SHAREHOLDING IN EU: IS "INDIRECT HOLDING" APPROACH APPROPRIATE IN ACHIEVING FINANCIAL INTEGRATION?

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Abstract[1]

The purpose of this paper is to focus on the specific "shareholder's" concept of transparency. It considers that indirect securities holding systems limited the degree of "post-trading" transparency. The main concern is that, in the effort to satisfy the need for globalizing the markets, implementation of said system had the adverse effect the real shareholders not be registered as such in the official registries and registrations to be effected in the name of intermediaries, acting on their behalf. It considers that new EU legislative action should be taken to address the legal effects of securities holding, as this field is of utmost importance in completing securities markets integration. To this end, the paper proceeds to propose a new architecture of securities holdings' markets which takes into account, on the one hand, the need to facilitate cross border functioning of EU internal markets and, on the other, the need to satisfy an appropriate degree of transparency in the "post trading" field.

Keywords: Corporate Governance, Shareholder's Transparency, E.U. Legislation, Mifid, Indirect Holding Approach

JEL classification: K22, G32, G34

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1 Introduction

One of the key aspects of the proper functioning of capital markets is "transparency". The principal of transparency has been broadly recognized in the financial sector and constitutes a milestone of most EU directives. Such directives are, among others, "Transparency Directive" (2004/109/EC) that implements transparency in the area of periodic reporting, ongoing disclosure and disclosure of major shareholdings for issuers; "Prospectus Directive" ((2001/34/EC) that stipulates the particular issuer's and securities' information requirements that a prospectus has to fulfill in enabling investors to make informed investment decisions; "MiFID" (2004/39/EC) that focuses on transparency organizational requirements of investment firms, best execution and reporting conduct of business requirements, as well as pre-trade and post-trade transparency obligations of investment firms; "Market Abuse Directive" (2003/6/EC) that aims at protecting the markets from insider dealing and market manipulation; "Banking Consolidation Directive" (2006/48/EC) that imposes among others particular corporate governance obligations to credit institutions aiming at achieving transparent lines in their administrative and accounting procedures; "Capital Adequacy Directive" (2006/49/EC) that establishes particular reporting requirements on credit institutions and investment firms in effecting adequate levels of transparency with regard to their capital adequacy; "Accounting Directive" (78/660/EEC) and, specifically, its new rules on establishing obligations in the listed companies to disclose an annual corporate governance statement, and last, but not

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least, "Shareholders Rights Directive" (2007/36/EC) that aims at solving cross border shareholding problems, mainly by seeking to address the following issue: "in case of securities holding systems where shares are held via chains of intermediaries acting across borders, who the shareholder is, or, put it differently, who is entitled to participate and vote in the shareholders' meeting".

It is apparent that transparency is a key component in effecting EU financial integration not only in the field of capital markets law but also in the one relating to corporate law. It is of utmost importance for the proper functioning and stability of the markets not to have legal uncertainty on the identity of the shareholder is and how the shareholders' rights towards the issuing company can be exercised.

The purpose of this paper is to focus on this specific "shareholder's" concept of transparency. It considers that indirect securities holding systems limited the degree of "post-trading" transparency. The main concern is that, in the effort to satisfy the need for globalizing the markets, implementation of said system had the adverse effect the real shareholders not be registered as such in the official registries and registrations to be effected in the name of intermediaries, acting on their behalf. To this end, indirect holding patterns raise many issues not only on the shareholding functioning but also on the functioning of the capital markets as a whole. In this scope, the paper examines the appropriateness of indirect holding patterns. It considers that new EU legislative action should be taken to address the legal effects of securities holding, as this field is of utmost importance in finalizing the markets integration. To this end, the paper proceeds to propose a new modeling of securities holdings' markets which takes into account, on the one hand, the need to facilitate cross border functioning of EU internal markets and, on the other, the need to satisfy an appropriate degree of transparency in the "post trading" field.

The remainder of the paper is organized as follows. Section 2 presents the direct and indirect holding systems. In section 3 we discuss the transparency issues related to the property nature of book entry securities as "intermediated securities". Section 4 presents the transparency issues related to the shareholders "register". In Section 5 we present the legal differences between the cash deposits and securities deposits with our suggestions and concluding remarks given in the Section 6.

