatly contributed to the development of capital market regulation, and as such to securities law. A textbook example of this development is the Capital Markets Act, which came in force in January 2009 (*Zakon o tržištu kapitala*, OG No. 88/2008, 146/08, 74/2009) and replaced both the Act on Issuance and Transactions with Securities and the Securities Market Act (*Zakon o izdavanju i prometu vrijednosnim papirima*, OG 107/95, 142/98, 87/00; *Zakon o tržištu vrijednosnih papira*, OG No. 84/02 and 138/06). The Capital Markets Act (hereinafter the CMA) incorporates the EU directives and regulations thus fully aligning Croatian legislation in this area with the EU regulatory requirements¹⁷.

According to Croatian law¹⁸, securities can be represented in two forms: as a physical document (certificated securities) or as an electronic entry. In the first case, the contractual claim with respect to the issuer of the security cannot be separated from the material certificate, meaning that from the actual physical transfer of the certificate (or the endorsement of a registered security) follows the transfer of the entitlement to the rights incorporated in the security. In the second case, and according to s. 490(1) of the CMA, the security is represented by electronic information recorded in a registry. Thus according to the law, the creation, the transfer and the exercise of rights can only take place as a consequence of entries in an electronic registry. In addition, securities may be issued as registered or bearer securities. Although in principle issuers of securities are free to determine the manner of representation of their securities, s. 490(2) and (3) of the CMA in line with the general

¹⁵ See Moloney, N., (2008): EC Securities Regulation, 2nd edition, (Oxford: Oxford University Press), p. 53.

¹⁶ See *supra* note 6.

¹⁷ It is the author's opinion that the Capital Markets Act is of somewhat poor legal quality, in the sense that it lacks a more streamlined approach to its regulatory objectives and instruments used. When reading the legislative text one comes to a conclusion that Croatian legislators wished for the remainder of EU law to be incorporated as soon as possible in Croatian legislation. The result is a non-coherent legislative text with some hastily found nomenclatures and provisions, which is detached from the Croatian legislative tradition in the area of securities and company law. In general, the Capital Markets Act concurs fully to the impression of EU decision-makers which seldom pointed to Croatia's *ad hoc* approach to measures of economic and financial policy. However, it has to be noted that the mere existence of this legislative text provides a starting point for further sophistication in the capital markets regulation.

¹⁸ See s. 1135 of the Civil Obligations Act, Official Gazette No. 35/2005.

provision mandated by s. 1135(2) of the Civil Obligations Act, provide that the book-entry form of representation (*i.e.* the issuance of dematerialised securities) is obligatory for all issuers registered within Croatian territory and who want to offer their securities by means of public offering, as well as all credit institutions, investment firms established as joint stock companies, insurance undertakings and close-end investment funds. For these types of securities, Croatia – similar to other European countries – has opted for a fully dematerialised scheme and immobilisation (see s. 490(1) of the CMA).

Irrespective of the argument put forward by Goode (1996, 167) and which states that, unlike full dematerialisation, immobilisation affects the direct relationship between investors and issuers, we argue that Croatia follows a “modern” direct holding system. In this system the majority of the securities are now intermediated, and *de facto* held indirectly. This is partly the result of the assumption made by Croatian legislators that dematerialised securities don't call for a radical change in the regulatory and conceptual framework traditionally applied to securities. Naturally, Croatian securities and company law had to be modified in order for them to be adapted to the technical and operational peculiarities of book-entry securities. The majority of adaptations regarded investor protection, where physical possession of the certificate as a form of protection, had to be replaced by an electronic registry that could fulfil the function equivalent to physical possession¹⁹.

The Croatian securities holding system is based on the idea of a single registry where entries of securities traded on regulated and unregulated markets take place. The central depository in Croatia is the Central Clearing and Depository Agency (*Središnje Klirinško Depozitarno Društvo*; hereinafter the CCDA). The CCDA was established in April 1997 as a joint stock company (*dioničko društvo*) under a somewhat different name but encompassing the same activities that it carries on at present. As for its ownership structure, the Republic of Croatia is a majority shareholder (it holds 62.30% of ordinary shares), followed by other participants in the capital market (such as banks, brokers, and exchanges) and the Croatian Financial Agency (*Financijska agencija*). In line with the provisions of the Capital Markets Act, as well as the Regulations and Guidelines²⁰, some of the most important activities of the CCDA are:

- (i) management of the central depository of dematerialised securities;
- (ii) management of the clearing and settlement system for securities transactions concluded on regulated and over-the-counter markets (OTC), as well as on multilateral trading facilities (MTFs)²¹;
- (iii) determining unique identification numbers for dematerialised securities²².

