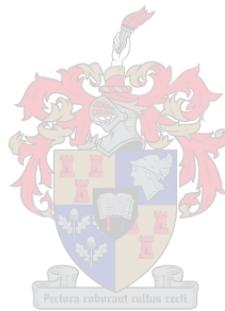


# **Securities within the realm of private law: a theoretical and practical analysis of the legal nature of shares**

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Faculty of Law at Stellenbosch University

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## **DECLARATION**

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## SUMMARY

This thesis provides practical and theoretical perspectives on the legal nature of shares. In South Africa and beyond, shares have undergone significant transformation over the last decades. They are held and transferred through a complex net of intermediaries. While commercial practice and financial markets have devised efficient and pragmatic holding and transfer mechanisms, the changes brought about by computerisation and a pervasive model of systemic intermediation have unsettled the existing consensus on the legal, conceptual underpinning of shares. The thesis therefore aims to provide clarity on the legal nature of holding mechanisms, the legal nature of transfer mechanisms and the legal nature of shares viewed more abstractly within the context of the taxonomy of private law.

The thesis approaches the first two questions historically and comparatively to show how the legal understanding of holding and transfer mechanisms has changed. While the nature of intermediation has changed dramatically, the thesis shows that the legal concepts and mechanisms underlying the holding of shares predominantly have proved to be sufficiently adaptable. This cannot be said to be the case when considering the legal nature of transfer mechanisms. Traditional transfer mechanisms, such as assignment, negotiation and delivery have largely been replaced by mechanical, account-based transfer ones. On this basis, the thesis suggests that the continued application of the principles of cession to a South African analysis of transfer should be scrutinised in a more fundamental fashion.

To complement the discussion, it is shown that conceptual alternatives to traditional doctrinal thinking can be found in a functional approach to legal reasoning and in a procedural “law of accounts” that synthesises the common characteristics shared by many rights held on accounts. Moreover, two theoretical models are considered that shed light on the question whether systemic intermediation leads to the creation of new and multiple assets which derive from a share and are held by lower-tier intermediaries and ultimate investors in place of the share itself. This approach, made popular by the introduction of “securities entitlements” by Article 8 of the UCC and also reflected in the notion of beneficial interests of a trust in English law, can be explained as establishing rights against the rights of a higher-tier intermediary. These rights function as assets. On the basis of the burdening of rights model, borrowed

from German law, the application of the rights-against-rights approach to South African law is rejected, however. The thesis concludes that South African law evidences neither a multiplication of assets nor a division of ownership in relation to intermediaries.

Lastly, the thesis considers the assertion that shares are, or should be, property or “property-like” to provide adequate protection to investors. An enquiry into the legal nature of shares is the overarching theme of the thesis that draws together its different parts. The thesis proposes an explanatory model that can be used to determine whether and under which circumstances obligations can have absolute effect in relation to third parties. It asserts that shares are obligations, but that a proper evaluation of the internal sphere (the issuer-investor bond) shows that shares are simultaneously object-like. The explanatory model suggests that obligations of this kind can serve as objects of other obligations (the external sphere) which may consequently have real or limited-real effect in relation to third-parties. The model therefore narrates the interrelation between property and obligations without calling into question the well-established fact that shares are personal rights, albeit with limited real effect.

## OPSOMMING

Hierdie proefskrif verskaf praktiese en teoretiese perspektiewe op die regsraad van aandele. In Suid-Afrika en elders, het aandele die afgelope dekades beduidende veranderinge ondergaan. Aandele word gehou en oorgedra deur 'n komplekse stelsel van tussengangers (bemiddeling). Terwyl kommersiële praktyk en finansiële markte doeltreffende en pragmatiese meganismes vir die houding en oordrag van aandele ontwikkel het, het die veranderinge wat deur gerekenaariseerde stelsels en omvattende sistemiese bemiddeling tot stand gekom het, die bestaande konsensus aangaande die juridiese en konseptuele onderbou van aandele ontstig. Die proefskrif poeg om sekerheid te skep oor die regsraad van meganismes waardeur aandele gehou word, die regsraad van oordragmeganismes en die regsraad van aandele beskou uit die oogpunt van die sistematiek van die privaatreë.

Die proefskrif benader die eerste twee vroeë historiese en regsvergelende omstandighede om aan te toon hoe die regsraad van aandeelhouding en oordragmeganismes verander het. Terwyl die aard van tussengangers dramaties verander het, toon die proefskrif dat die bestaande regskonsepte en –meganismes oor die algemeen voldoende aanpasbaar was. Dieselfde kan nie gesê word van die regsraad van oordragmeganismes nie. Tradisionele oordragmeganismes, soos sessie, verhandeling en lewering, is grotendeels vervang deur meganiese, rekeninggebaseerde oordrag. Op grond hiervan dui die proefskrif aan dat die voortgesette toepassing van die beginsels van die sessiereg in hierdie verband in die Suid-Afrikaanse reg op meer fundamentele wyse ondersoek moet word.

Om die bespreking aan te vul, word getoon dat konseptuele alternatiewe vir tradisionele regsteoretiese denke gevind kan word in 'n funksionele benadering tot juridiese analise en in 'n prosedurele "rekeningreg" wat van toepassing kan wees op meerdere regte wat op rekeninge gebaseerd is. Gegewe die vraag of sistemiese, veelvlakkige bemiddeling lei tot die vermenigvuldiging van bates wat uit 'n aandeel voortspruit en deur beleggers en hul tussengangers gehou word, word twee teoretiese modelle voorgestel. Die benadering van afsonderlike regte of bates het gangbaar geword met die erkenning van "securities entitlements" in Artikel 8 van die UCC en word ook weerspieël in die idee van "beneficial interests", wat voortspruit uit die Engelse trustreg. Na aanleiding van op 'n model ontleen aan die Duitse reg, wat

behels dat die primêre reg eerder beswaar word, word die Anglo-Amerikaanse benadering in hierdie proefskrif van die hand gewys. In die Suid-Afrikaanse reg lei sistemiese bemiddeling nóg tot die vermenigvuldiging van bates, nóg tot 'n verdeling van eiendomsreg.

Laastens behandel die proefskrif die bewering dat aandele “eiendom” (sake) is of eiendom moet wees om beleggers voldoende te beskerm. Die regsraad van aandele is die oorkoepelende tema en onder hierdie sambreel word die verskillende afdelings van die proefskrif saamgevat. Die proefskrif stel 'n verduidelikende model voor wat gebruik kan word om vas te stel of, en onder watter omstandighede, verbintnisse absolute regswerking kan hê. Al word aandele as verbintnisse beskou, toon 'n evaluering van die interne sfeer van die verhouding tussen die uitreiker en die belegger aan dat aandele terselfdertyd eienskappe van sake vertoon. Die verduidelikende model stel voor dat sulke verpligtinge as voorwerpe van ander verpligtinge (die eksterne sfeer) kan dien, wat derhalwe absolute regswerking teenoor derde partye kan hê. Die voorbeeld van aandele word dus gebruik om die verband tussen eiendomsreg en verbintnisreg nader te beskryf, maar sonder om die goed gevestigde siening dat aandele persoonlike regte is, maar met beperkte absolute werking, oorboord te gooi.

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## LIST OF ABBREVIATIONS

Acad Manag Rev	Academy of Management Review
Account Rev	The Accounting Review
AcP	<i>Archiv für die civilistische Praxis</i>
Am Econ Rev	American Economic Review
Am J Comp L	American Journal of Comparative Law
American LR	American Law Review
Ariz J Int & Com L	Arizona Journal of International and Comparative Law
Berkeley Tech LJ	Berkeley Technology Law Journal
BGB	<i>Bürgerliches Gesetzbuch</i>
Bus Info Systems Engineering	Business Information Systems Engineering
Bus L	The Business Lawyer
Calif Manag Rev	California Management Review
California LR	California Law Review
Cambridge LJ	Cambridge Law Journal
Can Bus LJ	Canadian Business Law Journal
Cardozo LR	Cardozo Law Review
Chi-Kent LR	Chicago-Kent Law Review
CILSA	Comparative & International Law Journal of Southern Africa
Columbia Bus LR	Columbia Business Law Review

Columbia LR	Columbia Law Review
Cornell LR	Cornell Law Review
Creighton LR	Creighton Law Review
CSD	Central Securities Depository
DTC	Depository Trust Company
DTCC	Depository Trust and Clearing Company
Duke LJ	Duke Law Journal
EPLJ	European Property Law Journal
EuCML	Journal of European Consumer and Market Law
Eur Bus LR	European Business Law Review
Florida State Uni LR	Florida State University Law Review
George Mason Uni LR	George Mason University Law Review
Harvard LR	Harvard Law Review
HKK	<i>Historisch-kritischer Kommentar zum BGB</i>
Idaho LR	Idaho Law Review
Iowa LR	Iowa Law Review
J Bus L	Journal of Business Law
J Comp Corp L & Sec Reg	Journal of Comparative Corporate Law and Securities Regulation
J Comp Econ	Journal of Comparative Economics
J Con L	Journal of Contract Law

J Corp L	Journal of Corporation Law
J Econ Lit	Journal of Economic Literature
J Financ Econ	Journal of Financial Economics
J Law & Econ	Journal of Law & Economics
J Law & Soc	Journal of Law & Society
J Polit Econ	Journal of Political Economy
JBF	Journal of Banking & Finance
JIBFL	Journal of International Banking and Financial Law
Jnl of Finance	Journal of Finance
LAWSA	Law of South Africa
Loyola of LA LR	Loyola of Los Angeles Law Review
LQR	Law Quarterly Review
Marquette LR	Marquette Law Review
Michigan LR	Michigan Law Review
MLR	Modern Law Review
NJILB	Northwestern Journal of International Law and Business
NJW	<i>Neue Juristische Wochenschrift</i>
NSCC	National Securities Clearing Corporation
Osgoode Hall LJ	Osgoode Hall Law Journal
Oxf J Leg Stud	Oxford Journal of Legal Studies
RESTUD	Review of Economic Studies

RTGS	Real Time Gross Settlement
SA Merc LJ	South African Mercantile Law Journal
SALJ	South African Law Journal
South Cal Interdisc LJ	Southern California Interdisciplinary Law Journal
Stan JL Bus & Fin	Stanford Journal of Law, Business & Finance
Stell LR	Stellenbosch Law Review
Temple LR	Temple Law Review
THRHR	Tydskrif vir Heedendaagse Romeins-Hollandse Reg
TSAR	Tydskrif vir die Suid-Afrikaanse Reg/ Journal of South African Law
UCC	Uniform Commercial Code
UCC	Uniform Commercial Code
UCLA LR	University of California Los Angeles Law Review
Uni Chicago LR	University of Chicago Law Review
Uni Miami Bus LR	University of Miami Business Law Review
Uniform LR	Uniform Law Review
University of Illinois LR	University of Illinois Law Review
UWA L Rev	University of Western Australia Law Review
Wake Forest LR	Wake Forest Law Review

Washington Uni LR

Washington University Law Review

West Virginia LR

West Virginia Law Review

WM

*Wertpapier-Mitteilungen*

ZHR

*Zeitschrift für das gesamte Handels-  
und Wirtschaftsrecht*

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## Chapter 1: Introduction

### 1 1 Context

Shares and financial instruments<sup>1</sup> in their various manifestations have become the linchpin of modern corporations and economies. They lie at the core of countless commercial transactions undertaken on a daily basis all over the globe. Despite their unparalleled importance in the modern economic landscape, their precise legal nature and operation remains marred by uncertainty. The introduction to a book on the matter dating back to 1917, still rings true today: “Stocks and shares are a matter of interest to all, and of bewilderment to most, of civilised society”.<sup>2</sup>

Securities have their historical origin in an attempt to finance medieval or colonial wars, early merchant trade, pioneering infrastructure projects and corporate expansions.<sup>3</sup> In South Africa, the large-scale issuing and trading of shares and securities emerged predominantly to finance mining operations, be it the copper boom of Namaqualand during the middle of the 19<sup>th</sup> century, the prospecting and mining operations of the first gold rush or the diamond boom in Kimberley.<sup>4</sup> The capital sums required to fund such ventures were so significant that they could not be financed by a single investor or bank. Funding in the form of a loan furthermore ties the otherwise liquid and easily exchangeable money of an investor to specific assets or ventures, thereby reducing the liquidity of the capital.<sup>5</sup> Breaking-up the capital financing required into smaller units enabled manufacturers, merchants and pioneers to attract a large number of small investors. The units issued to holders were in the form of debt instruments or shares.

This financial innovation enabled ordinary people to invest smaller sums of money in large projects. Securities are, however, long-term, even potentially indefinite

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<sup>1</sup> The Companies Act 71 of 2008 and the Financial Markets Act 19 of 2012 use the term “securities” as an umbrella for various financial instruments. Commercially, the term “securities” is used interchangeably with “financial instruments”; see below, 2 2 Shares as securities.

<sup>2</sup> H Withers *Stocks and Shares* 2 ed (1917) 1.

<sup>3</sup> For a detailed history of securities and securities markets see RC Michie *The Global Securities Market: A History* (2006). For a brief overview see also MM Siems “The Foundations of Securities Law” (2009) 20 *Eur Bus LR* 141.

<sup>4</sup> See E Rosenthal *On ‘Change Through the Years: A History of Share Dealing in South Africa* (1968); FHC Mazando “The Taxonomy of Global Securities: Is the U.S. Definition of a Security too Broad?” (2012) 33 *NJILB* 121 171.

<sup>5</sup> P Ireland, I Grigg-Spall & D Kelly “The Conceptual Foundations of Modern Company Law” (1987) 14 *J Law & Soc* 149 155-157; P Ireland “Company Law and the Myth of Shareholder Ownership” (1999) 63 *MLR* 32 40-41.

investments. A core characteristic, particularly of shares, is the indefinite duration of the capital commitment by shareholders.<sup>6</sup> This increases the risk for the investor. Investors must therefore be provided with an opportunity to withdraw their capital; in other words they must be able to transfer their shares to a third party in exchange for money. To enable the holder to withdraw the funds if needed, these units have to be transferable. Legal design and the establishment of organised markets for securities bolster the liquidity and transferability of instruments.<sup>7</sup> Markets for securities enhance liquidity by providing platforms that bring sellers and potential buyers together. Markets also enable indirect exchanges, expediting the exchange process by eliminating the need for direct contact between buyers and sellers of securities. A lack of liquidity can have serious implications – not only can it dissuade investors to purchase securities in the first place, but also assets that cannot be realised may decline in value. Transferability in effectively functioning markets has become a hallmark of securities.

The concept of “transfer” is not a simple one. Transfer can be understood, and is in fact relevant on various levels. This will emerge from the discussion in Part 2 below. Economic and market mechanisms dictate how securities change hands between market participants. Market mechanisms are aimed primarily at practicability and pragmatism. While “transfer” may not be a technical legal term, for a transfer of title to have legal effect, economic mechanisms must be underscored with legal consequences. At the same time, the law must facilitate efficient economic mobility. Any transfer must be convenient (that is speedy and free from excessive formalities), secure and final.

While factors such as deep and well-organised markets and the division of capital into small units are pivotal in enhancing the liquidity of shares and securities, the fundamental role played by the law must not be underestimated. From a legal perspective, the emergence and metamorphosis of securities raises the question how the law can and must facilitate their commercial functions. Trust has become a cornerstone of modern financial markets. It has become essential that potential buyers of securities, particularly on the secondary markets, have trust, both in the

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<sup>6</sup> Shareholders cannot demand a reimbursement of their capital input from the company, except in the case of share redemptions or share buy-backs. In the absence of these, shares must be said to exist for as long as the company exists.

<sup>7</sup> Ireland et al (1987) *J Law & Soc* 158-160.

effective functioning of the markets and in the title to the securities. Inevitably, any system of exchange is based on trust – trust in the performance of the counterparty and trust in the stability and proper functioning of markets and exchange mechanisms. The law must provide the mechanisms that enable valid and efficient transfer and exchange and facilitate trust in the system.

A survey of selected jurisdictions shows that the solutions provided by the law to questions of transferability and trust are by no means uniform. All jurisdictions, however, evidence that the market structures and mechanisms within which securities are held and traded have changed dramatically over the last decades. The issue of physical certificates enhanced this trust, further cemented, to a greater or lesser degree, by the transfer of securities in good faith, in other words by allowing a *bona fide* purchaser to receive transfer without any defects in title. An investor who purchases shares from an existing shareholder on the secondary market needs to have some degree of certainty that the legal title has in fact passed to him, or at least a level of assurance that he would be protected from adverse claims. It is usually argued that a lack of such certainty impedes the functioning of the securities markets by imposing an excessive burden on the purchaser to investigate the origin of the shares and securities. This would render the instruments less marketable and without an active market for shares transferability becomes an empty promise.<sup>8</sup> The trio of transferability, trust and certainty can be credited for much of the legal development in the sphere of shares and securities.

As the volume and frequency of share transactions increased, the certificates, initially devised to facilitate trust, transferability and exchange hampered the effective functioning of the markets. A system where certificates have to be delivered between market participants is slow, causing significant delays in the settlement of transactions.<sup>9</sup> The resulting inability of brokers and other intermediaries in the clearing and settlement process to efficiently and timeously handle the sharp increase in the volumes of securities traded became known as the “paper crunch” in

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<sup>8</sup> But see JS Rogers “Negotiability, Property, and Identity” (1991) 12 *Cardozo LR* 471 478-484, who argues that there is little evidence to support this point. The comparative analysis will show that both the South African and the English legal systems traditionally functioned without rules on good faith acquisition or similar negotiability rules; through estoppel these legal systems incorporate mechanisms to ensure a comparable level of certainty of transfer – see E Micheler *Property in Securities: A Comparative Study* (2007) 98. Also see below, 8 4 Certainty of transfer.

<sup>9</sup> MF Khimji “Intermediary Credit Risk – A Comparative Law Analysis of Property Rights in Indirectly Held Securities” (2005) *J Bus L* 287 290-291.

the US.<sup>10</sup> Furthermore, paper-based settlement carries the risk of theft and fraud.<sup>11</sup> In many jurisdictions, the physical movement of paper was consequently replaced by a system of electronic settlement. Paper certificates were either relegated to the vaults of central securities depositories or completely abandoned.<sup>12</sup> Additionally, face-to-face trading had to make way for a complex network of exchanges, depositories, clearing houses, banks, brokers and other intermediaries.<sup>13</sup> As a result of the aggregate of these changes, transactions in shares and other securities are now settled by corresponding book entries in the accounts of buyers and sellers of shares.