2 Book entry securities: The direct and indirect holding systems

In today's securities markets, securities are held in a "book entry" form. As securities are paperless, either dematerialized or immobilized, are held through accounts that the intermediaries keep for their portfolios or the portfolios of their clients in the official central securities depositories (CSDs) or registries. This electronic status of establishing property rights in securities arose as a consequence of globalization. Trading, commerce and, generally, free movement of securities can be better achieved throughout the world if it crosses borders and, therefore, expands the scope of potential "clients" to all markets concerned.

Integration of securities markets became an issue of great importance in implementing EU internal market in the financial sector. In this context, EU initiatives and relevant harmonization steps covered most of capital market aspects, including EU passports on services, products, marketplaces, issuers, infrastructures, service providers etc. Therefore, currently substantial effort is given at an EU level to harmonize "post trading" patterns. This refers not only to clearing and settlement infrastructures but also to securities holding in this modern book entry form.

Lack of harmonization in the securities holding field has been characterized as one of the most serious remaining obstacles in achieving EU financial integration, mainly due to the fact that securities as book entry type of property are defined differently by national laws. However, it is not only the nature of book entry securities that is treated differently in national securities markets but it is also the holding systems themselves, as developed in each market for the purposes of securities holding, that are also different in nature. In practice, such holding systems are distinguished in two main categories.

First, it is the traditional category which refers to the "direct" or "transparent" systems, where securities are held at an end investor level. From a shareholding's perspective, registered as shareholders in such systems, are the real investors and not the intermediaries acting on their behalf. These systems have the legal characteristics of the "regular deposit", i.e. the deposit in which the depositor retains the title of ownership over its deposited assets and, therefore, is entitled to exercise its property rights (as owner)

over them not only towards the custodian (depositary) but also towards any third party (*erga omnes* effect).

The second category consists of the "indirect" holding systems. In this category, as an implication of the indirect holding of shares, i.e. the holding through a chain of intermediaries, an "irregular deposit" is established. This irregular deposit scheme operates more or less as a bank or cash deposit. The intermediary, which is for example the custodian bank, holds in such system its clients' assets in a commingled manner (and not separately per client) and is entrusted by its clients to make use of the deposited assets or to redeposit them. In effecting this intermediation status, the depositor sacrifices its ownership right over its assets, which passes to the custodian. Consequently, the custodian becomes in this case the owner of the deposited assets, on its only obligation is to retain at the depositor's disposal, assets of the same quality and quantity of the deposited and return them to the depositor upon the latter's demand. Following this second approach, it could be easily explained why as registered shareholders appear in the registries not the investors themselves, but the intermediaries acting on their behalf. It is the intermediary that acts as the owner of the deposited shares in the context of the irregular framework, whereas the intermediary must also be prepared to redeliver shares of the same quantity and quality as of the deposited, immediately when asked so by the depositor.

Considering the above characteristics of the indirect holding systems, it is apparent that the intermediaries' role as shareholders is nothing more but a pure reflection of the systems' architecture. Under this irregular deposit scheme, intermediaries act as owners of the shares, and registered as such, i.e. as shareholders, in the official registries or CSDs.

It has been argued that indirect holding systems are appropriate means of securities holding as they minimize the inherent administrative or other costs in the multi-tier chain of intermediaries. The relevant argument is based on the fact that the intermediary, which is trying to access markets globally in the course of the provision of services (e.g. trading services, clearing services, settlement services, custody services, including proxy services, etc.) to its clients, can do so by using only one account per market, i.e. a commingled or an omnibus account gathering securities for all of its clients. Therefore it is not obliged to open separate accounts, i.e. per each of its clients, which case might entail administrative costs in its business.

Despite the economic value of this argument, which is however not undisputable considering the positive impact of technology in this area, the appropriateness of the indirect holding systems should be questioned for a series of reasons. As it will be analyzed in the next sections, the main argument with respect to these systems' disputed appropriateness is that they limit the degree of transparency needed not only from a shareholdings' perspective but also from a capital market's perspective.