In our analysis of the securities holding system exercised in Croatia and our argument in favour of a modern direct holding system, we rely heavily on these CCDA's legal documents.

In Croatia, investors often hold their securities on accounts opened directly with the CCDA (the so called “owner accounts” or “*osnovni račun*”²³). Therefore the Croatian securities holding system can be described as direct at first glance. However, the owner can

¹⁹ To this end the obligation of custody of materialized documents was replaced by the obligation of keeping a book-entry registry, the principle of good faith acquisition based on the appearance of physical possession was replaced by the acquisition based on the appearance of the electronic registry, the transmission by physical delivery was replaced by entries in the registry, and so on.

²⁰ *Pravila Središnjeg klirinškog depozitarnog društva d.d.*, Zagreb 7.05.2009; and *Uputa Središnjeg klirinškog depozitarnog društva d.d.*, Zagreb 7.05.2009. The Regulations and Guidelines are available in Croatian language from: www.skdd.hr

²¹ OTC markets are markets organized for trading securities that are not listed on an organized stock exchange (*i.e.* regulated market). A MTF is a multilateral system, operated by an investment firm or market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II of the Markets in Financial Instruments Directive. See Fitch, T. (1990): “*Dictionary of Banking Terms*”, (New York Hauppauge: Barron's), and Directive 2004/39/EC, available at: <http://eur-lex.europa.eu>

²² These are the International Securities Identification Number (ISIN) and the Classification of Financial Instruments code (CFI).

²³ See s. 104 of the *Uputa Središnjeg klirinškog depozitarnog društva*, Zagreb 7 May 2009, available in Croatian from: www.skdd.hr

assign another person to “hold” the securities, therefore a “nominee account”²⁴ (“*zastupnički račun*” and “*skrbnički račun*”²⁵) is also allowed. On these accounts it is noted that the account holder is holding the securities for the benefit of one or more investors. Thus, this type of holding does not interfere with the exercise of investors’ rights, which is also concurrent with our categorization of the Croatian securities holding system as direct. Furthermore, we support our argument of a direct holding system with the provision of s. 103 of the CCDA’s Guidelines which states:

“Every entity registered in the depository is registered as an investor or as an owner/nominee of an account, regardless of the fact whether the investor is the actual holder of the security, or one of the co-owners, legal or other representative, or a proxy authorized to exercise voting rights or whether he/she holds securities for a third party.”

We have already stated that in a modern direct holding system, the issuer of securities knows the end-investor, his/hers identity is disclosed. The provisions of s. 286 of the CCDA’s Guidelines regulate access to information related to accounts holders:

“Issuers of dematerialised securities have the right to access information regarding the type, class, quantity, proprietary rights and the persons entitled to these rights, as well as on the restrictions imposed on proprietary rights associated to dematerialised securities and the registration history of dematerialised securities and which regard the issuer’s accounts of dematerialised securities, as well as to information regarding the type, class, quantity, proprietary rights and the persons entitled to these rights, as well as on the restrictions imposed on proprietary rights of other holders of dematerialised securities issued by the same issuer.”

This model of central record-keeping of dematerialised securities established under Croatian law permits to maintain the conceptual framework of direct holding. The name of the owners of the securities appears in the detailed registries of the CCDA, and those owners, *i.e.* investors have direct rights in relation to the issuer and third parties, including the right to receive and enjoy the fruits of ownership of the securities, the right to dispose of the securities, and so on. The intermediary holds the accounts without having any right on the shares. Naturally, in order to exercise the rights arising from securities the owner may require the assistance of the intermediary, but nevertheless these are still rights of the investor whilst the intermediary acts in the capacity of an agent or an authorized person.

4. THE UNIDROIT CONVENTION ON INTERMEDIATED SECURITIES

The UNIDROIT Convention on Substantive Rules for Intermediated Securities²⁶ (the Geneva Convention) was adopted on a diplomatic convention held in Geneva in October 2009. The Geneva Convention represents the culmination of regulatory efforts made through an extensive negotiation process which started in 2002. As such, it is a major breakthrough in global harmonisation in what is probably one of the most complex and economically significant areas of financial regulation, which is securities law. The scope of the Geneva Convention is to improve the regulatory framework for securities holding, transfer and collateralisation, in order to enhance the internal stability of national financial markets and their cross-border compatibility (Estrella Faria, 2010, 196). The UNIDROIT intends to continue its research within projects relating to transactions on transnational and connected capital markets and considers the Geneva Convention to be one of the first instruments developed as part of its research.