Physical certificates, once the legal and commercial answer to demands of transferability, trust and certainty have fallen out of favour. Shares have morphed from certificated instruments to electronic entries in accounts. As a result, intermediaries have entered the picture, have impacted on the mechanisms of exchange and holding and have mostly severed the direct relationship between an issuer and an investor.

Any exchange brings with it the need for legal and commercial rules on certainty of transfer. Where buyers and sellers of securities no longer enter into personal relationships, the trust between transacting counterparties has been replaced by trust in the market participants and intermediaries that populate the spaces between the contracting parties.

Central to a legal discourse on shares and securities is an analysis of their legal nature and classification.<sup>14</sup> A characterisation of shares takes place at the intersection of the law regulating companies and securities as well as the private law disciplines of property and obligations. Shares seemingly elude clear-cut classification into one of these disciplines. The private law classification is particularly

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<sup>10</sup> 291.

<sup>11</sup> Khimji (2005) *J Bus L* 291; See also SA Law Commission *Protection for a Purchaser of Securities Working Paper 21* (1987) 42-54.

<sup>12</sup> On immobilisation and dematerialisation, see below, 9.2 Immobilisation and Dematerialisation.

<sup>13</sup> MJ Aronstein "The Decline and Fall of the Stock Certificate in America" (1978) 1 *J Comp Corp L & Sec Reg* 273-274. For an overview of intermediaries, see below, 9.3 Intermediation and the creation of new assets.

<sup>14</sup> Under the main aims of modern financial regulation, JH Dalhuisen lists: "The creation of a proper framework of investments generally in terms of their legal characterisation and structure...This is an important and often still neglected aspect of regulation which may also go into the transferability or proper unwinding of investments"; See JH Dalhuisen *Dalhuisen on International Commercial, Financial and Trade Law* (2000) 721.

difficult in the case of shares.<sup>15</sup> Shares are variably categorised as wealth, assets, property and personal rights.

The debate regarding the legal nature of securities, if ever settled, resurfaced with the introduction of book-entry securities. The world of securities has seen significant transformation in the last decades, including dematerialisation, electronic settlement and pooled, indirect holdings of securities. The changed mechanisms not only raise questions about the legal characterisation of securities, but also about the continued validity of legal rules and mechanisms developed in the context of certificated shares.<sup>16</sup> This then is the dual focus of this thesis: A theoretical study of the legal nature of shares as well as an examination of the legal and commercial mechanisms by which securities are held and transferred.

## **1 2 A prospect of the discussion**

The pivotal enquiry into the legal nature of securities is necessarily a complex and multifaceted matter. It must be explored within a three-dimensional setting comprised, broadly conceptualised, of three separate, yet interconnected sets of relationships: 1. issuer-investor; 2. investor-intermediary or intermediary-intermediary; and 3. investor-third party. These relationships can, and frequently, do, exist alongside each other. Particularly the investor-intermediary or intermediary-intermediary relationships are layered on the issuer-investor relationship and transform the way shares are held and transacted with.

The first relationship can be described as constituting the internal sphere of securities. Investor-third party relationships, on the other hand, are primarily those that arise between buyers and sellers of securities as well as between investors or intermediaries and security-takers. These fall squarely within the external sphere. The various intermediary relationships are more difficult to place in a categorical fashion. On the one hand intermediaries mediate the relationship that exists in the internal sphere between issuers and investors; on the other hand, a change in intermediary holdings is akin to a transfer. In addition, intermediaries today play a crucial role in facilitating transfers between buyers and sellers of securities and have

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<sup>15</sup> See M Haentjens "Between Property Law and Contract Law: The Case of Securities" in S van Erp, A Salomons & B Akkermans (eds) *The Future of European Property Law* (2012) 165 167.

<sup>16</sup> E Micheler "Farewell Quasi-Negotiability? Legal Title and Transfer of Shares in a Paperless World" (2002) *J Bus L* 358 359-660.

a significant impact on the form that these transfer mechanisms take. Relationships of transfer and holding will therefore be analysed together as part of the external sphere.

This structure broadly corresponds to the theoretical, explanatory model which will be proposed as a framework for guiding the enquiry into the legal nature of shares from a private law perspective.<sup>17</sup> In terms of this model, obligations can have both an internal and an external sphere. An obligation's characterisation in the internal sphere can aid to determine its external effect. Obligations must therefore be conceptualised on a continuum ranging from the purely personal to the highly impersonal. Obligations located on the highly impersonal end of the continuum are frequently described as incorporeal objects.

The focus of Part 1 is directed at the internal sphere. Due to the breadth of the term securities, shares have been selected as a particular manifestation thereof. Shares are among the traditional financial instruments; despite the emergence of alternative methods of financing, shares remain preeminent for corporate financing; and shares are particularly interesting for the unique blend of rights and duties incorporated therein. In the words of Pretto-Saakman, “[s]hares are conceptually anterior and chronologically antecedent to other financial instruments. It makes sense therefore to start with them.”<sup>18</sup>

In Part 1 a number of aspects of shares will be illuminated to throw light on the “dual nature” of shares;<sup>19</sup> that is those facets that highlight the personal nature of these instruments as well as those features that are more indicative of their existence as incorporeal objects.

The external sphere will shift into focus in Part 2 with particular emphasis on holding structures and transfer mechanisms. A statement that transferability is one of the quintessential features of securities is hardly novel. A descriptive analysis of transfer mechanisms is embarked upon because transfer can tell us something about the legal nature of shares. Usually, the legal nature or characterisation of a right determines the legal transfer mechanism. In reverse perspective, the transfer

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<sup>17</sup> See below, 17 4 3 Developing an explanatory model.

<sup>18</sup> A Pretto-Saakman *Boundaries of Personal Property: Shares and Sub-shares* (2005) 3.

<sup>19</sup> The dual nature of shares is for example highlighted by M Khimji “The Role of Legal Concepts in Commercial Law: Comments on Spink, Rogers and Scavone” (2007) 45 *Can Bus LJ* 94 98.

mechanism may reveal something about the legal nature of the right so transferred. Part 2 aspires not only to describe the current systems and mechanisms of holding and transfer, both commercial and legal, but also to show the progression towards the current state of law. This development can be seen to be one from a system of direct holding to one of indirect holding; alternatively from a paper-based environment to an electronic one. There is truth in both narratives. Yet, intermediaries, the analysis will show, were already present in systems often characterised as “direct”. Also, legal systems premised on immobilisation continue to rely on some form of physical representation of securities. In Part 2 the narrative of progression that most accurately catches all the jurisdictions selected is therefore determined to be one from “simple intermediation” to “systemic intermediation”.<sup>20</sup> The analysis is not strictly historical because in some jurisdictions the “old system” retains, at least in theory, legal validity. In South Africa, for example, certificated shares continue to exist alongside uncertificated ones, although new issues of securities to be traded on a stock exchange are required to be in uncertificated form.<sup>21</sup> In the US, on the other hand, the “old system” based on the concept of negotiability has ceased to exist.<sup>22</sup> The UCC continues to make provision for direct and indirect holding. The intention is not to draw a gapless picture of historic holding and transfer mechanisms, but to broadly sketch the legal antecedents from which the current systems have developed.

As part of this enquiry a number of subsidiary questions arise. Succinctly stated the question is whether existing legal concepts and narratives can be said to apply to the changed commercial and technological environment? More specifically, two aspects must be examined in more detail: 1. the legal nature of account-based intermediary relationships; and 2. the legal nature of account-based transfers.

The jurisdictions surveyed have in common that shares have always been conceptualised as obligations. The type of legal holding structure and transfer mechanism, were, however, largely dependent on the characterisation of the instrument as either an incorporeal obligation or as a “tokenised” obligation akin to an object of property. A characterisation of shares as “things” or objects of “property” can be observed in US and German law. English and South African law resisted the

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<sup>20</sup> See below, 9.3.2 Relationship-based and systemic intermediation.

<sup>21</sup> See s 33(2) of the Financial Markets Act 19 of 2012.

<sup>22</sup> Rogers (1991) *Cardozo LR* 507.

“tokenisation” or “reification” of the obligation. These choices filter through to the traditional transfer mechanisms and intermediary constructs. While the English and South African legal systems traditionally exhibit transfer mechanisms that reflect the characterisation of shares and other financial instruments as obligations, respectively assignment and cession, the US and German legal systems, in accordance with the reification of the obligation, selected delivery as the preferred mechanism of transfer. Part 2 will also show wide variations in how intermediary relationships were traditionally conceptualised in law, ranging from trust constructions in English law, agency relationships in South African law to deposit in US and German law. Again, the reification of the obligation played its part. Functionally, the intermediary constructs were aimed at the same result, namely distinguishing the right to benefit from the issuer’s performance from the ability to enforce such performance.

Theoretically, the reification of obligations did not result in a change of the nature of the right; practically, however, it placed such obligations within the realm of property law. This is reflected not only in relation to transfer mechanisms, but also when considering whether purchasers of shares who acquire the instruments in good faith are protected against adverse claimants. The advent of the book-entry system that accompanied the demise of the share certificate put the reification of obligations and with it the transfer- and holding mechanisms premised on proprietary legal concepts, in jeopardy.

In consequence, the question whether existing legal concepts and mechanisms continue to have validity, demands attention. The question has attracted significant discussion and debate in many jurisdictions; not so in South Africa. South Africa has seen a comparable transformation of the commercial and technological environment in which shares and other securities are traded, settled and held. An analysis of the conceptual legal underpinning of the relevant systems and mechanisms has been sorely neglected, however. Part 2 therefore culminates in an analysis of the South African legal position that is not merely descriptive. It includes an assessment of whether and to what extent existing transfer processes in the form of cession and traditional holding mechanisms in the nature of agency can be said to still be appropriate. Such an analysis is not only long outstanding, but particularly pressing considering that globally financial markets are once again on the verge of a major

technological overhaul triggered by the so-called “blockchain revolution”.<sup>23</sup> Clarity on existing legal characterisations will go a long way toward evaluating the legal implications of commercial and technological innovation.

Part 2 is not strictly limited to shares. Most legislative instruments work with the wider definition of securities. To illustrate with an example: The provisions of the South African Financial Markets Act<sup>24</sup> as well as the Strate Rules,<sup>25</sup> that provide the framework within which modern transfer and holding mechanisms must be evaluated, apply to “securities” as defined.<sup>26</sup> But commercial transfer mechanisms usually do distinguish somewhat between different categories of securities. The mechanisms described, particularly from a practical and commercial perspective, can thus be said to apply generally to equity instruments. Both the terms, “shares” and “securities” will therefore be used in Part 2.

In summary, Part 2 takes a look at exactly how shares can be transferred or held. It does so by taking into account that transfer and holding mechanisms have both a practical-commercial and a legal dimension. A robust synergy manifests between the two dimensions. “Perhaps more than in any other area”, Pretto-Sakmann suggests, “practice requires constant rethinking of underlying theory”.<sup>27</sup> From the outset, the law on securities was a reaction to commercial realities and in consequence a regulating rather than a systematising and creating force. The rapid developments in financial markets mean that the law is continuously treading behind. This can easily result in a lack of theoretical underpinning. The law, including commercial law, needs a sound theoretical basis; in fact, “the more flexible the law is, the stronger has to be the construction holding it together”.<sup>28</sup>

At the same time, Part 2 also indicates the consequences of transfer and intermediation – the way in which a purchaser of shares is protected or the rights that an investor enjoys against an intermediary, including protection against creditors of

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<sup>23</sup> Also see, 17 6 Back to “embodied” rights?

<sup>24</sup> Financial Markets Act 19 of 2012.

<sup>25</sup> *Strate Rules of Strate Pty (Ltd)* (September 2017). Strate is no longer the only CSD in South Africa. Granite is a CSD for bond securities and money market securities. Considering that this thesis purports to focus on shares, its rules and operation will not be analysed further.

<sup>26</sup> See s 1(2) of the Financial Markets Act 19 of 2012. On the definition of “securities” and “financial instruments”, also see, 2 2 Shares as securities.

<sup>27</sup> Pretto-Sakmann *Boundaries of Personal Property* 9.

<sup>28</sup> JN Druey “The Practitioner and the Professor: Is there a Theory of Commercial Law?” in E Wymeersch & M Tison (eds) *Perspectives in Company Law and Financial Regulation: Essays in Honour of Eddy Wymeersch* (2009) 607 612.

the intermediary. These are illustrations of external effects of shares. In the traditional taxonomy of the private law, certain rules are said to apply to assets classified as property, but not to those known as obligations. Part 3 attempts to provide a theoretical foundation to this external sphere.

In addition to the property-obligations divide, dominant themes that emerge from a study of the literature and that will be considered from a theoretical angle are the implications of a functionalist approach,<sup>29</sup> the notion of a “law of accounts”,<sup>30</sup> as well as theoretical perspectives on structures of intermediated holdings as either top-down “rights against rights” or bottom-up burdening of rights.<sup>31</sup> Part of this enquiry is to contemplate what it means, from a legal perspective to be an account holder or an account keeper.

In this context, much has been written about the “proprietary aspects” of shares. The move to a system characterised by intermediary holdings has brought with it the fear that shares and securities no longer constitute “property” in the hands of the investor.<sup>32</sup> Part 3 succinctly identifies that the assertion that shares are “property” or “proprietary” is in essence aimed at a finding that transaction in securities can have effect outside the contractual relationship. Such external, absolute or *erga omnes* effect is usually thought to be reserved for rights that can be placed in the category of “property”.<sup>33</sup> “Property” as distinguished from obligations, it will be shown, is a notoriously vague term and the standards for drawing the distinction are far from clear. A number of perspectives within the specific context of securities law will be considered that show the breadth of the debate and solutions proposed. The

<sup>29</sup> This approach is particularly evident in US law, see the references in n 35 below.

<sup>30</sup> The notion of a “law of accounts” particularly features in the work of Joseph Sommer, see JH Sommer “A Law of Financial Accounts: Modern Payment and Securities Transfer Law” (1998) 53 *Bus L* 1181; JH Sommer “International Securities Holding and Transfer Law” (2001) 18 *Ariz J of Int & Com L* 685; JH Sommer “Commentary: Where is the Economic Analysis of Payment Law?” (2008) 83 *Chi-Kent LR* 751. Also see M Dubovec *The Law of Securities, Commodities and Bank Accounts: The Rights of Account Holders* (2014).

<sup>31</sup> The “rights against rights” theory derives from B McFarlane & R Stevens “Interests in Securities: Practical Problems and Conceptual Solutions” in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 33. The “burdening of rights” approach can be traced back to German legal theory, see K Larenz *Allgemeiner Teil des deutschen Bürgerlichen Rechts* 7 ed (1989); M Wolf & J Neuner *Allgemeiner Teil des Bürgerlichen Rechts* (2012); S Enchelmaier *Übertragung und Belastung unkörperlicher Gegenstände im deutschen und Englischen Privatrecht* (2014). For an application of the theory to South African law, see GF Lubbe “Sessie in securitatem debiti en die komponente van die skuldeisersbelang” (1989) 52 *THRHR* 485.

<sup>32</sup> See for example E Johansson *Property Rights in Investment Securities and the Doctrine of Specificity* (2009) 4.

<sup>33</sup> See the discussion on the idea of property, 17 4 1 Drawing the boundary between property and obligations.

propositions can be placed in three categories: 1. Those solutions aimed at re-drawing the boundary between the law of property and the law of obligations in such a way that shares and securities can be said to fall within it.<sup>34</sup> 2. A recognition that securities, due to their absolute or partly absolute effect, are located somewhere between the categories of property and obligations. According to the latter view, securities are *sui generis* instruments located somewhere between “property” and “obligations”.<sup>35</sup> 3. An application of “property mechanisms” and “property consequences” by analogy.<sup>36</sup>

The model proposed, draws a distinction between the “internal” and “external” spheres of obligations by suggesting that a careful examination of the nature of the obligation in the internal sphere is imperative. In the internal sphere transactions in or relating to shares can be object-related as opposed to person-related. Shares, it will be asserted are obligations. Yet, drawing on the insights obtained from Part 1, it will be shown that shares can also constitute objects for purposes of other obligations. Coupled with underlying considerations and policy arguments the characterisation of an obligation in the internal sphere can give some guidance on the possibility and scope of the external effect of the obligation.<sup>37</sup>

These theoretical considerations cannot be said to be exclusive to shares – they apply equally to other securities, provided that, where appropriate, the unique elements and considerations that shape the “internal sphere” of the relevant financial

<sup>34</sup> See especially the contribution of J Benjamin *Interests in Securities: A Proprietary Analysis of the International Securities Markets* (2000) in the context of English law and M Lehmann *Finanzinstrumente: Vom Wertpapier- und Sachenrecht zum Recht der unkörperlichen Vermögensgegenstände* (2009) writing on German law. But cf Pretto-Sakmann *Boundaries of Personal Property*.

<sup>35</sup> See especially the contributions on US law, including CW Mooney “Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries” (1990) 12 *Cardozo LR* 305; Rogers (1991) *Cardozo LR* 480; JS Rogers “An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision” (1995) 31 *Idaho LR* 689; JS Rogers “Policy Perspectives on Revised U.C.C Article 8” (1996) 48 *UCLA LR* 1431. In the context of German law, see W Zöllner “Zurückdrängung des Verkörperungselements bei den Wertpapieren” in L Raiser & F Baur (eds) *Funktionswandel der Privatrechtsinstitutionen: Festschrift für Ludwig Raiser zum 70. Geburtstag* (1974) 249. Also see the work of Eva Micheler, including E Micheler “The Legal Nature of Securities: Inspirations from Comparative Law” in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 131 and E Micheler “Farewell Quasi-Negotiability? Legal Title and Transfer of Shares in a Paperless World” (2002) *J Bus L* 358.

<sup>36</sup> See especially E Micheler *Wertpapierrecht zwischen Schuld- und Sachenrecht: Zu einer kapitalmarktrechtlichen Theorie des Wertpapierrechts. Effekten nach österreichischem, deutschem, englischem und russischem Recht* (2004).

<sup>37</sup> This model is much indebted to ideas proposed by R Michaels ‘Vor § 241: Systemfragen des Schuldrechts’ in M Schmoeckel, J Rückert & R Zimmermann (eds) *Historisch-kritischer Kommentar zum BGB III* (2007) 1.

instrument are taken into account. For the reasons set out above, for current purposes this “internal aspect” of the analysis is restricted to shares.

Part 3 concludes with a brief prospect of current technological innovations that are, again, accompanied by projections of drastic modifications to the way in which securities are held, traded and settled. Distributed ledger technology, such as the blockchain, is aimed at revolutionising the indirect holding model by establishing a network of immutable ledgers that make intermediaries redundant.<sup>38</sup> Securities holding is therefore expected to, once again, found a direct relationship between an issuer and an investor. Moreover, the technology is said to have the potential to combine the trading, clearing and settlement functions into a single real-time process.<sup>39</sup> Such technological advances will not only alter commercial and technological processes but will challenge underlying legal mechanisms and concepts.