3 Transparency issues related to the property nature of book entry securities as "intermediated securities"

The term "intermediated securities" is used in this paper to reflect the function of securities as book entry securities held by intermediaries in the environment of indirect holding systems. Based on this notion, intermediated securities are defined in the present analysis under the scope of the irregular scheme which constitutes, as mentioned above, a core element in the functioning of these systems. Under most jurisdictions, securities were defined as movable assets when they were issued and held in a paper form. This definition has been abandoned by the insertion of the book entry securities concept in the capital markets. The recognition of their dematerialized nature affected drastically their definition as a means of property.

In the EU markets book entry securities are defined differently by national laws. The more traditional definitions retained the concept of securities as movable assets or assets with equivalent legal functionality. However, under the recent approaches the book entry securities are treated legally as rights *in persona* or as entitlement than as movable assets, i.e. rights in *rem.* It is apparent that such approaches were influenced not only by the paperless or book entry form of securities but also by the way securities are held, through intermediaries. Put it differently, as the securities are "intermediated securities" under the indirect holding concept, their substance in nature as well as the property rights in them are influenced by the irregular deposit that is established.

Application of the irregular deposit had as a consequence a drastic transformation of legal rights in securities as "intermediated securities". In this new legal context, the investor-depositor loses under the irregular deposit its right in *rem,* i.e. its right to be the owner of the securities. This right passes to the intermediary as custodian and the investor-depositor retains only a right towards the intermediary to maintain at the investor's disposal "intermediated securities" of the same quantity and quality. It is important to note that such legal approach has became as of having mandatory nature on the reasoning that book entry securities cannot be held directly by the investors, but through intermediaries only. Therefore, the investor can no longer be treated as owner of the securities in the new environment of indirect holdings. In this environment the investor has only rights *in persona* in securities and not rights *in rem.* As a legal implication, investor's property in securities diminishes in nature, as the investor does not retain any more "in its hands" the securities themselves but only a right in them, which can be exercised towards the intermediary.

From an economic perspective this transformation of the property substance of securities has as an effect the investor's property to be exposed to risks related to the role of intermediary as a custodian. More specifically, the investor is exposed to the "custody risk", i.e. to the risk to lose its property rights in securities in case the custodian becomes insolvent and thus unable to "return" to the investor the "intermediated securities" (namely by transferring them or, if the intermediary holds the securities through others, the rights in them, to investor's other custodians).

To this end, it is apparent that indirect holding patterns exposed investors to custody risks not familiar to the type of services that custodian used to provide when securities were formed in a paper manner or where securities are held through direct holding systems under the aforementioned meaning. In the latter case, the investor holds book entry securities through intermediaries acting as owner and in consequence is not exposed to the custodians' risks.

Some jurisdictions in their effort to take into account these risks created by the approach of indirect holdings set out particular prudential regulation requirements to the intermediaries. Other, adopted hard coded priority rules giving legal privileges to investors over the intermediary's property, either in securities or in another form, to be satisfied from such property prior to any other creditor of the intermediary in case of the latter's insolvency.

Therefore, it is clear that indirect holding systems le to the creation of grey zones to the investors' rights in securities as the exercise of their rights has been dependent on the creditworthiness of the intermediaries concerned. If the intermediary fails to provide its services due to its indebtedness, the investor's rights in securities will survive as privileged rights only on the condition that the law provides so and no uncertainty exists in exercising such privileges.

Hence, related to the approach of indirect holdings is not only the custody risk to which the investor is exposed linked with its "intermediated securities", but also the legal risk thereto, i.e. the risk the legal system fails completely to recognize or it fails to recognize in an appropriate manner the investor as a privileged creditor of the involved intermediary and therefore the risk that the investor faces to be treated as one of the intermediary's non privileged creditors under the *pari passu* principal.

Related to the nature of the "intermediated securities", as rights or entitlements, are the property rights of the investor in these securities, i.e. how the securities can be acquired or disposed or how a security interest can be created over them. In the indirect holding environment such rights can be exercised by relevant "credits" or "debits" to the account through which the "intermediated securities" are kept. But as the "intermediated securities" constitute a right or an entitlement in nature, the aforementioned property rights of disposition (e.g. sale, lending etc.) or security interest (e.g. pledge, transfer out right etc.) cannot have as a subject matter the securities themselves but only the aforementioned right or entitlement in them.