²⁴ In such an account the nominee is permitted to do only acts that are strictly necessary to maintain the client’s holding of securities. In addition there are several other accounts that entities may hold at the CCDA (“*trezorski račun*”, “*račun portfelja*” and so on). In all of these accounts the end-investor is disclosed and as such known to the issuer.

²⁵ *Ibidem*.

²⁶ Available at: <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm>

The transformation of market practice of holding and disposition of securities which we have discussed in previous sections of this paper meant that many countries have revised their legal framework applicable to the holding of securities in order to better suit market trends. However, in many countries, the legal framework which underlined the securities holding system was built on traditional legal concepts which were first developed for the traditional method of holding and the disposition of certificated securities. As a result, considerable legal uncertainty is caused by the fact that securities are widely transferred across borders whilst the applicable law remains uncertain, and thus the legal risk connected with these transaction increases. Henceforth, legal risk can in time of financial duress even trigger systemic risk (as was also demonstrated by events during the last economic and financial crisis) which in this way originates from capital markets; and from the aspect of financial stability it is very important to have effective capital markets. Several international initiatives addressed this issue, for instance the 2001 Recommendations issued by the International Organisation of Securities Commission, the 2003 G30 Plan of Action, and the 2006 Report on cross-border collateral arrangements of the Bank for International Settlement²⁷. On an EU level, the Report of the Giovannini group is the cornerstone for every analysis in this area²⁸. The wider community recognized the need for a reliable regulatory framework adapted to the modern securities holding system as a crucial element for efficient capital markets, and the protection of all participants – first of all investors, but also issuers of securities, clearing and settlement organizations and parties to collateral arrangements involving dematerialised securities. Private international law also addressed this subject by adopting the Hague Convention on the Law applicable to Certain Rights in respect of Securities held with an Intermediary in December 2002²⁹. However, its legal nature and orientation toward conflict-of-law rules means that the Convention does not address issues of substantive law.

During its negotiation the drafting of the Geneva Convention was guided by several policy goals (Estrella Faria, 2010):

- (1) to secure *internal soundness of systems* with respect to investor protection;
- (2) to ensure *compatibility of different legal systems* that should converge with respect to company law and financial supervision to some extent, when regulating cross-border securities transactions;
- (3) to ensure *validity of book entry accounts* which would dismiss any doubts regarding the effectiveness and finality of an interest represented by a book entry debit or credit;
- (4) to follow a *neutral and functional approach*, as the convention tries to accommodate different legal systems and traditions;
- (5) to use a “*minimalist*” approach to regulatory intervention only in those issues which clearly lack uniformity and from which systemic risk may arise, as well as to secure *compatibility with other policy instruments* (such as EU law or international regulations).

Let us now discuss the sphere of application of the Geneva Convention. A general observation is that the sphere of application of international conventions and other forms of international *soft law* in the field of financial regulation is often defined by a general description of the subject covered and a reference to some element of internationality. However, this is not the case with the Geneva Convention. As the high level of interdependency in contemporary financial markets makes the distinction between “national” and “international” obsolete, the Geneva Convention opted for the possibility to become part

²⁷ See Committee on Payment and Settlement Systems and the Technical Committee of the international Organization of Securities Commissions, *Recommendations for Securities Settlement Systems*, (Basel, BIS, January 2001), available at: www.bis.org; The Group of Thirty, *Global Clearing and Settlement – A plan of Action*, (Washington, D.C, 2003); available at: www.group30.org ; Committee on Payment and Settlement Systems, *Report on cross-border collateral arrangements*, (Basel, BIS, January 2006), available at: www.bis.org

²⁸ The Giovannini Group, *Second Report on EU Clearing and Settlement*, (Brussels, 04/2003), available at: www.ec.europa.eu

²⁹ Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary, adopted under the auspices of The Hague Convention on Private International Law, (The Hague, 12/2002), available at: www.hcch.net

of the substantive law of a Contracting State. Therefore, whenever the law of a Contracting State is the applicable law for matters covered by the Convention, the provisions of the Geneva Convention apply (rather than the State's law).