This thesis hopes to complement, from a South African vantage point, the large body of international literature that is testament to the importance of contemplating the legal nature of securities. While technological progress is imminent, it has as its yardstick merely what is technologically possible. Legal progress, on the other hand, this thesis aims to show, is only possible if we reflect on conceptual legal questions such as the legal nature of securities, the nature of the entitlement of account holders and account keepers as well as the nature of transfer mechanisms.<sup>40</sup>

### 1 3 Remarks on methodology

The origins of the South African law of companies can be found in English law. This congruence can be traced back to colonial legislation.<sup>41</sup> The close connection was severed only by the Companies Act of 1973<sup>42</sup> and even more so by the Companies Act of 2008. Even though both jurisdictions have undergone significant reform in the

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<sup>38</sup> E Micheler & L von der Heyde “Holding, Clearing and Settling Securities through Blockchain/Distributed Ledger Technology: Creating an Efficient System by Empowering Investors” (2016) 11 *JIBFL* 652 653.

<sup>39</sup> 653.

<sup>40</sup> Technological advancement, Van Erp cautions creates the risk that we replace the “rule of law” by a “rule of technology”. Writing from the perspective of property law (and not in the particular context of shares) he has repeatedly argued that classical private law is flexible enough to accommodate changes in technology. See S van Erp “Editorial: Ownership of Digital Assets?” (2016) 5 *EuCML* 73 73.

<sup>41</sup> JC de Wet & AH van Wyk *Die Suid-Afrikaanse Kontraktereg en Handelsreg* 4 ed (1978) 530.

<sup>42</sup> JT Pretorius, PA Delpont, M Havenga & M Vermaas *Hahlo’s South African Company Law through the Cases: A Source Book* 6 ed (1999) 1-2.

field of company law in recent years,<sup>43</sup> the historical origin of South African company law in English common law is still evident. English law also continues to exert its influence through case law.<sup>44</sup>

The dominance of English common law is not replicated in South African private law. The South African law of property is mainly based on Roman and Roman-Dutch principles.<sup>45</sup> Property law is therefore more closely related to continental civilian systems. The South African law of contract, on the other hand, is a fusion of Roman-Dutch and English common law.<sup>46</sup>

In any legal system, the interaction between commercial and private law, although integral to the functioning of the system as a whole, is difficult to canvas. This difficulty is exacerbated in a diverse and hybrid system. A comparative approach will therefore be of value. The jurisdictions that will be considered are, in addition to South African law, English- and German law, representing the common law and civilian legal traditions respectively, as well as the law of the United States of America. The latter is particularly influential in the securities landscape and illustrates, more so than the other two jurisdictions, a departure from existing legal traditions.

Without going into undue detail on the methodological disputes of comparative legal scholarship, it suffices to mention that the predominant approach will be a micro-comparison as described by Zweigert and Kötz.<sup>47</sup> This encompasses a comparison of the rules used to solve the specific legal problem identified above, albeit recognising that the boundaries between micro- and macro-comparison are fluid and a certain degree of macro-comparison cannot be avoided.<sup>48</sup> The purpose will be to use comparison as a tool for the critical evaluation of the South African legal

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<sup>43</sup> The United Kingdom through the Companies Act 2006 and South Africa through the Companies Act 71 of 2008.

<sup>44</sup> De Wet & Van Wyk *Kontraktereg en Handelsreg* 530-531; Pretorius et al *Hahlo's SA Company Law* 2.

<sup>45</sup> CG van der Merwe "Law of Property" in CG van der Merwe & JE du Plessis (eds) *Introduction to the Law of South Africa* (2004) 201 201.

<sup>46</sup> G Lubbe & J du Plessis "Law of Contract" in CG van der Merwe & JE du Plessis (eds) *Introduction to the Law of South Africa* (2004) 243 243-244.

<sup>47</sup> K Zweigert & H Kötz *Einführung in die Rechtsvergleichung: auf dem Gebiete des Privatrechts* 3 ed (1996) 4-5.

<sup>48</sup> 5.

landscape on shares and securities.<sup>49</sup> The aim is not to supplant the South African law, but to assist in an assessment of its doctrinal character i.e. its conceptual clarity and coherence and whether it conforms to the systemic approach of South African law.

The focus is a descriptive one with emphasis on the positions *de lege lata*. An account of the South African legal position<sup>50</sup> is similarly aimed at describing the existing law and identifying the applicable legal principles and concepts. Such an exercise necessarily involves a level of careful assessment and evaluation that strays from the purely descriptive and introduces a touch of normativity to the analysis. This does not mean that the proposition becomes one of *de lege ferenda*. The legal philosopher Svein Eng has shown that lawyers' propositions about what the law is are most accurately construed as including both, elements of descriptivity and normativity.<sup>51</sup>

Whereas the comparative analysis is most prominent in Part 2, Part 3 proceeds from the basis of a literature study. The literature highlights dominant themes that emerge across jurisdictions, but must always be read and understood within its proper jurisdictional context.

Where appropriate the comparative analysis will be interspersed with economic descriptions.<sup>52</sup> These parts are simply descriptive and literature-based and aim to enrich the legal and comparative analyses where appropriate.

Lastly, it is necessary to mention that the thesis purports to focus on shares. This and the interplay between shares and securities in the various parts of the thesis have been clarified above. To further specify, the emphasis will fall on publicly listed

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<sup>49</sup> The aim is not to evaluate the range of solutions as “better” or “worse”. Zweigert and Kötz *Rechtsvergleichung* 38-39, 46, caution that this is not possible. For a criticism of the evaluative function of comparison see R Michaels “The Functional Method of Comparative Law” in R Zimmermann & M Reimann (eds) *The Oxford Handbook of Comparative Law* (2006) 339 373-376.

<sup>50</sup> Particularly at the end of Part 2; see below, Chapter 13: The effect of systemic intermediation in South Africa.

<sup>51</sup> Eng coins for this the concept of “fusion of descriptive and normative propositions” and he explains: “Often in lawyers' propositions *de lege lata*, the lawyer's view of what other lawyers will probably assume to be the law (the descriptive proposition) *fuses with* the lawyer's view of what ought to be the law (the normative proposition) *into* the lawyer's view of what is tenable law (the fused descriptive and normative proposition)” (italics in the original); see S Eng “Fusion of Descriptive and Normative Propositions. The Concepts of ‘Descriptive Proposition’ and ‘Normative Proposition’ as Concepts of Degree” (2000) 13 *Ratio Juris* 236 248. Also see S Eng *Analysis of Dis/Agreement – With Particular Reference to Law and Legal Theory* (2003).

<sup>52</sup> See especially, 2 3 Economic descriptions and commercial realities; 4 3 The nexus theory; 9 3 1 The economic theory of intermediation.

shares. Despite substantial differences in company law rules and structures across various jurisdictions, Hansmann and Kraakman find that there is a common structure of company law and therefore an impressive “underlying uniformity of the corporate form”.<sup>53</sup> Companies can be identified by five basic legal characteristics, namely legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership.<sup>54</sup> Therefore, “a principal function of corporate law is to provide business enterprises with a legal form that possesses these five core attributes”.<sup>55</sup> These features are shared by companies across various jurisdictions that raise capital on capital markets. The primary focus will therefore be on companies that exhibit all of these characteristics, being public listed companies. It is of course true that unlisted public companies and private companies also share many of these features, but their shares, although transferable as a general rule, do not trade freely in open markets and their transferability may be subject to restrictions.<sup>56</sup> In addition, mechanisms of transfer may differ.

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<sup>53</sup> J Armour, H Hansmann, R Kraakman & M Pargendler “What is Corporate Law?” in R Kraakman, J Armour, P Davies, L Enriques, H Hansmann, G Hertig, K Hopt, H Kanda, M Pargendler, W-G Ringe & E Rock (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* 3 ed (2017) 1.

<sup>54</sup> 1, 5, 6-15.

<sup>55</sup> 2.

<sup>56</sup> 1-2.

## Part 1

The internal sphere: The relationship between issuers and shareholders

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## Chapter 2: Defining and describing shares

### 2 1 Introduction and a prospect of the discussion

Commercial ventures can only be realised and companies can only come into existence and remain in operation if they are able to secure sufficient resources. There are various ways in which companies can finance their operations. Shares are one of the most important methods for companies to raise capital. More specifically, shares are used to raise equity capital.

The purpose of this part is threefold: to identify some of the characteristic features of shares, to properly distinguish between the concepts of capital, rights and shares and to provide a brief description of the nature of the relationships that are created between issuing companies and investors. More specifically, Part 1 is aimed at disseminating the internal sphere of shares. For this part, it is assumed that a direct relationship exists between issuers of shares and investors and that no intermediaries are involved. An analysis of the internal sphere is based on the hypothesis that shares, as obligations, may exhibit characteristics that range from personal relationships as established between a company and its shareholders, to impersonal asset-like characteristics. While the legal nature of shares and securities will be considered in more detail in Part 3, in this part shares are illuminated from various angles to further illustrate these two dimensions. The dual nature of shares is aptly expressed by Khimji, who writes that “investment securities are creatures of an exceptional nature as they, depending on the context, constitute both assets and obligations”.<sup>1</sup>

The review of the characteristic features of shares will start widely by examining shares as part of the genus of securities, by considering economic or commercial aspects of shares, both in chapter 2, and by exploring shares within the context of capital in chapter 3. An appraisal of these aspects of shares will particularly call attention to the “asset-like” features of shares. That this “proprietary” nature of shares creates difficulties in conceptualising the relationship between an issuing company and investors will appear from the discussion in chapter 4. The obligatory realm within which companies and investors must be located is complex and multifaceted.

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<sup>1</sup> M Khimji “The Role of Legal Concepts in Commercial Law: Comments on Spink, Rogers and Scavone” (2007) 45 *Can Bus LJ* 94 98.

This will also appear from chapter 5 where the individual strands that make up the issuer-investor relationship and the way they are woven together shift into focus. Part 1 will conclude with a brief description of the mechanisms through which investors obtain shares in chapter 6.

## 2.2 Shares as securities

Securities lie at the core of financial markets and transactions. Nonetheless, the term “securities” is a highly abstract legal concept. Part of the difficulty in defining securities is that it is in essence an umbrella term, encompassing a wide category of highly diversified financial instruments. The continuous and rapid development of innovative securities makes the term a dynamic rather than static one.<sup>2</sup>

The global character of securities trading suggests that the concept and definition of “securities” is homogenous, when, in fact, it varies significantly between countries and national legal systems. Although the discrete instruments traded on financial markets are remarkably uniform in design and function, no global consensus exists on the use and particularly on the reach of the term “securities”.

It is abundantly clear that shares are part of the genus of “securities”. Shares and debt instruments, as the historical foundation of this disparate group, have left their mark on it. At the same time, the widespread financial and technological innovations of the last decades have changed the face of shares and debt instruments. This has been augmented by the need to conceptualise and regulate financial instruments as a group – legally, economically and commercially.

In South African companies’ legislation, a general definition of the term “securities” appears for the first time in the Companies Act 71 of 2008 (the “Companies Act”).<sup>3</sup> The term is defined as “any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company”.<sup>4</sup> The Companies Act pursues a comparably broad approach with a flexible measure being found in the phrases “any”, “other instruments” and “irrespective of their form or

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<sup>2</sup> GG Castellano “Towards a General Framework for a Common Definition of ‘Securities’: Financial Markets Regulation in Multilingual Contexts” (2012) *Uniform LR* 448 457.

<sup>3</sup> The South African Companies Act 61 of 1973 refers to securities mainly in the context of “uncertificated securities” in provisions inserted through later amendments and with reference to definitions provided in the Security Services Act 36 of 2004.

<sup>4</sup> Companies Act 71 of 2008 s 1.

title”.<sup>5</sup> No general criteria can be gleaned from the Act for the identification of “other instruments”.<sup>6</sup> With its focus on shares and debentures, the Act clearly highlights the more traditional capital financing aspect of securities.

Considerable deviations from, and extensions of the traditional use of the term can be found in securities regulation legislation. The South African Financial Markets Act 19 of 2012 defines the term “securities” in a manner comparable to the approach of US securities regulation laws<sup>7</sup> by listing a wide variety of commonly traded, standardised instruments.<sup>8</sup> Both listed and unlisted instruments issued by public

<sup>5</sup> S 1.

<sup>6</sup> S 43, titled “Securities other than shares” defines “debt instruments” as including “any securities other than shares of a company”. In light of the definition, the use of the term “debt instruments” seems to assume that apart from shares, all other securities are debt instruments.

<sup>7</sup> The definition in s 2(a)(1) of the US Securities Act, 1933 is as follows: “The term ‘security’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing”. Although there are small differences between the above definition and the one provided in the Securities Exchange Act, 1934, the courts have construed them in an identical manner. See MI Steinberg *Understanding Securities Law* 6 ed (2014).

<sup>8</sup> South African Financial Markets Act 19 of 2012 s 1(1); The full definition reads:

“securities” means –

(a) listed and unlisted –

- (i) shares, depository receipts and other equivalent equities in public companies, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980);
- (ii) debentures, and bonds issued by public companies, public state-owned enterprises, the South African Reserve Bank and the Government of the Republic of South Africa;
- (iii) derivative instruments;
- (iv) notes;
- (v) participatory investments in a collective investment scheme as defined in the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), and units or any other forms of participation in a foreign collective investment scheme approved by the Registrar of Collective Investment Schemes in terms of section 65 of that Act; and
- (vi) instruments based on an index;

(b) units or any other form of participation in a collective investment scheme licensed or registered in a country other than the Republic;

(c) the securities contemplated in paragraphs (a)(i) to (vi) and (b) that are listed on an external exchange;

(d) an instruments similar to one or more of the securities contemplated in paragraphs (a) to (c) prescribed by the registrar to be a security for the purposes of this Act;

(e) rights in the securities referred to in paragraphs (a) to (d),

but excludes –

- (i) money market securities, except for the purposes of Chapter IV; or if prescribed by the registrar as contemplated in paragraph (d);

the share capital of the South African Reserve Bank referred to in section 21 of the South African Reserve Bank Act, 1989 (Act No. 90 of 1989); and

- (ii) any security contemplated in paragraph (a) prescribed by the registrar.

companies are included.<sup>9</sup> Money market securities are expressly excluded.<sup>10</sup> The definition is, however, more restricted than the US equivalent.<sup>11</sup> Broad and general terms are not included. A measure of flexibility is achieved by allowing the registrar to add new instruments to the list.<sup>12</sup> These must be similar to those already specified.<sup>13</sup>

While the term “securities” has gained popularity in legislation, “financial instruments” is more commonplace in financial terminology.<sup>14</sup> The term does not feature prominently in US and South African legislation. It does, however, make a timid appearance in UK Companies’ and Financial Markets Laws. The impetus for this change comes from European law, where “financial instrument” is a term of central importance.<sup>15</sup> Employing the laundry-list approach to definition also popular for defining “securities” in national legislative instruments, “financial instruments” is an umbrella term comparable in meaning and scope to the definition of “securities” in US securities regulation laws.<sup>16</sup> With its counterparts it has in common that these typological types of definitions that come with the promise to be at once comprehensive and sufficiently flexible, provide little guidance when attempting to identify common characteristics of the group they purport to define.

<sup>9</sup> This was not specified by its predecessor, the Security Services Act 36 of 2004.

<sup>10</sup> Financial Markets Act 19 of 2012 s 1(1).

<sup>11</sup> US federal securities regulation evidences an exceptionally wide definition of securities, deriving from broad legislative language as well as an inclusive interpretation of the term by the US Supreme Court. The definition is interspersed with general and descriptive terms, such as “investment contract”, “transferable share” and “in general any interest or instrument commonly known as a security” (see the definition in n 7 above). The US Supreme Court has used this interpretive room to construe the term as including “novel, uncommon, or irregular devices” [*SEC v CM Joiner Leasing Corp* 320 U.S. 344 (1943) 351], as a “flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits” [*SEC v Howey Co* 328 U.S. 293 (1946) 299] and as “sufficiently broad to encompass virtually any instrument that might be sold as an investment” [*Reves v Ernst & Young* 494 U.S. 56 (1990) 62]. The court emphasises the economic substance of transactions and the commercial character of securities [See for example *SEC v CM Joiner Leasing Corp* 320 U.S. 344 (1943) 352-353; *SEC v Howey Co* 328 U.S. 293 (1946) 298; *Tcherepnin v Knight* 389 U.S. 332 (1967) 336; *Landreth Timber Co v Landreth* 471 U.S. 681 (1985) 688]. Despite construing the term 12 times since 1943, the Supreme Court has failed to clearly formulate the meaning and ambit of “securities”. As a result, the US definition of securities is frequently criticised as being overly-broad and too inclusive.

<sup>12</sup> S 1(1) “securities” (d).

<sup>13</sup> S 1(1) “securities” (d).

<sup>14</sup> See below, 2 3 Economic descriptions and commercial realities.

<sup>15</sup> See Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (“MiFID I”), as well as Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (recast) (“MiFID II”) Annex 1 Section C.

<sup>16</sup> See C Kupman “Financial Instruments”, in J Basedow, KJ Hopt, R Zimmermann & A Stier (eds) *The Max Planck Encyclopaedia of European Private Law I* (2012) 697 697.

More instructive, however, is the category of “transferable securities” included under the European list of “financial instruments”. The most noteworthy characteristic of “transferable securities” as defined in the European context is already apparent from the term itself, namely their transferability on capital markets.<sup>17</sup> To implement the European Directives, the term “Finanzinstrumente” has been incorporated into German legislation.<sup>18</sup> These include the traditional category of “Wertpapiere”, but confined to “übertragbare Wertpapiere” (transferable securities), “die ihrer Art nach auf den Finanzmärkten handelbar sind” (that are transferable on capital markets by their very nature).<sup>19</sup> “Wertpapiere” is a term that originated in German law long before the meteoric rise of modern financial markets. Nonetheless, similar to securities, no general legal definition exists.<sup>20</sup> The term appears in several statutes, but its meaning varies, depending on the context and legislative purpose of each statute. Whereas paper-based instruments such as bills of lading and cheques form the traditional core of the concept, other legislation restricts the use of the term to instruments traded on capital markets.<sup>21</sup> Frequently the term is not defined at all,<sup>22</sup> or is defined in the same fashion as described before, namely by providing a list of examples.<sup>23</sup> Transferability has also been identified as one of the key characteristics of securities in the definition put forward in Article 8 of the Uniform Commercial Code,<sup>24</sup> aimed at harmonising transactions involving “investment securities”.