For example, in case of collateral provided in "intermediated securities", both the collateral buyer and the collateral seller are exposed to the custody risk related to the custodian, in the books/accounts of which the collateral has been perfected. Therefore, in case of the custodian's default, the collateral taker undertakes the risk to lose the collateral if the legal system does not provide particular protection to the "intermediated securities" deposits (e.g. investors-depositors privileges). If the system fails to give the

required degree of such protection, the collateral buyer undertakes the risk its exposure, which the collateral intended to cover, to be uncovered. Accordingly, the collateral seller faces the risk, in case of the mentioned custodian's default, to be asked by the collateral taker to provide new collateral. In this case, it is common practice collateral that cannot be used or liquidated by the collateral byuer due to legal or other risks, even not attributed to the collateral seller, to be estimated as being of a zero value. Therefore, lack of legal certainty as regards "intermediated securities" deposits may have negative effects to the value of "intermediated securities" as a means of collateral financing.

Needless to say that that these legal abnormalities initiated from the fact that securities holdings, considered as a post trading function of EU capital markets, abolished the direct relationship between the investor and the issuing company due to the interposition of the indirect holding patterns between them. This interposition, as discussed above, had as a legal implication that the title of ownership over intermediated securities to be passed from the hands of the investor to the hands of the intermediary as a result of the establishment of mandatory irregular deposit relationships in such securities. As a further implication, such ownership is reflected in the official registries. In terms of shares, intermediaries as owners of them are registered in the shareholding's "register" even if they do not hold any securities in their own portfolio but they are shareholders of the portfolio of their clients.

4 Transparency issues on the shareholders "register"

The concept of "intermediated shares" as a form of "intermediated securities" is reflected, as discussed above, in the books of the register or CSD, where the shares are held. The issue is that as shares are held in accounts that are kept through one or more intermediaries in the multi-tier chain, linked in its upper tier level with each registry or CSD, it has been argued that it is difficult in practice to find the actual investor, by streamlining the chain to the end-account, i.e. the one that the intermediary keeps not for other intermediaries but for the investor itself. It is further argued that as this chain of intermediaries crosses borders and is linked to different laws and jurisdictions, there is legal uncertainty on the identity of the actual investor.

Therefore, lack of transparency as a result of indirect holding systems appears not only in the property law field, where the real owner loses, as mentioned above, its title of ownership, but also to the field of corporate law, where the real shareholder loses its shareholding status. As a corollary of this situation, it is questionable who will be entitled to exercise shareholdings rights, mainly the basic ones related to the participation in the issuing company's general meeting and the cast voting.

In order to solve these problems, national legal systems developed as possible alternatives the following. The first alternative approach refers to the recognition by the legal system of the intermediaries' right to designate end investors as shareholders. These systems function commonly under the scope of an "omnibus account" that does not abolish in total the direct relationship between the investors and the issuing company. Upon the designation by the intermediary of the actual investor, shareholding status "returns" is attributed to the investor operating in a manner of a retroactive effect. In some cases, such investors are designated, in a more informal manner, as pure holders (not necessarily as shareholders) of the entitlement to control the voting right, as well as other rights for example dividend rights, directly towards the issuing company. In this set up, such legal systems recognize the legal entitlement of the actual investor to vote, without making any fundamental changes in the company law regime with respect to the "intermediated shares".

This alternative approach cannot be regarded as of undisputed value, as the investors' protection, i.e. the recognition of their rights as shareholders to the issuing company, depends on the proper exercise by the intermediary of the above "designation right". Consequently, if the intermediary does not exercise such right, despite the investor's contrary demand, the investor will not be legalized to exercise its shareholding entitlement. To this end, this alternative approach is rather not appropriate to ensure a transparent result in the exercise of shareholding rights. In any event, its proper implementation would presuppose increased supervisory effort and relevant costs.

The second alternative approach refers to less transparent but more practical solutions. More specifically, it is based on the fact that the actual investor is given a power of attorney by the intermediary that is entitled to vote. By this approach, the legal entitlement to vote remains with the registered as shareholder

intermediary (under lex societatis of the issuing company) but the intermediary is entitled to give a power of attorney to the investor to vote on shares the intermediary holds as a formal shareholder for the investor. A supplement to this approach is the one referring to the right of the investor to instruct the intermediary, who is the registered shareholder, to vote in accordance with the former's instruction. In this case, the investor does not exercise voting rights directly towards the issuing company, as such rights are exercised by the intermediary acting on the investor's behalf.