The key elements regulated by the Geneva Convention are the following three terms: “*intermediated securities*”, “*intermediary*” and “*securities account*”. According to s. 1(a), (b) an “intermediated security” refers to any share, bond or other financial instrument or financial asset, capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of the Convention and which have in fact been credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account. Following the provisions of s. 1(c), (d) we can define a “securities account” as an account to which securities may be credited or debited and which is maintained by an “intermediary”, that is, a person who in the course of a business or other regular activity maintains securities accounts for other or both for others and for its own account and is acting in that capacity. Among central banks, credit institutions and brokers, that can be considered as intermediaries by deduction the Geneva Convention expressly includes Central Securities Depositories (CSDs). As for the types of securities regulated, the Geneva Convention mandates two characteristics:

- (1) they must be capable to be credited to securities accounts held by an intermediary and
- (2) they must be capable of being acquired or disposed of in accordance with the Convention's provisions³⁰.

The Geneva Convention does not provide an exhaustive list of securities included under its framework, but we can conclude that the Convention's provisions apply to bearer and registered securities, securities represented by individual certificates, those represented by a global certificate as well as purely dematerialised securities. Thus, the Geneva Convention excludes certificated securities held physically and directly by an investor as well as securities registered directly with an issuer in the name of investors.

An interesting observation has to be made at the end of this discussion regarding the limitations of the sphere of the Convention's application. The Geneva Convention doesn't define the term “issuer”. The interpretation of this term is not problematic with respect to issuers of “traditional” securities such as shares and bonds, but in structured financial products, such as asset-backed securities for instance, it is more complicated to determine the issuer. Such issues, which are not addressed by the Convention, will be the subject of UNIDROIT's further efforts; the UNIDROIT will surely compose a document which will serve as a guideline in relation to these issues, or it will allow Contracting States to provide otherwise³¹.

5. EU REGULATORY INITIATIVES WITH RESPECT TO SECURITIES HOLDING SYSTEMS

Looking at the various securities holding systems currently exercised across EU Member States, at first glance we will note a somewhat irreconcilable difference between the “direct ownership-book entry intermediation” approach of most civil law countries, and the “derivative property” approach of common law countries. It must be noted however, that EU legislation does not regulate the prerequisites neither for book-entry keeping nor for custodian services provision. The perspective under which the majority of EU Member States developed ruled regarding securities holding systems was driven by practices of local stock exchanges and referred mostly to domestic issuers. The reason for this is the lack of links between

³⁰ See s. 12 of the Geneva Convention which deals with acquisitions and dispositions of intermediated securities by three additional methods (other than credits or debits).

³¹ To this end the UNIDROIT Secretariat has started to prepare an Accession Kit to the Convention that will provide advice for countries that ratify the Convention on how to incorporate its provisions and integrate the Convention into their national legal systems.

issuers and the CSDs governed by different legislations, due to the fact that the Member States company legislation governing the issuer, in the absence of harmonization, cannot establish rights and obligations regarding book-entries kept by foreign intermediaries³². As a result, the regulatory framework in force across Member States governing holding and transactions of securities through securities accounts differs considerably. Additionally, national rules often prohibit the depositing of securities issues in a Member State different from the one in which the issuer is registered. In December 2008 the European Commission affirmed that legislative intervention in this area, at a supranational level, would provide for a more harmonised legal framework for intermediated securities and a better protection of investors' rights. On top of legal uncertainties caused by the current situation in this area, some costly operational consequences emerged as well – holding chains of securities are more complicated than necessary and restrictions hamper competition as well as operational efficiency. Thus, it is a common stance that EU law should regulate the legal framework governing the holding and disposition of securities held through securities accounts and the processing of rights flowing from these securities. Although the issue and its possible solutions are legal in nature the underlying problems have a significant economic impact.

Against this background, the Commission is preparing a draft Directive on legal certainty of securities holding and transactions (hereinafter the Securities Law Directive or SLD)³³. This draft Directive is a result of policy efforts made in consultations with the Legal Certainty Group – a group of legal experts that advises the Commission on legislation that should be adopted in the field of securities holding. The Directive is expected to address three issues:

- (i) the legal framework of holding and disposition of securities held in securities accounts;
- (ii) the legal framework governing the exercise of investor's rights flowing from securities through a "chain" of intermediaries, in particular in cross-border situations;
- (iii) the submission of any activity of safekeeping and administration of securities under an appropriate supervisory regime³⁴.

The SLD comes as part of an extensive regulatory reform package that will shape the post-crisis market environment in which investors will operate. The Directive's aim is to dismantle some of the so called Giovannini Barriers to safe and effective cross-border clearing and settlement of securities in the EU³⁵. It is important to note that the Directive does not seek to harmonize whom the issuer of the securities has to recognize as the legal holder of its securities. To harmonize the national laws of legal ownership of shares between Member States would be highly impractical and unnecessary. In fact, this would require intervention into core legal areas and concepts (such as property law, company law, etc.) which vary greatly across EU countries, and not all Member States would be ready to accept such supranational intervention.