Instead of highlighting the feature of transferability, other instruments, most notably the Hague Securities Convention and the UNIDROIT Convention on Substantive Rules for Intermediated Securities, instead direct focus at the capability

<sup>17</sup> See MiFID I/II art 4(1)(18)/(44), which uses the term “negotiability” instead of transferability. Any reference to “negotiability” is avoided because of its technical legal meaning in Anglo-American and South African law. For a brief overview of the meaning of “transferable”, see Kupman “Financial Instruments” in *Max Planck Encyclopaedia of European Private Law* I 698.

<sup>18</sup> See especially Wertpapierhandelsgesetz § 2(2b), but also Kreditwesengesetz § 1(11).

<sup>19</sup> Wertpapierhandelsgesetz § 2(2b) as read with § 2(1).

<sup>20</sup> Compare this to the position in Switzerland, where such a definition exists: “Wertpapier ist jede Urkunde, mit der ein Recht derart verknüpft ist, dass es ohne die Urkunde weder geltend gemacht noch auf andere übertragen werden kann”; Art 965 Schweizerisches Obligationenrecht. This definition can be traced back to Heinrich Brunner. A Hueck & CW Canaris *Recht der Wertpapiere* 12 ed (1986) 1 formulate it as follows: “Ein Wertpapier ist eine Urkunde, in der ein privates Recht in der Weise verbrieft ist, dass zur Geltendmachung des Rechts die Innehabung der Urkunde erforderlich ist” (A “Wertpapier” is a certificate that reifies/securitises a private law right in such a way that the enforcement of the right depends on the possession of the certificate).

<sup>21</sup> See for example Depotgesetz § 1(1); Wertpapierhandelsgesetz § 2(1).

<sup>22</sup> The term is for example used numerous times in the BGB without being defined and has different meanings throughout. See for example BGB § 232(1), 234, 312g(2) 8, 372, 675b, 700, 702, 783, 1667(2), 1807(1) 4, 2116. The same is true of the Handelsgesetzbuch and the Zivilprozessordnung.

<sup>23</sup> See for example § 1(1) Depotgesetz; § 2(1) Wertpapierhandelsgesetz.

<sup>24</sup> See UCC § 8-102(15).

of securities to be credited to an account.<sup>25</sup> In the explanatory report to the Hague Securities Convention, the definition of “securities” is said to be intentionally broad,<sup>26</sup> with the only limiting factor being, that the instruments in question “must in addition be of a kind capable of being credited to a securities account with an intermediary”.<sup>27</sup> Similarly, the UNIDROIT Convention on Substantive Rules for Intermediated Securities defines securities as “any shares, bonds or other financial instruments or financial assets (other than cash) *which are capable of being credited to a securities account*”.<sup>28</sup>

What are the defining features of securities? - A deceptively easy question with no definite answer. A generally applicable definition of the legal concept of securities can be found neither in South African law nor in many foreign jurisdictions. In contradistinction, legislative definitions abound. Legislative instruments naturally formulate definitions in a fashion that best suits their regulatory purpose. They neither endeavour to distill a general definition nor crystallise a fixed meaning. In legislation, definitional flexibility frequently proves to be advantageous. In the context of a more theoretical and normative enquiry, two features of securities emerge from the definitions, namely the attribute of transferability as well as, more recently, the fact that securities are increasingly credited to accounts. These characteristics have in common that they place a high emphasis on shares as incorporeal assets. The same is true when considering shares from an economic or commercial angle. Commercial mechanisms are transaction-based and transfer is a particularly noteworthy and economically important share transaction.

### **2 3 Economic descriptions and commercial realities**

Securities must in addition be viewed through the lens of business and economics: “What securities law attempts to regulate – and what legal language attempts to

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<sup>25</sup> Kupman “Financial Instruments” in *Max Planck Encyclopaedia of European Private Law* I 699.

<sup>26</sup> “Securities” are defined as “any shares, bonds or other financial instruments or financial assets (other than cash) or any interest therein” - Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (2006) art 1(1)(a).

<sup>27</sup> R Goode, H Kanda & K Kreuzer *Hague Securities Convention: Explanatory Report* 2 ed (2017) Note 1-1.

<sup>28</sup> UNIDROIT Convention on Substantive Rules for Intermediated Securities of 25 September 2013 art 1(a) (own emphasis).

capture – is, in fact, a series of transactions shaped to realise a specific economic function.”<sup>29</sup>

In demarcating the commercial playing field of securities transactions, a brief overview of relevant commercial structures and context is merited. In the academic and economic study of financial markets, not much time and effort has been devoted to a proper demarcation and uniform use of terminology. Market terminology developed in response to commercial practices and is not used consistently. The exposition below is an attempt to summarise predominant economic classifications and terminology. Yet, variations in the use of market terms abound.<sup>30</sup>

A market can be described as “a mechanism for effecting purchases and sales of assets and services in a relatively public manner”.<sup>31</sup> The market can be divided into two broad categories based on the type of asset or service traded, namely the product market and the factor market, the latter being the market for labour and capital.<sup>32</sup> Companies seeking capital become active on the financial market - a specific branch of the factor market.<sup>33</sup> On financial markets they interact with investors who provide the required capital in exchange for future revenue which is either fixed or contingent on the performance of the company. The investors become the holders of financial assets as opposed to real or tangible assets.

Financial assets have no physical existence and can be defined as “claims against present or future income from another (or more than one) participant in the economy.”<sup>34</sup> Newly created financial assets, Moore finds, “*originate only in an act of borrowing, and are reduced only in an act of debt repayment or default*”.<sup>35</sup> The creation of financial assets is therefore a lending-borrowing transaction as opposed to a buying and selling transaction of already existing financial assets.<sup>36</sup> Their price is

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<sup>29</sup> Castellano (2012) *Uniform LR* 462.

<sup>30</sup> Particularly the terms financial securities, financial instruments, financial assets or financial claims are often used interchangeably.

<sup>31</sup> JM Burns *A Treatise on Markets: Spot, Futures and Options* (1979) 5.

<sup>32</sup> FJ Fabozzi & F Modigliani *Capital Markets: Institutions and Instruments* 2 ed (1996) 2.

<sup>33</sup> 2.

<sup>34</sup> RD Auerbach *Financial Markets and Institutions* (1983) 10; BJ Moore *An Introduction to the Theory of Finance: Asstholder Behaviour Under Uncertainty* (1968) 11-12 specifies that financial assets constitute generalised and indirect claims as opposed to the highly specific form and use of real assets.

<sup>35</sup> Moore *Theory of Finance* 15 (emphasis in the original).

<sup>36</sup> 15. The use of the terms “borrowing”, “lending” and “debt” should be seen as a description of the typical commercial transactions in financial assets. They are of course not wholly accurate in the case of equity instruments.

determined by taking the present value of all expected future cash flows. Financial assets do not only arise when companies raise capital – included under the rubric of financial assets are cash, any contractual rights to receive cash from another entity, ordinary bank deposits, as well as debt and equity instruments, amongst others.<sup>37</sup> In the particular instance of shares, the company obtains capital in exchange for granting a title to revenue in conjunction with certain control rights to the investor. According to the International Accounting Standards (IAS), a company issuing shares must account for them as equity instruments, while the investor will account for them as a financial asset. An “equity instrument” is defined as “any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities”.<sup>38</sup>

Both financial assets and equity instruments are classified as financial instruments, which are “contract[s] that give rise to a financial asset of one entity and a financial liability or equity instrument of another entity”.<sup>39</sup> “Financial instrument” is therefore an umbrella term. Two parts of the definition merit special mention: 1. Financial instruments are contracts. Securities represent legal claims and the relationships created when transacting with securities are legal relationships. A legal analysis of the nature and working of securities therefore lies at their core. 2. Each contractual right to receive a stated benefit (financial asset) is matched by a corresponding contractual obligation to pay the benefit (accounted for as a financial liability or equity).<sup>40</sup>

When such a financial asset in the hands of an investor can easily be transferred to another person or entity, the financial instrument is frequently referred to as a financial security. While any financial instrument has the inherent potential to be traded, financial securities are specifically designed to be traded, be it on organised exchanges or in “over-the-counter” (OTC) transactions.<sup>41</sup> Their transferability is a feature of their legal design, even if their actual liquidity is dependent on other factors such as the existence of an active market.<sup>42</sup>

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<sup>37</sup> See the definition of “financial assets” in International Accounting Standards Board *International Accounting Standards (IAS) 32 Financial Instruments: Presentation* 11.

<sup>38</sup> 11.

<sup>39</sup> 11.

<sup>40</sup> Financial instruments in the sense delineated here are therefore sometimes described as “claims” – see International Monetary Fund *Balance of Payments and International Investment Position Manual* 6 ed (2009) 81.

<sup>41</sup> 82.

<sup>42</sup> 82.

There are various ways to further classify financial securities. First, a “type of claim” classification splits debt securities from equity securities.<sup>43</sup> A second method of classification is based on the term of maturity of the claim, thereby distinguishing money market securities from capital market securities.<sup>44</sup> The express exclusion of money market securities by South African legislation requires that a distinction is drawn between capital markets and money markets. Long-term securities are traded on the capital market, whereas short-term securities are traded on the money market.<sup>45</sup> Short-term is frequently said to refer to a period not exceeding 12 months.<sup>46</sup> In practice, however, (particularly in South Africa) the normal term to maturity of short-term instruments is accepted to be three years.<sup>47</sup>

The issuing of securities has traditionally attracted most attention.<sup>48</sup> In its early stages, the trading of securities was often associated with speculative behavior,<sup>49</sup> and was therefore initially not subjected to rigorous economic and legal analysis.<sup>50</sup> This position no longer holds. Both the issuing and trading legs are part of the corpus of securities. Economically and legally it is therefore useful to distinguish primary, or issuing markets from secondary or trading markets. The trading in securities shifts the focus from the issuer-investor relationship that dominates the initial issue of securities, towards a variety of investor-third party relationships. Trading, transfer and

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<sup>43</sup> Fabozzi & Modigliani *Capital Markets* 12; FJ Fabozzi “Overview of Financial Instruments and Financial Markets” in FJ Fabozzi (ed) *Handbook of Finance: Financial Markets and Instruments I* (2008) 3 4; K Pilbeam *Finance and Financial Markets* (1998) 15, 23; Auerbach *Financial Markets and Institutions* 11. There are, however, financial securities that refuse clear-cut classification into either of the categories of “debt” or “equity”.

<sup>44</sup> Fabozzi & Modigliani *Capital Markets* 12; Pilbeam *Finance and Financial Markets* 24; There are several other methods to classify financial markets that do not simultaneously also classify financial securities. The most common of these methods include firstly a classification in terms of the date of issue of the financial security i.e. primary vs secondary markets and secondly the time of completion of the transaction i.e. immediate settlement (spot or cash market) vs future settlement (futures market or derivatives market); See further Pilbeam *Finance and Financial Markets* 23-24; B van den Berg *Understanding Financial Markets and Instruments* (2000) 11-12.

<sup>45</sup> Van den Berg *Understanding Financial Markets* 12; Fabozzi & Modigliani *Capital Markets* 12; Pilbeam *Finance and Financial Markets* 24; Fabozzi “Financial Instruments and Markets” in *Handbook of Finance* 6.

<sup>46</sup> See *Van den Berg Understanding Financial Markets and Instruments* (2000) 67; Fabozzi & Modigliani *Capital Markets* 12.

<sup>47</sup> Van den Berg *Understanding Financial Markets and Instruments* 67.

<sup>48</sup> RC Michie *The Global Securities Market: A History* (2006) 1, 333, 336.

<sup>49</sup> Today, it is the trading of derivatives that is regarded as speculative, not the trading of equities. For modern contributions to the speculative nature of trading, see for example J Kay *The Truth about Markets: Why Some Nations are Rich but Most Remain Poor* (2004), who describes markets as “arenas for sophisticated professional gambling”, disputes the efficient market theory and states that “selling bits of paper to one another at ever-higher prices creates only the illusion of wealth”; See also R Schiller *Irrational Exuberance* 3 ed (2016 revised & expanded); For a historic overview see Michie *Global Securities Market* 1-4.

<sup>50</sup> Michie *Global Securities Market* 1, 333, 336.

the resulting relationships will be considered in detail in Part 2. As illustrated above, the financial market is an important mechanism for the allocation of resources by providing “a means of allocating funds to where they can be used most profitably”.<sup>51</sup> Viewed as such, financial markets enable the transfer of funds from market participants with surplus funds to those that can utilise them.<sup>52</sup> Bringing together buyers and seller of securities is a core function of financial intermediation. Securities markets, in particular, are a “flexible interface between borrowers and lenders and between credit and capital”.<sup>53</sup> From an economic viewpoint, the major role played by securities markets is threefold: They enable price discovery; they offer liquidity by providing for mechanisms of transfer and they reduce transaction costs, particularly search and information costs.<sup>54</sup> Key characteristics shared by all instruments traded on securities markets are therefore their transferability, liquidity and price visibility. The degree to which these characteristics are present vary, depending on whether a given instrument is traded on public, organised securities markets or on a more ad-hoc basis. Standardised, homogenous instruments traded on public exchanges represent the extreme on this spectrum.

Although, in a commercial and economic context, securities elude clear definition, the structures, characteristics and effects outlined above must form the basis of an understanding of the term and its implications. Three core features of securities identified above merit repetition as being particularly useful in conceptualising the economic and commercial essence of securities: 1. Securities are legal claims against present or future income; 2. Securities are issued for the purpose of raising capital, traditionally to finance operations and 3. Securities are financial instruments that can be traded. The characteristics of transferability, liquidity and price visibility are predominantly a result of the last of these features. It is also the potential ease with which they can be traded that distinguishes securities from ordinary contracts –

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<sup>51</sup> Auerbach *Financial Markets and Institutions* 38.

<sup>52</sup> Pilbeam *Finance and Financial Markets* 13-14; This is frequently described as the allocative efficiency function of markets. Analysed from an economic perspective, markets are said to exist because they promote efficiency. Market efficiency is analysed in three ways: allocative efficiency, operational efficiency and informational efficiency. The last is most prominent in academic literature. Markets are said to exhibit informational efficiency when market prices instantly and fully reflect available information. Liquidity is the primary element of informational efficiency.

<sup>53</sup> Michie *Global Securities Market* 3.

<sup>54</sup> Fabozzi “Financial Instruments and Markets” in *Handbook of Finance* 6; Fabozzi & Modigliani *Capital Markets* 11; TH McIntish *Capital Markets: A Global Perspective* (2008) 37.

a feature that is as much central to shares and debt instruments as it is to more innovative financial products.

In the specific context of shares, however, the second feature identified above, namely that shares are issued for the purpose of raising capital, remains highly relevant and merits a closer examination of the concept of capital. While economic theory highlights the feature of capital in the hands of the company, the discussion below will show that shares themselves are independent units of capital.

## Chapter 3: The concept of capital

### 3 1 Capital and equity

The term shares depicts an aggregate, namely “[t]he capital raised by a company or corporation through the issue or subscription of shares”.<sup>1</sup> Shares are capital. This conception of capital is a quantitative measure of the monetary pool and financial wealth of a company. For a company, capital, at the same time as representing a monetary aggregate, denotes its productive assets. Capital today is frequently conceived as growth. This sentiment is reflected in the work of many economists – Adam Smith may be used as an exemplary illustration. He defines capital as that part of a man’s stock “which, he expects, is to afford him [this] revenue”.<sup>2</sup> To a company, capital is simultaneously the money expended to create a return – the machinery purchased to produce a commodity to be sold at a profit or the money spent on creating a valuable brand, as well as these physical or intangible capital goods themselves. The former is known as financial capital and the latter as productive capital.

In financial circles, shares represent a means of raising equity capital. Equity is defined in finance as “the residual interests of the entity after deducting all its liabilities”.<sup>3</sup> It is sub-divided into funds contributed by shareholders, retained earnings and reserves.<sup>4</sup> In finance, equity capital becomes a function of double-entry bookkeeping, where equity equals assets less liabilities.<sup>5</sup> A financial concept of capital therefore corresponds to a company’s net assets or equity.<sup>6</sup>

Capital, however, cannot be confined to a single meaning and this brief overview by no means attempts to dabble in the complexities of determining what capital is

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<sup>1</sup> Oxford Dictionaries (available online).

<sup>2</sup> A Smith *The Wealth of Nations* (1776) ch 1, book II, 112. The use of “stocks” by Adam Smith, is naturally not confined to company shares.

<sup>3</sup> International Accounting Standards Board *International Financial Reporting Standards (IFRS): The Conceptual Framework for Financial Reporting* (2010) 4.4(c).

<sup>4</sup> 4.20.

<sup>5</sup> This is also known as a financial, as opposed to a physical concept of capital – see International Accounting Standards Board *IFRS: Conceptual Framework* 4.57. Also see Max Weber’s understanding of capital, which he defines as “the money value of the means of profit-making available to the enterprise at the balancing of the books” – M Weber *Economy and Society: An Outline of Interpretive Sociology* (1978) 91 (translation of the German original *Wirtschaft und Gesellschaft: Grundriss der verstehenden Soziologie*, edited by G Roth & C Wittich). To Weber, accounting in the form of double-entry bookkeeping is essential for the development of rational capitalism.

<sup>6</sup> International Accounting Standards Board *IFRS: Conceptual Framework* 4.57. A physical concept of capital, on the other hand, denotes the productive capacity of a company – see 4.57.

and neither does it attempt to provide a comprehensive summary of the economic discourse of this search. The aim is merely to highlight some thoughts on capital that assist us in understanding the interaction between capital, rights and shares.

### 3 2 Capital in legislation

The concept of capital is central to the idea of companies and traditionally features prominently in companies' legislation. It is, however, conspicuously absent from the South African Companies Act of 2008. Abandoning par-value shares has ushered in the decline of the legislative concept of share capital.

The previous dispensation, even if not prescribing a minimum share capital,<sup>7</sup> demanded that the share capital with which a company proposed to be registered be set out in its memorandum of association, divided either into nominal shares of a fixed value or into a certain number of shares (for non-par value shares).<sup>8</sup> This nominal capital, frequently referred to as authorised share capital, signified the maximum capital the company was allowed to raise through issuing shares.<sup>9</sup> Any supplementary amount paid for shares over and above their nominal value was accounted for in share premium accounts and not as share capital. Share capital, or legal capital, was thought to provide a buffer for creditors by being non-distributable to shareholders, whether as dividends, upon liquidation or otherwise.<sup>10</sup>

Today, a company must only set out in its memorandum of incorporation the number of shares of each class it is authorised to issue.<sup>11</sup> Capital as an expression of a monetary aggregate of the nominal value of all shares has vanished together with the par value shares and the concept of capital maintenance.<sup>12</sup> This change is also

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<sup>7</sup> JT Pretorius, PA Delpont, M Havenga & M Vermaas *Hahlo's South African Company Law through the Cases* 6 ed (1999) 121.