It is worth noting that this alternative approach and its twofold parts have been adopted by the E.U. Shareholders Rights Directive (under its article 13). The E.U. Directive admits "proxy voting" as well as "split voting" without any limitations only if relevant said rights are exercised by a registered as shareholder intermediary acting in the course of its business on behalf of others. In this case and on the condition that the applicable law permits so, any split voting is regarded as being exercised by the intermediary on behalf of others. Therefore, jurisdictions that implemented said split voting rule ensure that split vote cast, i.e. votes in part in favor, votes in part against and in part abstentions, have a valid effect.

However, it is ambiguous whether this E.U. Directive fulfilled successfully its aim, as set on its outset, to raise any legal barrier on cross border shareholding at an EU level and to encourage the investors' participation in the general assembly as a means of good corporate governance in the case of listed companies. The reason is that the E.U. Directive refers to a rather limited scope of shareholders' rights, i.e. to the participation in the general assembly and to cast voting. Thus, it leaves outside from its scope all other shareholders' rights, including reception of dividends, splits etc. It is also apparent that the E.U. Directive does not refer to other types of "intermediated securities", such as bonds, but only to shares, which means that legal uncertainty still exists with regard to other securities holders' rights in the environment of such indirect holdings.

Moreover, the E.U. Directive does not provide answers as to the treatment of shareholders' rights in other less indirect or more direct holding systems. For example, in case of interactions, e.g. links, between indirect and direct holding systems how can such shareholding or other securities holding rights be accommodated? What will happen in case a direct system does not permit intermediaries to be registered as shareholders when they act on behalf of their clients? Would the direct holding system be entitled under the scope of EU harmonization to impose its transparency rules on shareholders "registry" by forcing the intermediaries to disclose the real investors and register them as shareholders in their registers? Which will be the appropriate measures in case the intermediary does not comply with the above obligations? How indirect holding systems and the direct ones can be accommodated in the EU markets considering that they are contradictory in essence? (i.e. the indirect holding systems permit registered to be the intermediaries acting on behalf of others, while the direct holding systems prohibit such concept and impose registration to be effected at an end investor's level).

These are a few of the questions and legal issues that arose with regard to the impact of indirect holdings to the shareholdings aspects of registration. As these issues cannot be answered by the aforementioned alternatives, the problem of transparency in the field of shareholding rights remains open.

5 Cash deposits and securities deposits: Legal differences

Cash deposits have been one of the traditional banking services. In the course of their business, banks intermediate in the money markets accept deposits and they grant loans. In doing so, banks have to comply with a specific framework of capital and liquidity requirements.

The question is whether this intermediation activity is recognized to be provided in a similar manner in the field of securities. In other words, are banks or investment firms entitled by profession to accept deposits and grant loans in securities, as the case is for cash and relevant money instruments?

Taking into account the nature of securities as assets of a specific kind, giving to the holder not only a proprietary or simply property right but also participating rights towards the issuing company, most legislators made the choice to treat any deposit of securities to depositaries as regular deposits and not as irregular ones. This choice is not only apparent in civil law context but also in the specific area of capital markets law. MiFID rules, for example, state that the investment firm is entitled to use investors'

securities entrusted to it only on the consent of the investors. This concept, which is adopted by most regulations, has as an implication an initial regular deposit to be permitted to be transformed to an irregular deposit one upon the investor's consent. Therefore, intermediaries entitled by law to hold securities and provide relevant safekeeping services may act as custodians or depositaries in a similar manner as of cash deposits, i.e. on the basis of an irregular deposit, provided however that their clients consent to that.

Legal systems in terms of accommodating book entry securities made clearly their choice as regards the legal status governing the nature of holding in the systems' (CSDs or registries) patterns. As it has been pointed out above, the systems have been divided to the direct ones that retained the regular deposit concept and to the indirect ones that function on the basis of the irregular deposit. In this context, it is apparent that the way of holding securities in the capital markets became not only a matter of intermediaries' choice but also, or rather, a matter of the holding system's choice.