The envisaged European approach is completely compatible with the Geneva Convention as a global instrument for the substantive law of holding and disposition of securities. This is a certainly a complicated area of law and the scope of the SLD seems wide enough to cover the majority of issues. At the same time this "broad coverage" may cause some problems as the Directives brings into its remit some unconventional securities such as derivatives and fund units. Similarly, the term "account provider" includes custodians, nominees, UCITS and other potential depositories. One of the cornerstones of the SLD is to ensure that the ultimate account holder enjoys equal rights with the registered shareholder.

³² Tsibanoulis, D.: Scope, Legal Certainty Project, Brussels 26.03.2006, available at: www.ec.europa.eu, p. 2.

³³ This piece of EU legislation should be finalised by mid-2011 and transposed at national level by mid-2012.

³⁴ See: http://ec.europa.eu/internal_market/financial-markets/securities-law/index_en.htm

³⁵ For more information on these barriers and other findings related to the EU securities clearing and settlement systems see the report of the Giovannini Group.

Available at: http://ec.europa.eu/internal_market/financial-markets/clearing/communication_en.htm

Moreover, the Directive's "value added" contribution is to convert account-provision into a fully fledged investment service for the purposes of the Markets in Financial Instruments Directive³⁶. This is because the objective of European policymakers is to ensure that persons providing accounts are duly regulated in the same way as investment firms.

6. CONCLUSION

Even though the regulation of intermediated securities takes place in a global and competitive marketplace, the existing legal regimes are notable for their stark national differences in the regulation of intermediaries and secured transactions. This paper has discussed recent regulatory developments in this area, focusing primarily on the functionalist approach of the Geneva Convention. Its flexible approach accommodates both types of securities holding systems. This is a result of the UNIDROIT's regulatory intention – namely the drafting of functional rules and the setting out of certain legal features of intermediated securities without prejudice to the fundamental characterisation of the interests which account holders derive from credits to their securities account. Croatia was quick in adopting EU legislation in the area of securities markets; this also included the manner in which securities are represented (*i.e.* mainly dematerialised) and held – indirectly with a central securities depository. But the true effects of this regulation on the market have yet to emerge. For the time being, the Croatian system of modern direct holding of securities is adequate to the modest needs of the national capital market. As the EU trend of more market-oriented economies has come to a halt, and at time when policy confusion is cleared with new regulatory interventions, unhurried thinking is a highly praised virtue. In the end, why should Croatia develop its securities market more aggressively? It is our opinion that a market-oriented economy is not equally beneficial for all countries. What Croatia needs is a more studious approach to securities markets – about its functions, the regulatory environment it is based upon, and about the direction that the EU law and international regulations will lead.

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³⁶ Directive 2004/39/EC.

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PROMIŠLJANJE O SUSTAVU DRŽANJA VRIJEDNOSNICA U HRVATSKOJ U VEZI S UNIDROIT KONVENCIJOM O POSREDOVANIM VRIJEDNOSNIM PAPIRIMA

SAŽETAK

Sustavi držanja vrijednosnih papira su od vitalne važnosti za efikasno funkcioniranje tržišta kapitala. Oni umanjuju rizike povezane s transferom vrijednosnica između sudionika na tržištu; njihovo glatko funkcioniranje ovisi o sigurnosti u prava i obveze raznih subjekata. Ukoliko takva sigurnost ne postoji, sustav je podložan pravnom riziku a, u vremenu financijskih prisila, i sustavnom riziku. Cilj ovog rada je dvostruk: prvo, analizirati razliku između raznih sustava držanja vrijednosnih papira, drugo (1. i 2. dio), procijeniti hrvatski sustav držanja vrijednosnih papira (3. dio). Posebnu pažnju pridajemo hrvatskom zakonodavstvu na polju vrijednosnica, s naglaskom na državnu Centralnu depozitarnu agenciju. U 4. dijelu raspravljamo o UNIDROIT Konvenciji o međunarodnim vrijednosnim papirima. Na kraju, u 5. dijelu se govori o novijim regulatornim inicijativama u EU koje su dijelom plana reformi financijskih tržišta poslije krize.

Ključne riječi: *posredovani vrijednosni papiri, sustav držanja vrijednosnih papira, Ženevska konvencija, centralni depozitar vrijednosnih papira, direktiva o zakonu koji regulira vrijednosnice*