<sup>8</sup> See Companies Act 61 of 1973 s 52(2)(a).

<sup>9</sup> It was calculated by multiplying the maximum number of shares a company was allowed to issue with the par value per share.

<sup>10</sup> See JJ Hanks "The New Legal Capital Regime in South Africa", in TH Mongalo *Modern Company Law for a Competitive South African Economy* (2010) 131 136.

<sup>11</sup> Companies Act 71 of 2008 s 36(1)(a). Also see s 2.1(1) of Form CoR 15.1B, with which a company's memorandum of incorporation is lodged.

<sup>12</sup> The concept of capital maintenance prohibited a company from distributing capital to its shareholders, except through a reduction of share capital. The capital maintenance rule was intended to protect a company's creditors by preventing that the funds that were contributed by shareholders were returned to them. Dividends to shareholders could, for example, be paid only out of profits not out of capital. The contributions of shareholders were intended to serve as a buffer for creditor protection. This rule was successively abandoned from 1999 onwards in favour of a solvency and liquidity test as developed in US law and now found in s 4(1) as read with s 46 of the Companies Act

reflected in the definition of a “share” – whereas a share was previously defined as “a share in the share capital of that company”, the reference to share capital has been discarded.<sup>13</sup> Share capital today describes, at most, the number and type of shares that a company is authorised to issue. The focus has rightly shifted to the rights of which shares are composed, rather than an artificial value that bears no relation to the market value of the shares.

### 3 3 Shares as capital in their own right

The value of the concept of share capital is doubtful wherever it is used to refer to the aggregate nominal value of shares. Nonetheless, the explanatory value of the notion of capital is compelling, particularly in illustrating how shares as a form of capital turn into units of capital in their own right, independent of the capital advanced to the company by its shareholders.

Capital was the central concept of Karl Marx’s book of the same name. Disregarding the political positions advanced in the book, Marx formulates an interesting theory on the evolution of capital culminating in the development of money as capital and the emergence of fictitious capital.<sup>14</sup>

Sketched in very brief terms, it is useful first to describe the original forms of capital, which Marx terms industrial capital and merchant capital. In simple terms, the distinguishing feature of capital is the potential to produce surplus value.<sup>15</sup>

An industrial capitalist invests his money (M) in commodities (C), in the form of labour (L) and means of production (MP). In a process of production (P), these are converted to commodities with different characteristics (C<sub>1</sub>), which are sold for a sum of money (M<sub>1</sub>) greater than that initially invested in the venture. The metamorphosis of commodities takes place through production.<sup>16</sup> Money changes hands twice during

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71 of 2008. For a history of the capital maintenance rules, see MS Blackman, RD Jooste, CK Everingham, JL Yeats, FHI Cassim & R De La Harpe *Commentary on the Companies Act (2002)* (RS 9 2012) 5-8 – 5-16. On the solvency and liquidity test, see K van der Linde “The Solvency and Liquidity Approach in the Companies Act 2008” (2009) 2 *TSAR* 224.

<sup>13</sup> The legal position in South Africa is comparable to the Model Business Corporation Act in the US, § 6.01(a), which also demands that the classes of shares and the number of shares of each class that a company is authorised to issue, be set out in the articles of incorporation. Direct references to the concept of capital are equally absent (but compare this to the position in the Delaware Code).

<sup>14</sup> For a brief overview, also in the context of shares, see P Ireland, I Grigg-Spall & D Kelly “The Conceptual Foundations of Modern Company Law” (1987) 14 *J Law & Soc* 149 150.

<sup>15</sup> See K Marx *Capital: A Critique of Political Economy I* (1867) ch 4, 107.

<sup>16</sup> See K Marx *Capital: A Critique of Political Economy II* (1885) ch 1.

the process,<sup>17</sup> but only functions as a transient form of capital, money-capital, not as capital in its own right.<sup>18</sup>

$$M \rightarrow C \dots P (L \& MP) \dots C_1 \rightarrow M_1$$

Commercial capital, on the other hand, is devoted, not to a process of production, but to the simple buying and selling of commodities. The merchant expends money on commodities, which are resold at a profit. In the process, the merchant does not change the character of the commodities. Money changes hands twice, facilitating a change of place of the commodity rather than its complete metamorphosis.<sup>19</sup> In this process, money-capital acts simply as money, as a means of purchasing commodities for resale, not as capital.<sup>20</sup>

$$M \rightarrow C \rightarrow M_1$$

Described in its simplest form, the industrial capitalist has to finance the production process himself and the merchant likewise has to finance the purchase of commodities. The key element of the capital enterprise – the generation of a surplus – may at times assume a money-form, at times a commodities form. Money and commodities are only capital as long as they keep circulating and creating a surplus.<sup>21</sup> The essential factor, therefore, is value, which is both self-preserving and self-expanding.

This position changes significantly where the financing of capitalist activity is externalised – where money is transferred from one person to another temporarily as a loan to be used in the process of production or the buying and re-selling of goods. While the money capitalist contributes the funds, the industrial capitalist or the merchant capitalist utilises them to produce surplus value. Only the process underlying the creation of industrial or commercial capital, as described above, is

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<sup>17</sup> Marx *Capital I* ch 4, 105; K Marx *Capital: A Critique of Political Economy III* (1894) ch 21, 231.

<sup>18</sup> Marx *Capital III* ch 24, 267: “In the reproduction process of capital, the money-form is but transient – a mere point in transit”.

<sup>19</sup> Ch 21, 231.

<sup>20</sup> Ch 21, 232.

<sup>21</sup> Marx *Capital I* ch 4, 107. Also see Adam Smith, who draws a distinction between circulating (floating) and fixed capital. Circulating capital was employed in manufacturing or the purchasing and reselling of goods. Smith writes: “The capital employed in this manner yields no revenue or profit to its employer, while it either remains in his possession, or continues in the same shape. ... His capital is continually going from him in one shape, and returning to him in another, and it is only by means of such circulation, or successive exchanges, that it can yield him any profit.” – Smith *Wealth of Nations* 112.

described by Marx as the actual, active investment as capital.<sup>22</sup> The transfer of funds (the first outlay of money) from the money capitalist to the active capitalist is a simple transfer. Only the 2<sup>nd</sup> outlay of money by, for example, the merchant to purchase commodities for resale, is a phase of the reproduction of capital.<sup>23</sup> The double outlay of money is matched by a double reflux of money as capital.<sup>24</sup> The first reflux is a conversion of commodities to money at a value higher than that expended at the beginning of the process ( $M_1$ , which is  $M + \Delta M$ , while  $\Delta M$  is made up of profit and interest). A part of this surplus must be surrendered to the money capitalist. The second reflux is therefore the transfer of the loan amount plus interest from the active capitalist to the money capitalist. To the money capitalist, money has the ability to produce a surplus in the form of interest (the  $M_1$  of the money capitalist is the loan amount plus interest). Money becomes capital – a commodity – in its own right. In this process, Marx labels money as a commodity *sui generis*.<sup>25</sup> To the money capitalist, the circuit of his capital becomes simply  $M - M_1$ .

$$(M \rightarrow) M \rightarrow C \dots P \dots C_1 \rightarrow M_1 (\rightarrow M_1)$$

$$(M \rightarrow) M \rightarrow C \rightarrow M_1 (\rightarrow M_1)$$

For money to function as capital in the sense just described, it must be expended as labour (L) or means of production (MP) in the process of industrial capital or to purchase commodities in the process of merchant capital. The active transformation of money into capital takes place as part of these processes. According to Marx, money as capital (or capital as a commodity) can become disconnected from the active function of industrial or merchant capital. This takes place, for example, in the case of shares in a company.<sup>26</sup> The money invested in the company is industrial or merchant capital to the company, actively utilised by the company to produce a surplus. This is described as actual or real capital.<sup>27</sup> This “loan capital” cannot be withdrawn. To ensure the reflux of money to the money-capitalists, they receive shares, which are termed titles to revenues or titles to real capital. This process is described as capitalisation – the periodic future income that will flow from advancing

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<sup>22</sup> Marx *Capital* III ch 21, 231.

<sup>23</sup> Ch 21, 231.

<sup>24</sup> Ch 21, 232.

<sup>25</sup> Ch 21, 230. Also see ch 24.

<sup>26</sup> Ch 29.

<sup>27</sup> Ch 29, 334-335.

the real capital is capitalised to produce a present value of the title.<sup>28</sup> Marx describes this as the formation of fictitious capital.<sup>29</sup> These titles to revenue can be sold and bought freely and in the process develop a value that is disconnected from the money initially advanced for these claims as well as from the value created by the real capital and the value of the asset-base of the company.<sup>30</sup> The value of shares is rather a market price influenced by factors such as the interest rate and the expected profitability of the company.

In a company context, it is therefore useful to distinguish two strata of capital: The capital of the company and the capital of the shareholder. The latter is the share, which is a unit of capital in its own right. As Ireland puts it: “The same sum of money thus comes to function as capital for two people. Industrial capitalists use it as capital *in* the production process and money capitalists use it as capital *outside* the production process.”<sup>31</sup> Active markets on which shares are traded promote the emergence of shares as distinct units of capital.<sup>32</sup>

While a company’s share capital still consists of its authorised and issued shares, the conception of shares as a monetary portion of a company’s share capital is in decline,<sup>33</sup> as evidenced by a review of the concept of capital in companies’ legislation.<sup>34</sup> Parallel to this, the notion of shares as independent units of capital has increased in importance. This shift in emphasis not only underscores the centrality of the feature of transferability of shares as identified above,<sup>35</sup> it further highlights the relatively impersonal nature of shares as assets. The conceptual severance of the company from the holders of its shares can not only be explained with reference to the concept of capital. It is also a milestone in the historic development of the company as a specific business form. A review of the historic development of the legal conception of companies<sup>36</sup> as well as on economic theories of the company

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<sup>28</sup> Ch 29, 335.

<sup>29</sup> Ch 29, 334. Marx viewed fictitious capital with strong aversion, describing it as “a meaningless form of capital” and “the perversion and objectification of production” – ch 24, 267.

<sup>30</sup> Ch 29, 336. The same applies to the market value of a company, which is today typically much greater than the underlying value of its capital goods.

<sup>31</sup> Ireland et al (1987) *J Law & Soc* 157.

<sup>32</sup> 158.

<sup>33</sup> Above, 3 1 Capital and equity.

<sup>34</sup> Above, 3 2 Capital in legislation.

<sup>35</sup> Above, 2 2 Shares as securities and 2 3 Economic descriptions and commercial realities.

<sup>36</sup> Below, 4 2 The entity theory.

form,<sup>37</sup> even if generally considered to be a moot debate,<sup>38</sup> is therefore useful for showing, just like Marx's theory on fictitious capital, the development of shares as assets separate from the company.

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<sup>37</sup> Below, 4 3 The nexus theory.

<sup>38</sup> See for example 4 2 1 The development of the doctrine of juristic personality, text to nn 49-52, below.

## Chapter 4: Considerations of ownership

### 4 1 Introduction

The entanglement of the capital of shares with the capital of the company frequently leads to assertions that “ownership” of the company vests in its shareholders. The International Financial Reporting Standards (IFRS) Conceptual Framework indicates that “[classifications such as equity capital or other reserves] may also reflect the fact that parties with ownership interests in an entity have differing rights in relation to the receipt of dividends or the repayment of contributed equity”.<sup>1</sup> In fact, historically, the extensive rights with which shareholders are furnished in relation to the company have frequently been justified with reference to their position as “owners” of the company.<sup>2</sup> The idea of shareholder ownership of the company is deeply woven into the fabric of the theory of the firm, its structure, responsibilities, government and governance. Ideas of shareholder ownership of the company are the foundation on which economic theories such as the separation of ownership and control, the agency problem and shareholder primacy are constructed. Conceptions about shareholder ownership and shareholder primacy frequently lie at the center of both legal and economic theories of the corporation.

The enquiry into the nature and structure of companies has engaged the minds of legal academics and economists alike. A company has both a legal and an economic structure, comprised on the one hand of the rules that determine the rights and obligations of the parties involved, and on the other the material relations that flow from a specific economic arrangement.<sup>3</sup> Whilst a company is characterised as a juristic person in law, the most prominent theory of the company, or firm,<sup>4</sup> in economic circles in the past decades has been the conception of the company as a nexus of contracts. Although these theories are aimed at showing how companies come into existence, they simultaneously disclose much about the relationship between a company and its shareholders.

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<sup>1</sup> International Accounting Standards Board *IFRS: Conceptual Framework* 4.20.

<sup>2</sup> RB Grantham “The Doctrinal Basis of the Rights of Company Shareholders” (1998) 57 *Cambridge LJ* 554.

<sup>3</sup> R Flannigan “The Economic Structure of the Firm” (1995) 33 *Osgoode Hall LJ* 105 106.

<sup>4</sup> In economics a firm includes a wide variety of business organisations, including sole proprietorships, partnerships and companies. The theory applies to firms in general. As the focus of this thesis is on companies, the terms “firm”, “company” and “corporation” will be used interchangeably.

## 4 2 The entity theory

### 4 2 1 The development of the doctrine of juristic personality

The decisive outcome of incorporation is the establishment of juristic personality. Juristic personality is so central to the concept of a company that the South African Companies Act emphasises it in defining a company.<sup>5</sup> A company, as a juristic person, comes into existence upon incorporation<sup>6</sup> and “has all of the legal power and capacity of an individual”.<sup>7</sup> The concept of juristic personality establishes the company as an entity separate from its shareholders and treated in law as having the capacities of a natural person, where applicable.<sup>8</sup>

What appears to be axiomatic from today’s vantage point was not always as clear-cut. The British joint-stock company has its origins in partnership law, which dictated that a special and personal relationship exists between the partners.<sup>9</sup> Partners owned the assets of the partnership and were liable jointly and severally for its debts.<sup>10</sup> The departure of one of the partners from the partnership marked its termination. The association of partners constituted the partnership. What worked well in the context of a partnership, and still does, was less suitable for an association of a large number of natural persons.<sup>11</sup> Legislative intervention was required to establish a legal entity separate from the persons associating to form it.<sup>12</sup> This timid legal initiative, however,

<sup>5</sup> Companies Act 71 of 2008 s 1: “company’ means a juristic person incorporated in terms of this Act”. J Armour, H Hansmann, R Kraakman & M Pargendler “What is Corporate Law?” in R Kraakman, J Armour, P Davies, L Enriques, H Hansmann, G Hertig, K Hopt, H Kanda, M Pargendler, W-G Ringe & E Rock (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* 3 ed (2017) 1 5-8 identify legal personality as one of the five core structural characteristics of companies.

<sup>6</sup> See South African Companies Act 71 of 2008 s 19(1)(a). Also see for the UK, Companies Act 2006 s 16(2), which refers to a “body corporate”. The Model Business Corporation Act § 2.03(a) refers to a “corporate existence”. The terminology of “corporate existence” and “body corporate” is also employed by the Delaware Code § 106. The German Aktiengesetz § 1(1) describes the nature of a company (“Aktiengesellschaft”) as “eine Gesellschaft mit eigener Rechtspersönlichkeit”. The German BGB similarly refers to “Juristische Personen” in Part 2. On “juristic personality” in German legal theory also see H Wiedemann *Gesellschaftsrecht I* (1980) § 4, 191; W Flume *Allgemeiner Teil des Bürgerlichen Rechts I: Die juristische Person* (1983) § 1, 1; K Schmidt *Gesellschaftsrecht* 4 ed (2002) § 8 II, 186.

<sup>7</sup> Companies Act 71 of 2008 s 19(1)(b). A similar provisions can be found in the Model Business Corporation Act in § 3.02, stating that a corporation “has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs”. Also see Delaware Code § 121.

<sup>8</sup> Some attributes of natural persons cannot be extended to companies, such as feelings or race. See RC Williams “Companies: Part 1” in WA Joubert & JA Faris (eds) *LAWSA 4(1)* 2 ed (2012) para 64; PA Delpont (ed) *Henochsberg on the Companies Act 71 of 2008* (RS 15 2017) 82-83. Also see s 19(1)(b)(i) of the Companies Act 71 of 2008.

<sup>9</sup> Grantham (1998) *Cambridge LJ* 557-558.

<sup>10</sup> 557-558.

<sup>11</sup> 558.

<sup>12</sup> This was first stipulated in the English Companies Act of 1844; See Grantham (1998) *Cambridge LJ* 558.

passed into oblivion for the greater part of the 19<sup>th</sup> century. Ireland, Grigg-Spall and Kelly describe the position prevailing during the 19<sup>th</sup> century as follows:

“Incorporation did create an entity, the incorporated company, which was legally distinguishable from the people composing it, but there was no suggestion that this entity was ‘completely separate’ from its members. On the contrary, up to the middle of the nineteenth century incorporated joint stock companies were consistently identified with their component members and were conceptualized not as depersonalized objects but as entities composed of those members merged into one legally distinguishable body.”<sup>13</sup>

Even though the joint stock company exhibited many features still associated with companies today, such as transferable shares, a management body and a board of directors,<sup>14</sup> it was essentially viewed as an entity comprised of an aggregation of shareholders – an entity nonetheless, but not one distinct from such shareholders. As a logical consequence, the shareholders were considered to be the owners of the company.<sup>15</sup> As owners of the company the shareholders were simultaneously owners of its assets, they could manage the company or dictate how it ought to be managed for their benefit. The company was regarded as holding the assets in trust on behalf of the shareholders.<sup>16</sup>

Only the seminal case of *Salomon v A Salomon and Co Ltd*<sup>17</sup> shifted the focus to the legal characterisation of companies as entities not only distinguishable, but also completely separate from its members or shareholders. The facts of the case are well-known and it suffices to mention that the salient question to be answered by the court was whether Mr Salomon, a shareholder and secured creditor, could be held personally liable for the debts of the company upon its liquidation.<sup>18</sup> It was contended that Mr Salomon had established the company to shield himself from his creditors and that the other six shareholders, being his family members, were essentially “dummies” as he was the only active shareholder. The decision by the House of Lords represents a substantial paradigm shift in the conception of a company. A

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<sup>13</sup> P Ireland, I Grigg-Spall & D Kelly “The Conceptual Foundations of Modern Company Law” (1987) 14 *J Law & Soc* 149 150.