However, intermediation in securities markets by means of irregular deposit entails, as discussed above, custody risks in these markets become more intensive when the legal systems are not well developed to cover them. This lack of legal certainty may attributed to the fact that under the traditional forms of securities' safekeeping the banks or other intermediaries were not authorized to accept securities deposit under the only obligation to redeliver to the investor-depositor securities of the same quality and quantity (irregular deposit). It was common praxis, that the bank held the securities in the name and on behalf of the investor and it did not have the right to use the securities or redeposit them. Therefore, investors and shareholders under this type of securities holding did not face the risk not to be appeared in the local registries as securities holders – shareholders of the securities concerned.

In view of the above, it remains an issue under investigation whether indirect holding systems provide sufficient legal certainty and stability to the financial markets as to the irregular deposits risks to which the investors are exposed considering that intermediation in the field of securities is not of the same profession and culture with regard to banking services.

6 Policy suggestions and concluding remarks

The aforementioned analysis pointed out that indirect holding system brought a less transparent environment with regard to the property rights as well as shareholding rights when focusing on shares. To this end, EU initiatives should be strengthened in addressing in an efficient and safe manner the investors' rights as a prerequisite in achieving EU integration in the capital markets field.

It is considerable that many solutions might be put on the EU agenda in facing the lack of transparency problem in the securities holding markets without increasing the costs of such markets' functioning. A key point in this process could be technology. As information processing has been fully developed, financial markets could make use of such new technology in gapping any lack of information and transparency in securities field. More specifically, regardless of whether a system has the characteristic of a more direct or more indirect one for holding purposes, it could use these means of technology so as to transmit registration data to the register or CSD, even if crossing borders is needed in doing so. In this context, technology could help the intermediaries to disclose the identity of shareholders to the registers in a codified manner, thus enabling their registration directly to the systems concerned. This effect will contribute to the transparency and moreover could be used as a basis in transforming holding systems to function under the concept of regular deposit even if they act as commingled or omnibus patterns. By transmitting through the chain of intermediaries the identity of the shareholder to the CSD concerned in a "codified form" and thus unanimously (for example for privacy or other purposes) under the means of technology, any indirect holding based on clients commingled accounts, where applicable, will be deemed regular deposits' account, thus protecting the clients for the intermediaries custody or other inherent risks. In terms of adopting said approach at an EU level legislative action as a means of harmonization should be demanded.

Put it in another more conceptual dimension, technology could be used in transforming either functionally or at least legally the indirect model to a more direct one. This could be achieved not necessarily by imposing the concept of direct holding to the markets but by imposing more transparency on the "registration" process. Even in case of an indirect model, an intermediary should be obliged to transmit to

the official CSDs or registers the real shareholders' data. Intermediaries should not be permitted to be registered as shareholders in such registers when they act on behalf of others. Direct registration, even if not necessarily being based on a direct holding, could ensure a more transparent concept of "post trading" at an EU level. It should be noted that coordination of such direct registry concept could be easily implemented by the market factors as technology provides sufficient means of common protocols and data transmission tools in enabling harmonized solutions in EU.

Practically, this means that even if omnibus accounts are kept for the purposes of clearing or settlement at a local or EU cross border level, registration should be segregated at an end investor level in terms of restoring the abolishment of the direct relationship between the investor and the issuing company. From a legal perspective, this "direct" registration could be deemed, if the current legislation does not provide the required framework, as a transformation of all legal holding patterns to a direct one based on regular deposit concepts.

Such approach could be treated as the cornerstone in changing the architecture of "post trading" environment in E.U. It should be stressed out that such change in more regular deposit patterns could have a positive impact to the business of intermediaries from a cost efficiency perspective as well. As intermediaries will not expose their clients to irregular deposit risks, less financial resources may be sufficient in terms of meeting their business obligations. To this end, adjustment of the securities holding model may result to more efficient E.U. financial markets, assuming that the irregular deposit concept in the securities markets is not by definition necessary and it presupposes increased financial obligations in meeting its inherent risks. This new designing of direct registry could also assist financial markets in eliminating systemic risks from a securities holding perspective, as service providers in this field (intermediaries and other) will not be needed to be exposed to custody risks familiar to banking sector (irregular deposit concept) in exercising such type of business.

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