<sup>14</sup> Grantham (1998) *Cambridge LJ* 558.

<sup>15</sup> 560.

<sup>16</sup> *Child v Hudson’s Bay Co* (1723) 2 P Wms 207. See also Grantham (1998) *Cambridge LJ* 562; Ireland et al (1987) *J Law & Soc* 152.

<sup>17</sup> [1897] AC 22.

<sup>18</sup> For a summary of the facts see D Kershaw *Company Law in Context: Text and Materials* 2 ed (2009) 30-31; D French, SW Mayson & CL Ryan *Mayson, French & Ryan on Company Law* 31 ed (2014-2015) 122-123.

company, it was decided, is an entity in itself, completely separated from its shareholders:

“The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or the trustee for them.”<sup>19</sup>

The re-conceptualisation of the company as a separate entity and legal person cannot be viewed in isolation. It was heralded by a change in the nature of the share itself.<sup>20</sup> During the 18<sup>th</sup> and early 19<sup>th</sup> century not only the shareholders, but also their shares were seen as closely connected to the property of the company – the shareholders as owners of the assets and the shares themselves as an equitable interest in those assets.<sup>21</sup> The concept of a “share” therefore corresponded to the ordinary meaning of the word, namely – a part of a whole – to be precise a part of the property of the company.<sup>22</sup> This had a profound impact on the nature of a share. A share, it was commonly believed, could either be personalty or realty depending on the type of assets held by the company.<sup>23</sup>

The case of *Bligh v Brent*<sup>24</sup> marked a departure from this position. The issue that had to be decided by the court was whether shares in an incorporated waterworks company were realty.<sup>25</sup> Although the decision did not tamper with the concept of shareholders as proprietors of the company,<sup>26</sup> the court made it clear that shareholders have no direct and severable interest in the assets of the company. The nature of a share was thus severed from the nature of the company’s assets. Shares were described as personalty or personal property irrespective of the nature of the assets held by the company.<sup>27</sup> This idea of a separation between shares and the assets of the company was extended to unincorporated companies in *Watson v*

<sup>19</sup> Lord Mcnaghten in *Salomon v A Salomon and Co Ltd* [1897] AC 22 51.

<sup>20</sup> Ireland et al (1987) *J Law & Soc* 151, Grantham (1998) *Cambridge LJ* 562-564.

<sup>21</sup> DG Rice “The Legal Nature of a Share” (1957) 21 *Conveyancer & Property Lawyer* 433 433-434; Ireland et al (1987) *J Law & Soc* 152.

<sup>22</sup> Rice (1957) *Conveyancer & Property Lawyer* 433.

<sup>23</sup> Rice (1957) *Conveyancer & Property Lawyer* 433; Ireland (1987) *J Law & Soc* 152.

<sup>24</sup> 1837 2 Y & C Ex 268.

<sup>25</sup> All the assets of the company were clearly realty. Realty can be equated to immovable property in South African law.

<sup>26</sup> The separate juristic personality of the company was only articulated in *Salomon v A Salomon & Co Ltd* [1897] AC 22 as illustrated above.

<sup>27</sup> *Bligh v Brent* 2 Y & C Ex 268.

*Spratley*.<sup>28</sup> It is a logical step from detaching the nature of the shares from the assets of the company, to separating the shareholders from those assets altogether.

Similar developments took place in American law, as a result of which a company was conceptualised as an entity separate from its shareholders. In particular, the company was viewed as an artificial entity that owed its existence to the law.<sup>29</sup> This characterisation of the corporate form followed from a number of features exhibited by corporations – the characteristics of immortality, perpetual succession, the ability to manage its own affairs as well as the ability to hold property.<sup>30</sup> Another important factor was the fact that companies were incorporated individually by special charters that required an act by the state legislature in each case – incorporation was construed as a “concession”, a privilege bestowed by the state.<sup>31</sup>

Renewed academic interest in the enquiry about “corporate personality” was sparked by both changes in the legal landscape, as well as philosophical legal enquiry.<sup>32</sup> The emergence of general incorporation statutes during the second half of the 19<sup>th</sup> century eliminated the need to incorporate each company individually and changed the conception of the corporation from an artificial entity depending for its creation on the law, to a natural entity that is the product of the private initiative of entrepreneurs and investors.<sup>33</sup> The decline of the *ultra vires* doctrine,<sup>34</sup> the abrogation of prohibitions to act beyond the borders of the state in which a company was incorporated<sup>35</sup> and the abolition of other regulatory restrictions, contributed to this development.<sup>36</sup> In the wake of the emerging general incorporation laws, the need arose to re-conceptualise the corporation. By making incorporation freely available, the theory that corporations are artificial creatures created by the state became tenuous. To fill the void, competing theories were put forward. Initially, the prevailing

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<sup>28</sup> (1854) 2 CLR 1434.

<sup>29</sup> See for example the case of *Trustees of Dartmouth College v Woodward* 17 U.S. 518 (1819) 636-637: “A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law”. In *Santa Clara County v Southern Pacific Railroad Company* 118 U.S. 394 (1886) corporations were determined by the court to be persons. For a brief summary of the development of American law, see D Millon “Theories of the Corporation” (1990) 39 *Duke LJ* 201 206-207.

<sup>30</sup> *Trustees of Dartmouth College v Woodward* 17 U.S. 518 (1819) 636.

<sup>31</sup> Millon (1990) *Duke LJ* 206; MJ Horwitz “*Santa Clara* Revisited: The Development of Corporate Theory” (1985) 88 *West Virginia LR* 173 181.

<sup>32</sup> Horwitz (1985) *West Virginia LR* 173.

<sup>33</sup> Millon (1990) *Duke LJ* 206-208.

<sup>34</sup> Horwitz (1985) *West Virginia LR* 186-188; Millon (1990) *Duke LJ* 208-213.

<sup>35</sup> Horwitz (1985) *West Virginia LR* 188-190; Millon (1990) *Duke LJ* 208-213.

<sup>36</sup> Millon (1990) *Duke LJ* 208-213.

view was that the corporation was similar to a partnership.<sup>37</sup> The corporation was analysed as being created through the free contracting of its shareholders.<sup>38</sup> Central to the theory of these early “contractualists” was the primacy of shareholders. Strong emphasis was placed on the shareholders as the real actors in the corporation and on the property and control rights of shareholders.<sup>39</sup> Gradually, however, a new theory emerged in the 1890’s – the “entity theory” that attempted to establish the corporation as a “real” or “natural” entity. Instead of portraying the company as dependent for its existence on the state, emphasis shifted to the initiative of private incorporators and investors in bringing the company to life. With the contractualists, the entity theorists had in common that they construed the corporation as “private”, as being separate from the state.<sup>40</sup> They differed, however, in that the entity theorists maintained that the corporation was an entity distinct from its shareholders, albeit one that was not created artificially by the law, but was “real” or “natural”.<sup>41</sup> This development was both an American one as well as significantly influenced by legal theories developed in Europe.<sup>42</sup> A good description of the natural entity theory was provided by the American academic Ernst Freund:

“The law does not create the corporate person, but finding it in existence invests it with a certain legal capacity. The corporation rests upon a substratum of physical persons, but it is not identical with them, for out of the association of the individuals the new personality arises, having a distinctive sphere of existence and a will of its own. If corporate rights are distinguished from individual rights it is because they are controlled by this distinctive will. The corporation as a person distinct from its members is not a fiction, but a reality.”<sup>43</sup>

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<sup>37</sup> Horwitz (1985) *West Virginia LR* 182, 204; Millon (190) *Duke LJ* 213-214. In a Note on “The Legal Idea of a Corporation” (1885) 19 *American LR* 114 115-116, JN Pomeroy is quoted as writing: “these associations [of shareholders] differ very little in their essential attributes from partnerships”.

<sup>38</sup> Horwitz (1985) *West Virginia LR* 184-185.

<sup>39</sup> Courts “pierced the corporate veil” to look behind the company to its shareholders – see for example *State v Standard Oil Company* 49 Ohio St. 137 (1892) 177, where the court describes “[t]he general proposition that a corporation is to be regarded as a legal entity, existing separate and apart from the natural persons composing it” as “a mere fiction”. Also see V Morawetz *A Treatise on the Law of Private Corporations* (1886) § 1, 2, who writes: “The word ‘corporation’ is but a collective name for the corporators or members who compose an incorporated association; and where it is said that a corporation is itself a person, or being, or creature, this must be understood in a figurative sense only.” For a summary of the positions, see Horwitz (1985) *West Virginia LR* 182, 185.

<sup>40</sup> Horwitz (1985) *West Virginia LR* 218.

<sup>41</sup> 218.

<sup>42</sup> In general see Horwitz (1985) *West Virginia LR*.

<sup>43</sup> E Freund *The Legal Nature of Corporations* (1897) 14.

Freund's theory, like that of many American jurists at the time, was particularly inspired by the theoretical forays of German jurists, most notably Otto Gierke<sup>44</sup> and his seminal work, *Das deutsche Genossenschaftsrecht*.<sup>45</sup> The debate among German jurists was particularly lively and influential and ran along similar lines as outlined above, split between the traditional "Fiktionstheorie" proposed by famous Pandectists such as Savigny and Puchta,<sup>46</sup> and the "Realitätstheorien"<sup>47</sup> put forward by jurists of the Germanic legal school.<sup>48</sup> A full exposition of the discussion is beyond the scope of this dissertation and is today considered closed and not conducive for an understanding of juristic personality.<sup>49</sup> The juristic person, Karl Schmidt writes, has become a manageable category.<sup>50</sup> Even in American law, it is viewed with hindsight as "so abstruse an inquiry"<sup>51</sup> so much so, that Horwitz asks: "Why should so metaphysical a subject, even if it attracted the speculative instincts of German and French jurists, have appealed to the practical, earth-bound sensibilities of English and American legal thinkers?"<sup>52</sup> The answer lies, at least in part, in the translation and discussion of Otto Gierke's work by the English legal historian Maitland,<sup>53</sup> who became a staunch defender of the entity theory.<sup>54</sup> It was, however, not until 1905 that an American court in *Hale v Henkel*<sup>55</sup> confirmed, albeit reluctantly, the natural entity theory. By 1900 the theory had gained dominance and by the 1920's it was at its peak,<sup>56</sup> spurred on by the demise of shareholder influence in and control of the

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<sup>44</sup> Generally known as Otto von Gierke, the title of nobility was only awarded to him by German emperor Wilhelm II in 1911.

<sup>45</sup> See particularly O Gierke *Das deutsche Genossenschaftsrecht: Die Staats- und Korporationslehre des Altertums und des Mittelalters und ihre Aufnahme in Deutschland III* (1881).

<sup>46</sup> See particularly FC von Savigny *System des heutigen römischen Rechts II* (1840) § 85, 236, who describes companies as "künstliche durch bloße Fiction angenommene Subjecte". But see, Flume *Juristische Person* § 1, 3-11, who argues that it is misleading to suggest that Savigny viewed juristic persons as a fiction.

<sup>47</sup> See in particular Gierke *Genossenschaftsrecht III*; O Gierke "Juristische Person", in F von Holtzendorff *Rechtslexikon II* 3 ed (1880) 418-423.

<sup>48</sup> For a summary of the debate, see Wiedemann *Gesellschaftsrecht I* § 4; Schmidt *Gesellschaftsrecht* § 8 II.

<sup>49</sup> Wiedemann *Gesellschaftsrecht I* § 4, 191.

<sup>50</sup> Schmidt *Gesellschaftsrecht* § 8 II, 186.

<sup>51</sup> Horwitz (1985) *West Virginia LR* 179.

<sup>52</sup> 179.

<sup>53</sup> See the translation by FW Maitland; O Gierke *Political Theories in the Middle Age* (1900).

<sup>54</sup> See in particular, FW Maitland "Moral Personality and Legal Personality" in HAL Fisher (ed) *The Collected Papers of FW Maitland III* (1911) 304 304-320.

<sup>55</sup> 201 U.S. 43 (1905).

<sup>56</sup> Horwitz (1985) *West Virginia LR* 182, 217.

company and the somewhat problematic consequences of an “aggregate theory” for the construction of limited liability.<sup>57</sup>

Today, the theoretical justification of “legal personality” is rarely mentioned in company texts. There is widespread consensus, however, that the company is an entity separate and distinct from its members. The question whether this entity is artificial or natural has passed into oblivion. The focus has rather shifted to the consequences of this attribute. One of the underlying motives for the debate was with some probability the issue of the status of shareholders – a question that remains contentious to this day.<sup>58</sup>

#### 4 2 2 The consequences of juristic personality

The law concerns itself with relationships.<sup>59</sup> Juristic personality endows the company with the ability to enter into such legal relationships – to become the owner of property, to enter into contracts or to become a party to legal proceedings.<sup>60</sup>

The pivotal concomitant feature of separate juristic personality is readily apparent: the assets of the company belong to the company, not to the shareholders.<sup>61</sup> Shareholders own the shares, not the company’s assets. As the owner of its assets, a company has all the rights normally associated with owning property – it can use the assets, sell them or burden them. The separation of company assets from the shareholders is described as “asset partitioning”, particularly “entity shielding” by Hansmann, Kraakman and Squire.<sup>62</sup> As a default rule, creditors can seize the assets of a defaulting debtor. A defaulting individual’s creditor can seize assets in this manner, as can the creditor of a defaulting company. The law regards the individual and the company as separate persons. This formula does not change if shareholders are added to the equation. If the company’s assets belong to the company and are conceptually separate from the assets of the shareholders, the creditors of the

<sup>57</sup> Horwitz (1985) *West Virginia LR* 223; Millon (1990) *Duke LJ* 215.

<sup>58</sup> See for example Flume *Juristische Person* § 2, 31, who writes: “Es geht ... darum, wie die vermögensmäßige Eigenberechtigung der Aktionäre hinsichtlich des Unternehmens der Aktiengesellschaft mit dem Wesen der Aktiengesellschaft als juristischer Person in Einklang zu bringen ist.”

<sup>59</sup> French et al *Mayson Company Law* 5.

<sup>60</sup> 5.

<sup>61</sup> See *Macaura v Northern Assurance Co Ltd* [1925] AC 619. Also see *Short v Treasury Commissioners* [1948] 1 KB 116 122.

<sup>62</sup> H Hansmann, R Kraakman & R Squire “Law and the Rise of the Firm” (2006) 119 *Harvard LR* 1335; H Hansmann & R Kraakman “The Essential Role of Organisational Law” (2000) 110 *Yale LJ* 387; Armour et al “What is Corporate Law?” in *The Anatomy of Corporate Law* 6-7.

shareholders have no access to the assets of the company in the event of an insolvency or default of the shareholder. In addition to the restriction on the creditors of a shareholder to demand a share of the assets of the company, strong entity shielding also restricts the shareholders themselves to demand such a share of company assets.<sup>63</sup> The separate existence of a company therefore manifests itself in the separate patrimony of the company.

The flipside of entity shielding is limited liability or so-called “owner shielding”.<sup>64</sup> Shareholders neither own the assets of the company, nor are they liable for the company’s debts. Just as the personal creditors of shareholders cannot attach company assets, the creditors of the company cannot seize the assets of the shareholders. In other words, the liability of shareholders is limited to the capital amount invested in the company.

In order to function effectively as a legal entity, a company must have the ability to enter into contracts – be it to purchase assets, procure services, sell products or services, incur debt, enter into employment relationships or another of the myriad of contracts concluded as part of everyday business transactions. Additionally, a company can enter into contracts with its shareholders, illustrated by the allotment and issue of shares,<sup>65</sup> for example, or the payment of dividends. As an artificial person, a company is unable to fulfil this role itself. The function of contracting for and on behalf of the company must be delegated – usually to the board of directors and management of the company.<sup>66</sup> An important implication of separate juristic personality is that the board acting as a whole is acting as a company organ. The tasks performed and the contracts entered into by the board are considered to be performed or entered into by the company itself. A catalyst of the transformation of companies from partnership-like structures to personified entities was the significant growth in the size of companies and their capital demands.<sup>67</sup> Shareholders were re-

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<sup>63</sup> Hansmann et al (2006) *Harvard LR* 1337-1338. The additional restriction on shareholders is termed liquidation protection. In addition to strong entity shielding, Hansmann, Kraakman and Squire also identify weak entity shielding and complete entity shielding. Weak entity shielding can be observed in modern partnerships. It prioritises company creditors over personal creditors. Complete entity shielding is typical for non-profit organisations and denies personal creditors any claim to the organisation’s assets.

<sup>64</sup> See Hansmann et al (2006) *Harvard LR* 1339-1340.

<sup>65</sup> See, 6 2 Allotment and issue of shares.

<sup>66</sup> Usually, the constitutional document delegates this power to the directors. Individual directors and managers of a company act as agents with delegated authority from the board.

<sup>67</sup> P Ireland “Company Law and the Myth of Shareholder Ownership” (1999) 62 *MLR* 32 41.

conceptualised as contributors of capital and it was no longer deemed appropriate that they be involved in the management of the company.<sup>68</sup> Nonetheless, as briefly described above, the shareholders are sometimes considered to assign this power to the board of directors through the constitutional document.<sup>69</sup> Yet, a consistent application of the notion of separate juristic personality dictates that the power to manage and bind the company flows from the company itself, not from its shareholders.<sup>70</sup>

As a separate legal entity, a company survives its shareholders. The exit of one or even all of its shareholders does not necessitate the dissolution of the entity. This characteristic, together with the free transferability of shares, enables shares to be traded on secondary markets. In fact, public companies are generally characterised by a fluctuating shareholder base.

### **4 3 The nexus of contracts theory**

#### **4 3 1 Introduction to the theory**

While the legal theorising about corporate personality exhibited a flurry of activity at the beginning of the 20<sup>th</sup> century, it was only in the 1980's that a new theory of the corporation emerged based primarily on economic conceptions. The theory of the corporation as a "nexus of contracts", as it became known, shifted the focus away from an entity-based perspective to an aggregate-view of the company. While the theory originated in economics, it became widely accepted in both legal and economic circles.<sup>71</sup>

A paper by Jensen and Meckling is probably the most widely-known description of the neoclassical variant.<sup>72</sup> "The private corporation or firm", they write, "is simply one form of legal fiction which serves as a nexus for contracting relationships".<sup>73</sup> This includes not only the relationship with employees, but also relationships with

<sup>68</sup> Grantham (1998) *Cambridge LJ* 564-565.

<sup>69</sup> See below, 5 1 Contract, bargaining and the origin of rights; 5 2 Rights and duties encapsulated in shares.

<sup>70</sup> Grantham (1998) *Cambridge LJ* 565.

<sup>71</sup> In fact, WW Bratton "Nexus of Contracts Corporation: A Critical Appraisal" (1989) 74 *Cornell LR* 407 410 argues that the theory has been overvalued in legal circles.

<sup>72</sup> See MC Jensen & WH Meckling "The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structures" (1976) 3 *J Financ Econ* 305.

<sup>73</sup> 311.

customers, suppliers, lenders and other creditors;<sup>74</sup> relationships that become interwoven, creating a web of contracts. In line with neoclassical economic theory, the parties to these transactions are rational, self-interested and wealth-maximising individuals.<sup>75</sup> The exchange transactions between them create a complex equilibrium and the result of their contracting behaviour is the firm.<sup>76</sup> The theory declares companies to be creatures of contract created by and consisting of a web of voluntary arrangements.<sup>77</sup> The literature, also summarised under the rubric “property rights”, aims to determine how the rights that flow from such an undertaking established through multiple contracts are divided between the owners of the various inputs.<sup>78</sup>

Ronald Coase is often regarded as laying the foundations of the theory.<sup>79</sup> Coase draws a distinction between markets and companies and asks why we transact and co-ordinate production within companies instead of simply transacting for all our needs and wants on the open market.<sup>80</sup> In attempting to define the nature of a company and in examining why economic activity takes place through companies, he introduced the concept of transaction costs.<sup>81</sup> Entering into a contract with a third party attracts costs beyond the cost of the goods or services that are the subject of the contract, in other words the costs of participating in a particular market. Typically, these are divided into three categories: search and information costs, bargaining costs as well as policing and enforcement costs.<sup>82</sup> Production requires various inputs, the most common of which are labour and raw materials. Production within a market requires an exchange transaction with the “owner” of each factor of production. Coase argues that transaction costs can be reduced by centralising the contracting

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<sup>74</sup> 310.

<sup>75</sup> See MC Jensen “Organisation Theory and Methodology” (1983) 58 *Account Rev* 319 331; also see Bratton (1989) *Cornell LR* 417.

<sup>76</sup> Jensen (1983) *Account Rev* 327; Bratton (1989) *Cornell LR* 417; Jensen & Meckling (1976) *J Financ Econ* 311.

<sup>77</sup> See for example FH Easterbrook & DR Fischel “The Corporate Contract” (1989) 89 *Columbia LR* 1416 1428; Jensen & Meckling (1967) *J Financ Econ* 311.

<sup>78</sup> Jensen & Meckling (1976) *J Financ Econ* 307-308. Inputs are for example labour, raw materials, capital and so forth.

<sup>79</sup> See RH Coase “The Nature of the Firm” (1937) 4 *Economica* 386.

<sup>80</sup> 386-389.

<sup>81</sup> Coase, however, never uses the term “transaction costs”, but rather refers to the “cost of using the price mechanism” or “contract costs”; see Coase (1937) *Economica*.

<sup>82</sup> Also see Coase (1937) *Economica* 390-391. Coase’s concept of transaction costs was developed further by Williamson to include costs of negotiating contracts as well as post-contracting costs such as execution of the contract, monitoring of performance and dispute resolution; see OE Williamson “The Modern Corporation: Origins, Evolution, Attributes” (1981) 19 *J Econ Lit* 1537 1544.

function in a firm, more notably, an entrepreneur, who enters into a contract with each factor of production.<sup>83</sup> This greatly reduces the number of contracts to be entered into.<sup>84</sup> Exchange transactions are organised within a company structure and the company has the authority to direct the allocation of resources. In summary, Coase finds that “[a] firm, therefore, consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur”.<sup>85</sup>

Alchian and Demsetz take up Coase’s idea and develop it into an explicit notion of the firm as a “centralised contractual agent”.<sup>86</sup> They propose that the formation of the company, in a contractual form, is linked to the benefits of cooperative team production.<sup>87</sup> In team production, it is not easy to monitor the performance of the various team members. This provides an incentive to “shirk”; that is to perform at less than full capacity. To minimise the costs of shirking it is sensible that the contracting parties appoint a monitor.<sup>88</sup> As a reward for reducing the incidence of shirking and as incentive himself not to shirk, the monitor receives the right to the residual outputs of the joint production.<sup>89</sup> While shareholders themselves were initially envisaged to undertake this monitoring exercise, the structure of large corporations with a dispersed shareholder base has made it more useful to appoint a third party as the monitor. While managers therefore conclude the contracts with and generally manage and monitor all other inputs, shareholders retain a measure of control over the managers.<sup>90</sup> Shareholders are described as centralagent-monitors in this process of contracting.<sup>91</sup> Note that in the exercise of the monitoring powers, “[n]o authoritarian control is involved; the arrangement is simply a contractual structure subject to continuous renegotiation”.<sup>92</sup> In summary, the essence of the company is described as “a contractual structure with: 1) joint input production; 2) several input owners; 3) one

<sup>83</sup> Coase (1937) *Economica* 388, 390-393.

<sup>84</sup> 391.

<sup>85</sup> 393.

<sup>86</sup> AA Alchian & H Demsetz “Production, Information Costs, and Economic Organization” (1972) 62 *Am Econ Rev* 777 778, 794.

<sup>87</sup> 777-778.

<sup>88</sup> 781.

<sup>89</sup> 782.

<sup>90</sup> 788.

<sup>91</sup> 777-778. But note that from a legal perspective shareholder control is today diluted. The board of directors is ordinarily given original authority directly by legislation to manage the affairs of a company. The board does not derive this power from the shareholders; see for example Companies Act 7 of 2008 s 66(1). Likewise, legislation usually restricts shareholder control to instances of the removal of directors and fundamental transactions.

<sup>92</sup> 794.

party who is common to all the contracts of the joint inputs; 4) who has rights to renegotiate any input's contract independently of contracts with other input owners; 5) who holds the residual claim; and 6) who has the right to sell his central contractual residual status. The central agent is called the firm's owner and the employer.”<sup>93</sup>

Fama criticises the central role that the shareholder takes in the theory developed by Alchian and Demsetz.<sup>94</sup> While the shareholder to Alchian and Demsetz is both the owner-employer and the central-agent-monitor, Fama, like other later scholars, criticises the insufficient separation between ownership and control inherent in the theory.<sup>95</sup> Without using the terminology of “agency costs”, Berle and Means provided an early description of the separation of ownership and control that occurs in the corporate form.<sup>96</sup> In fact, much of the nexus of contracts theory has developed into a description of the agency problem.<sup>97</sup> Agency costs arise if the interests of shareholders and managers are dis-aligned, in other words if management acts in their own interest to the detriment of shareholders.<sup>98</sup> Furthermore, managers are privy to information unknown to shareholders – resulting in so-called information asymmetry. Contractarians argue that in an efficient capital market, the rational shareholder would estimate agency costs and take them into account when purchasing shares and would pay less for the shares.<sup>99</sup> Thus, management bears the agency costs and no transfer of value takes place from the shareholders to management, which in turn means that rationally acting managers will act to minimise agency costs.<sup>100</sup> According to the theory, market forces therefore provide the strongest incentive to minimise agency costs.<sup>101</sup> Additionally, managers may be

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<sup>93</sup> 794.

<sup>94</sup> See EF Fama “Agency Problems and the Theory of the Firm” (1980) 88 *J Polit Econ* 288 289.

<sup>95</sup> 291.

<sup>96</sup> See AA Berle & GC Means *The Modern Corporation and Private Property* (1932) Also see above, 5 2 Rights and duties encapsulated in shares. Bratton (1989) *Cornell LR* 413 however identifies Berle and Means with the so-called “managerial-model”, which views corporations as hierarchical structures.

<sup>97</sup> In economic terms, managers are described as the agents and shareholders as principals. In legal terms, of course, neither the managers nor the company are the agents of shareholders. See Kershaw *Company Law in Context* 175-176.

<sup>98</sup> J Armour, H Hansmann & R Kraakman “Agency Problems and Legal Strategies” in R Kraakman, J Armour, P Davies, L Enriques, H Hansmann, G Hertig, K Hopt, H Kanda, M Pargendler, W-G Ringe & E Rock (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* 3 ed (2017) 29 29.

<sup>99</sup> Jensen & Meckling (1976) *J Financ Econ* 345; Easterbrook & Fischel (1989) *Columbia LR* 1430-1434.

<sup>100</sup> Jensen and Meckling (1976) *J Financ Econ* 345.

<sup>101</sup> Millon (1990) *Duke LJ* 230.

monitored to reduce the agency problem.<sup>102</sup> Fama on the other hand, suggests that it is the managerial labour market as well as the monitoring of managers by managers from the top-down as well as the bottom-up that provides the strongest incentive to maximise the performance of the company.<sup>103</sup> The top-level of management is monitored in turn by the competition that exists amongst each other as well as by the board of directors, in particular nonexecutive directors.<sup>104</sup> Fama therefore criticises the shareholder-centred monitoring model of Alchian and Demsetz as well as Jensen and Meckling, developing instead a model that is based on the complete separation of risk-bearing and control.<sup>105</sup> All control rests in the managers. All models have in common that rational contracting will achieve the efficient monitoring of management.

Armour and Whincop posit that the focus on asymmetric information and the agency problem has been accompanied by a more general shift – the question is no longer why firms exist, prominent in the writings of Coase, but rather why contracts concerning the firm exist in a particular form.<sup>106</sup> In other words, the question has become why certain rights such as residual benefits accrue to a certain group of contracting parties.

Proponents of the neoclassical variant of the nexus of contracts theory strongly reject the “personalization of the firm”,<sup>107</sup> stating that a firm “is not an individual”.<sup>108</sup> The company as an entity “dissolves into disaggregated but interrelated transactions among the participating human actors”.<sup>109</sup> If the company is depicted as an entity – mostly for the purposes of making it one of the contracting parties – it is for convenience only.<sup>110</sup> In fact, it is likely that the company is the counterparty to every contract concluded. Some academic commentators therefore suggest that a more accurate characterisation may be of the company as a “nexus for contracts”.<sup>111</sup>

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<sup>102</sup> Jensen & Meckling (1976) *J Financ Econ* 323-325; Jensen (1983) *Account Rev* 328-329; Alchian & Demsetz (1972) *Am Econ Rev* 381-383.

<sup>103</sup> Fama (1980) *J Polit Econ* 293.

<sup>104</sup> 293-294.

<sup>105</sup> 294-295.

<sup>106</sup> J Armour & MJ Whincop “The Proprietary Functions of Corporate Law” (2007) 27 *Oxf J Leg Stud* 420 432-433; also see O Hart “An Economist’s Perspective on the Theory of the Firm” (1989) 89 *Columbia LR* 1757 1764-1765.

<sup>107</sup> Jensen & Meckling (1976) *J Financ Econ* 311.

<sup>108</sup> 311.

<sup>109</sup> Bratton (1989) *Cornell LR* 420.

<sup>110</sup> 420.

<sup>111</sup> Armour et al “What is Corporate Law?” in *The Anatomy of Corporate Law* 5. cf MA Eisenberg “The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm” (1999) 24

According to Bratton the nexus of contracts theory diverged into two main variants – the neoclassical variant, described above, as well as the institutional variant.<sup>112</sup> Institutionalists work with a watered-down version of the neoclassical assumptions that transacting parties are rational and wealth maximising economic actors. Most prominently, Williamson argues that transacting parties are at most capable of “bounded rationality” and act “opportunistically”.<sup>113</sup> The institutionalists acknowledge the existence of the company as an entity and highlight the importance of the internal organisation of the company. They pick up many of the threads initially spun by Coase: Williamson highlights the importance of recognising individual relationships within companies. Drafting comprehensive long-term contracts to govern such relationships would attract significant transaction costs. The factor that distinguishes ordinary markets from companies is the level of organisation of resources that can be observed in a company; organisation which reduces transaction costs as well as production costs.<sup>114</sup> Governance or management structures, particularly hierarchal structures of organisation within companies are therefore an essential component of the theory. Economic actors within this paradigm organise economic exchange by contract. Contracting remains the key explanatory force behind companies. Nonetheless, in the light of bounded rationality and opportunistic behaviour, contractual economic exchange is incomplete and the drafting of long-term contracts to govern a range of eventualities attracts significant transaction costs.<sup>115</sup> Transacting parties leave some matters open and in turn agree on governance structures to resolve them.<sup>116</sup>

Although the institutionalist approach acknowledges the existence of the company as an entity, like its neoclassical counterpart, it primarily views the company as a creature of contract. If the firm exhibits features of central organisation, these are the result of private, contractual ordering, not public, legislative concession or intervention. Both versions of the new economic theory reject the characterisation of

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*J Corp L* 819 830-832, who argues that the nexus of contracts theory lacks intellectual coherence. Assuming that the company is the signatory of every contract is non-contractarian as “it is centered on a legal entity that is presumably not itself a nexus of contracts”.

<sup>112</sup> Bratton (1989) *Cornell LR* 407.

<sup>113</sup> Williamson (1981) *J Econ Lit* 1541-1542, 1544-1546; Bratton (1989) *Cornell LR* 421; R Richter *Essays on New Institutional Economics* (2015) 11. Williamson coined the term “new institutional economics”.

<sup>114</sup> Williamson (1981) *J Econ Lit*. See Coase (1937) *Economica*. The factor of production costs is an additional dimension that did not feature prominently in the theory of Coase.

<sup>115</sup> Williamson (1981) *J Econ Lit* 1545-1546; Hart (1989) *Columbia LR* 1762-1763.

<sup>116</sup> Bratton (1989) *Cornell LR* 421-422.

the company as a separate juristic person. Juristic personality is not regarded as a representation of reality.<sup>117</sup> The authors recognise that juristic personality is associated with many of the basic features which enable the company to contract in the first place – separate patrimony as well as the capacity to enter into contracts and to enforce them.<sup>118</sup> Nonetheless, they describe juristic personality merely as a convenient way to bundle these features together, not as a “necessary precondition” for their existence.<sup>119</sup> Consequently, it is not legislation that brings a company into being, but rather contract.<sup>120</sup> At most, legislation may provide a convenient set of non-mandatory, standard terms. These “off-the-rack” terms may reduce the costs of contracting.<sup>121</sup> Additionally, they assist courts to resolve uncertainties and conflicts not anticipated by the contracting parties.<sup>122</sup> A public company is one example of such a “standard-form” contract.<sup>123</sup> It follows that the contractarian view of the company strongly rejects the notion of mandatory legal rules.<sup>124</sup> Contractarians consequently reject state intervention, not only in the formation of a company, but also in regulating its operation. This position is justified with reference to the principles of freedom of contract, which dictates that parties may structure their relations as they see fit.<sup>125</sup> The role of the state is limited to providing legal rules and mechanisms for the enforcement of contracts.<sup>126</sup>

The notion of the company as a creature of contracts is primarily an ontological enquiry that seeks to reveal the nature and structure of companies either as hierarchal, manager-driven structures or as networks of voluntary arrangements.<sup>127</sup> Theories of the corporation are furthermore aimed at revealing: 1. how companies are created; 2. how a company is “regulated” during its existence; and 3. how the relationship between the company and its shareholders is structured. The theory may

<sup>117</sup> See Easterbrook & Fischel (1989) *Columbia LR* 1425-1426.

<sup>118</sup> Armour et al “What is Corporate Law?” in *The Anatomy of Corporate Law* 6-9.

<sup>119</sup> 9.

<sup>120</sup> Companies, Easterbrook and Fischel posit, are therefore “arrangements that depend on contracts and positive law, not on corporate law”; Easterbrook & Fischel (1989) *Columbia LR* 1426.

<sup>121</sup> Easterbrook & Fischel (1989) *Columbia LR* 1444. Additional reasons for relying on default terms rather than detailed contracts are the cost of enforcement as well as strategic reasons, whereby information withheld may reduce the price. See Armour & Whincop (2007) *Oxf J Leg Stud* 435 and n 25.

<sup>122</sup> Easterbrook & Fischel (1989) *Columbia LR* 1444-1445.

<sup>123</sup> Also see Hart (1989) *Columbia LR* 1764.

<sup>124</sup> See 6 3 The obligatory realms of shares and some conclusions, especially nn 73 and 74.

<sup>125</sup> HN Butler “The Contractual Theory of the Corporation” (1989) 11 *George Mason Uni LR* 99 100.

<sup>126</sup> 100.

<sup>127</sup> Bratton (1989) *Cornell LR* 412.

present a useful manner of deconstructing the company to examine the relationships it invariably enters into.<sup>128</sup>

#### 4 3 2 Shareholder ownership and shareholder primacy

Of particular interest is what the nexus of contracts theory reveals about the status of shareholders as “owners”. Despite legal assertions to the contrary, shareholders are regarded by many as “owners” of a company. Within this line of thinking, companies must prioritise the interests of shareholders, in other words, maximise profits.<sup>129</sup> Assertions of shareholder primacy may, however, be independent of shareholder ownership. This is primarily an issue of corporate governance and the shareholder versus stakeholder debate. From the perspective of understanding the nature of shares, shareholder “ownership” reveals what the totality of rights may or may not entitle the shareholder to.

Generally, shareholder ownership of the company is said to be irreconcilable with basic tenets of the nexus of contracts idea. The denial of shareholder ownership of the company is a critical feature of the nexus of contracts theory: shareholder ownership would make the company more than a simple web of contracts. Alchian and Demsetz describe shareholders simply as one of the various inputs. As Bratton aptly puts it “[e]quity capital, the traditional legal situs of ownership, devolves into one of many types of inputs”.<sup>130</sup> Nonetheless, the description of shareholders as owners of a company appears quite often in the work of Alchian and Demsetz. They define the owner of the company as “the party common to all input contracts and the residual claimant”.<sup>131</sup> Furthermore, the focus on the agency theory, which has at its core the separation between ownership and control, implies that something must be owned and that this is the firm. Many scholars are in fact imprecise on the content of the “ownership” concept. The incident of residuarity is a recurring feature; Jensen and Meckling define the firm as being “characterized by the existence of divisible

<sup>128</sup> BR Cheffins *Company Law: Theory, Structure, and Operation* (1997) 32.

<sup>129</sup> See below, nn 141-145. Milton Friedman, famously stated that “a corporation’s responsibility is to make as much money for the stockholders as possible”. M Friedman & RD Friedman *Capitalism and Freedom* 40th Anniversary ed (2002) 133.

<sup>130</sup> Bratton (1989) *Cornell LR* 420. Also see JR Macey “An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties” (1991) 21 *Stetson LR* 23 27-28; Millon (1990) *Duke LJ* 229.

<sup>131</sup> Alchian & Demsetz (1972) *Am Econ Rev* 783.

residual claims on the assets and cash flows of the organization”,<sup>132</sup> held by an “owner-manager” having an “ownership interest in the firm”.<sup>133</sup>

Proponents of the so-called “property-rights theory of the firm”, also known as the Grossman-Hart-Moore theory, in addition emphasise the importance of control. They define a firm/company as consisting of “those [physical] assets that it owns or over which it has control”,<sup>134</sup> while ownership is defined as the power to exercise residual rights of control.<sup>135</sup> They focus on the residual control, not the monetary value of residual claims. Based on this, they deduce that shareholders are the owners of the firm, justified by Hart with this circular explanation: “Finally, identify a firm with all the non-human assets that belong to it, assets that the firm’s owners possess by virtue of being owners of the firm”.<sup>136</sup> Shareholders, so the argument runs, are owners of the firm, which makes them owners of the firm’s assets, which gives them residual control rights.<sup>137</sup>

Eugene Fama is more specific about “ownership” claims, signalling clearly that shareholders own only their input.<sup>138</sup> They are, however, described as owners of the capital, which Ireland criticises as meaning essentially the same thing as owning the company.<sup>139</sup> Fama also consistently distinguishes between “*security* ownership and control of the firm” and identifies risk-bearing (security ownership) and management (control) as entirely separate functions and factors of production. He writes:

“However, ownership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared

<sup>132</sup> Jensen & Meckling (1976) *J Financ Econ* 311.

<sup>133</sup> 314.

<sup>134</sup> SJ Grossman & OD Hart “The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration” (1986) 94 *J Polit Econ* 691 693

<sup>135</sup> 692, 693-694.

<sup>136</sup> Hart (1989) *Columbia LR* 1766.

<sup>137</sup> The theory aims, amongst others, to explain incomplete contracts. Specific rights are created by concluding a contract. Frequently, however, a contract cannot cover all eventualities, thus the party who exercises residual control over an asset fills the gaps in the contract. Ownership therefore determines who will have the power to shape a relationship in the post-contracting stage. See Hart (1989) *Columbia LR* 1765.

<sup>138</sup> Fama (1980) *J Polit Econ* 290.

<sup>139</sup> P Ireland “Property and Contract in Contemporary Corporate Theory” (2003) 23 *Legal Studies* 453 474. Similar, V Brudney “Corporate Governance, Agency Costs, and the Rhetoric of Contract” (1985) 85 *Columbia LR* 1403 1436, who finds that there is barely any difference between considering shareholders as owners of the corporation or as residual claimants as the result is the same, namely that shareholder interests must be prioritised.

among inputs. In this "nexus of contracts" perspective, ownership of the firm is an irrelevant concept."<sup>140</sup>

Some authors suggest that shareholder ownership matters because it determines in whose interests the management of a company must act.<sup>141</sup> In fact, shareholder ownership and the maximisation of shareholder value are closely connected. That shareholder primacy is not necessarily dependent on shareholder ownership appears from the nexus of contracts theory. The theory is said to support both a shareholder- or stakeholder-centred approach.<sup>142</sup> Mostly, however, the theory finds that the interests of the shareholder are paramount. While Easterbrook and Fischel ask "what is the goal of the corporation? Is it profit (and for whom)? Social welfare more broadly defined? ... Our response to such questions is: 'Who Cares?'"<sup>143</sup> On the other hand they recognise that "[f]or most firms the expectation is that the residual riskbearers have contracted for a promise to maximize long-run profits of the firm".<sup>144</sup> In the wake of the increasing recognition of the social responsibility of corporations in the corporate governance discourse the shareholder-centred approach has become increasingly marginal.<sup>145</sup>

Whatever the corporate governance implications of assertions of shareholder ownership and shareholder primacy are, which cannot be discussed here, it is trite to reiterate that shareholders do not own the assets of the company; they do not own the company, if and in what form it may exist. They own the unit of capital that is their share. About this the entity theory and the nexus theory are generally in consensus. Their share gives investors certain rights that can be enforced against the company and may include rights that can be termed "interests in the company". These rights

<sup>140</sup> Fama (1980) *J Polit Econ* 290.

<sup>141</sup> See for example the more recent contribution by J Velasco "Shareholder Ownership and Primacy" (2010) *University of Illinois LR* 897 944.

<sup>142</sup> See for example Eisenberg (1999) *J Corp L* 833: "the nexus-of-contracts conception does not give primacy to any single group". Also see JR Macey "Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective" (1999) 84 *Cornell LR* 1266 1267-1269, 1727-1273, who argues that shareholder primacy is the default rules of the nexus of contracts theory, but not the mandatory rule.

<sup>143</sup> Easterbrook & Fischel (1989) *Columbia LR* 1446-1447.

<sup>144</sup> 1446-1447.

<sup>145</sup> The father of the stakeholder theory is thought to be RE Freeman "Stockholders and Stakeholders: A New Perspective on Corporate Governance" (1983) 25 *Calif Manag Rev* 88. Also notable: T Donaldson & LE Preston "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications" (1995) 20 *Acad Manag Rev* 65. On the development towards a non-shareholder-centred approach, see Grantham (1998) *Cambridge LJ*.

depend on the design of share classes and the apportionment of rights to those classes.

#### **4 4 Concluding remarks**

The legal theory of separate juristic personality primarily achieves one objective: It establishes the company and its assets as an entity separate in law from its shareholders. In reverse, it therefore asserts that shares are assets separate from the company and as such constitute assets or units of “property” in their own right. In addition, the theory establishes that these units are obligations.

What the entity theory does not do is provide any detail on particular aspects of these units of shares and particularly on the nature and content of its obligatory facet. The economic nexus of contracts theory, on the other hand, takes characteristics such as residuary and the control aspect of shares into account. This has utility because it provides a more accurate description of the dual nature of shares as both assets and personal relationships. In addition, the nexus theory emphasises that the shareholder input is expressed in a complicated obligatory relationship of the shareholder with the company and that shareholders are claimants or creditors, albeit of a special kind. The nexus theory therefore places much more stress on individual relationships. It is within this context that the theory is described as an ontological enquiry.<sup>146</sup> While the entity theory explains the formal legal relationships resulting from the incorporation of a company it gives no sense of the dynamic reality of its activities, namely the orchestration of a multitude of inputs and the continual transformation of these by means of economic exchanges.

Far from contradicting the entity theory, the nexus theory rather complements it. The two theories are in agreement on the basic precepts of the company-shareholder relationship, namely that shareholders own neither the assets of the company nor the company itself. In addition, the nexus theory highlights both individual as well as systemic aspects of the obligatory realm of shares. It underscores that it is necessary to take into account elements of the individual relationship that arises between an issuer of shares and an investor. Also, it attempts to place this relationship into its proper context taking into account the various other relationships that converge within a firm. The nexus theory therefore, in addition to showing that

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<sup>146</sup> See text to n 127 above.

companies and shareholders are separate, also seeks to clarify the nature of their interconnection. Whether or not the economists' understanding of concepts such as "contract" or "ownership" are perfectly aligned with those held by lawyers is therefore of secondary importance, considering that the value of the nexus theory lies not so much in its theoretical or empirical accuracy but rather in its descriptive and narrative persuasiveness.

## Chapter 5: Rights, obligations and classes of shares

### 5 1 Contract, bargaining and the origin of rights

By placing emphasis on shares as separate assets, the discussions above on the transformation of the concept of capital as well as on the historical legal and economic evolution of the company articulate the importance of appraising the substance of the asset. The essence of shares is comprised of certain rights that can be exercised against the company. More important still, the crux of shares lies in the manner in which these rights and duties are grouped together.

The rights flowing from shares have their origin in company law statutes as well as in a “contract” concluded between the company and a shareholder. Whereas the statute puts a basic framework of rights in place, in most jurisdictions companies have significant powers to vary these rights in the constitutional document and fashion them to fit the unique requirements and preferences of the company. The constitutional document is alternatively known as the memorandum of incorporation, articles of association, constitutional document or “Satzung”.<sup>1</sup> It is a body of rules that sets out the companies’ objectives, the persons authorised to act on its behalf as well as its relations with shareholders and other parties. The constitutional document therefore regulates both the internal and external relationships of the company. Concerning the former, Kershaw points out that the constitution, together with the relevant statutory provisions, aims to establish, organise and balance two structural elements of the company: a body of “owners” or shareholders and a governing or

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<sup>1</sup> The term “constitution” derives from English law. The English Companies Act 2006 distinguishes between a “memorandum of association”, which is the founding document of the company and is no longer considered to be part of the company’s “constitution” and the “articles of association” which are part of the “constitution”; see Companies Act 2006 s 8 and Part 3, especially ss 17 and 18. The South African Companies Act provides for a “memorandum of incorporation”, which is both the incorporation document and the document setting out the internal structure of the company, including directors’ duties and shareholders’ rights; see the definition of “memorandum”, Companies Act 71 of 2008 s 1. The same distinction as in English law could be found in the previous South African Companies Act; see the definitions of “articles” and “memorandum” in the Companies Act 61 of 1973 s 1. US law, like its South African counterpart predominantly employs one document for both incorporation and internal governance questions – the “articles of incorporation” in the Model Business Corporation Act or the “certificate of incorporation” in the Delaware Code; see definition of “articles of incorporation” Model Business Corporation Act § 1.40, §§ 2.02 and 2.03; see Delaware Code §§ 101-105. German law also provides for a combined document, the “Satzung”, alternatively known as “Gesellschaftsvertrag” (company contract); see Aktiengesetz § 23 and Part 4. BGB § 705 applies to companies incorporated under the Aktiengesetz. The provision emphasises the contractual nature of incorporation: “Durch den Gesellschaftsvertrag verpflichten sich die Gesellschafter gegenseitig, die Erreichung eines gemeinsamen Zweckes in der durch den Vertrag bestimmten Weise zu fördern, insbesondere die vereinbarten Beiträge zu leisten”.

managing body.<sup>2</sup> On the side of the shareholders, of central importance are the rights and duties that flow from their relationship with the company as well as the manner in which the relationship is established. To reflect this, the South African Companies Act defines a “Memorandum of Incorporation” as “the document ... that sets out rights, duties and responsibilities of shareholders [amongst others]”.<sup>3</sup>

The constitutional document is therefore, at least partly, the root of the rights that flow from shares, prompting the frequently-held assumption that such rights are contractual in nature. To state it in the words of Farwell J in *Borland’s Trustee v Steel Brothers & Co*,<sup>4</sup> “[t]he contract contained in the articles of association is one of the original incidents of the share”.<sup>5</sup> The legislation makes the memorandum of incorporation, as it is known in South African legal parlance, binding between the company and each shareholder as well as amongst shareholders.<sup>6</sup> Of course the company does not contract with each shareholder individually. The memorandum is construed *as if* it were a contract.<sup>7</sup> This presumption of an act of contracting appears even more clearly from the provisions of the UK Companies Act which state that “[t]he provisions of a company’s constitution bind the company and its members to the same extent *as if there were covenants* on the part of the company and of each member to observe those provisions”.<sup>8</sup>

The contractual idea also features in German company law literature. The mechanism through which the “Satzung” is finalised, known as the “Satzungsfeststellung”,<sup>9</sup> is characterised as a *sui generis* contract containing both subjective rights and duties of its founders as well as objective norms.<sup>10</sup> Through

<sup>2</sup> D Kershaw *Company Law in Context: Text and Materials* 2 ed (2009) 80.

<sup>3</sup> Companies Act 71 of 2008 s 1. Also see s 36(1)(b)(ii).

<sup>4</sup> 1901 1 Ch 279.

<sup>5</sup> *Borland’s Trustee v Steel Brothers & Co* 1901 1 Ch 279 288. Also see *In Re Sir William Thomas Paulin; In Re Percy Crossman* [1935] 1 KB 26 57.

<sup>6</sup> Companies Act 71 of 2008 s 15(6)(a)-(b); also see *Gohlke & Schneider v Westies Minerale (Pty) Ltd* 1970 2 SA 685 (A) 692F; *Smuts v Booyens* 2001 4 SA 15 (SCA) para 14. After a thorough analysis, DG Rice still concluded in an article published in 1957 that the shareholders (or members) do not contract with each other, but only with the company. This uncertainty is clarified by the wording of the Companies Act 2006. See DG Rice “The Legal Nature of a Share” (1957) 21 *Conveyancer & Property Lawyer* 433 438-447.

<sup>7</sup> In *Gohlke & Schneider v Westies Minerale (Pty) Ltd* 1970 2 SA 685 (A) 692G-F the court states: “The company and its members are bound only to the same extent *as if the articles had been signed by each member*, that is, *as if they had contracted* in terms of the articles.” (own emphasis).

<sup>8</sup> Companies Act 2006 s 33 (own emphasis).

<sup>9</sup> In general, see Aktiengesetz § 23.

<sup>10</sup> The literature describes it as a “Schuld- und Organisationsvertrag”. A Pentz “§§ 23-53” in W Goette, M Habersack & S Kalss (eds) *Münchener Kommentar zum Aktiengesetz* 4 ed (2016) § 23 [27]-[28]; U Hüffer & J Koch *Aktiengesetz* 13 ed (2018) § 23 [7]. The dual character of the document emphasised

incorporation the document is separated from the will of the company founders and becomes valid against third parties, particularly new shareholders.<sup>11</sup> It is described as an objective system of norms fulfilling the functions of objective law.<sup>12</sup>

The idea that the constitutional document is a contract concluded between the company and every shareholder does not always find favour. Van der Walt and Sutherland describe the notion of the constitutional document as a contract as artificial, finding that “[t]he memorandum and articles are a statutory rather than a real contract ... Many of the rights of shareholders flow from the common law and the Act rather than from the constitution of a company”.<sup>13</sup> The memorandum is in any case subject to regulatory approval before the company is registered,<sup>14</sup> and can thus be said to gain validity only upon the receipt of such approval. Even if companies have considerable scope to delineate such rights and duties, legislation dictates the basic framework within which this freedom must be exercised, including a number of mandatory rules. A company may, for example, issue shares without voting rights, as is typical for preference shares, yet, legislation requires at least one class of shares to have voting rights.<sup>15</sup> Likewise, shares may yield fixed dividends, provided that the company is in a financial position to make distributions.<sup>16</sup> Gulliver and Payne make

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here, is, at least partly, a reflection of the fact that the documents of incorporation and association are not split, as is the case in English law – see, n 1 above. Vetter, like other German authors, therefore finds: “Die Satzung hat eine doppelte Funktion und ist einerseits schuldrechtliche Vereinbarung der Gründer über die Errichtung der AG und zugleich Grundordnung der Vereinigung sowie Herrschafts- und Organisationvertrag.”; E Vetter “Aktiengesetz § 23” in M Henssler & L Strohn *Gesellschaftsrecht* 3 ed (2016) § 23 [1].

<sup>11</sup> Pentz “§§ 23-53” in *Münchener Kommentar zum AktG* § 23 [27]; Hüffer & Koch *Aktiengesetz* § 23 [7].

<sup>12</sup> Hüffer & Koch *Aktiengesetz* § 23 [7].

<sup>13</sup> AJ van der Walt & PJ Sutherland “Dispossession of Incorporeals or Rights – Is the Mandament van Spolie the Appropriate Remedy?” (2003) 15 *SA Merc LJ* 95 97. The statutory basis is also recognised by Cameron, JA in *Smuts v Booyens* 2001 4 SA 15 (SCA) para 14, when he finds: “Enersyds is die statute 'n reeks verbintenisse tussen die aandeelhouders. In dié opsig is hulle kontraktueel van aard. Andersyds word die kontrak in ooreenstemming met en binne die perke van die maatskappywetgewing aangegaan. Aan die aard van die regte wat in die aandeelhouding vervat word, word derhalwe statutêre beslag gegee”. Eisenberg refers to the “dual nature” of the corporation, which he understands to consist of both reciprocal arrangements as well as hierarchical bureaucratic rules; MA Eisenberg “The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm” (1999) 24 *J Corp L* 819 827-830.

<sup>14</sup> In South Africa, the memorandum must be lodged together with a Notice of Incorporation, see s 13(1), 13(2)(b) of the Companies Act 71 of 2008; and an amendment to the memorandum must similarly be filed together with a Notice of Amendment, see s 16(7).

<sup>15</sup> South African Companies Act 71 of 2008 ss 37(2), 37(3), 37(4); For US law see Delaware Code Title 8 § 151(b); Model Business Corporation Act § 6.01(b)(1).

<sup>16</sup> This example is also provided by L Gulliver & J Payne *Corporate Finance Law: Principles and Policy* 2 ed (2015) 11. For South Africa see Companies Act 71 of 2008 s 37(c) and (d) as read with s 46(b) and (c). The company must meet the solvency and liquidity tests immediately after making the

an important point in relation to debt instruments, which are generally regarded to be purely contractual in nature: “The restrictions [imposed by legislation] contrast with the position regarding debt, where the parties are, in principle, free to make their own bargain”.<sup>17</sup> The contractual idea conveys an image of bargaining between the contracting parties. Shares in public companies, particularly those listed on a stock exchange, are, however, standardised packages of rights and duties.<sup>18</sup> Investors have no basis for negotiating these terms.

The basic rights which make up shares can be said to come into existence upon the registration of the company,<sup>19</sup> or, if shares have been left unclassified or rights and limitations have not yet been affixed to a class of shares set out in the memorandum, once such a classification or determination of rights has taken place in accordance with the provisions of the Act and the memorandum.<sup>20</sup>

## 5 2 Rights and duties encapsulated in shares

The rights flowing from shares can have both economic content and embody an aspect of control. Central to the nature of shares as instruments of investment are economic considerations. Shareholders primarily invest in companies for the financial return yielded by the investment. The total return on equity is the net cash flow generated by the company for the duration of its existence.<sup>21</sup> Economically, the total return yielded by shares is therefore composed of distributions made by the company throughout its life as well as distributions made upon its liquidation.<sup>22</sup> Distributions made during a company’s lifetime are frequently referred to as income-sharing, whereas the right to a final distribution, made when a company ceases to exist, is known as a right to the capital of the company.<sup>23</sup> Shareholders may therefore have the right to a share of the profits generated by the company. In addition, a shareholder may have the right to share in the surplus funds at liquidation. If the financial claim of shareholders against the company is comprised of the value of the

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distribution. See s 4 for the solvency and liquidity tests. For UK law see Companies Act, 2006 ss 830 and 831.

<sup>17</sup> Gullifer & Payne *Corporate Finance Law* 11.

<sup>18</sup> BR Cheffins *Company Law: Theory, Structure, and Operation* (1997) 66-67.

<sup>19</sup> In South Africa, a company is incorporated as from the date stated on the registration certificate – see ss 14(1)(iii) and 14(4)(b) of the Companies Act 71 of 2008.

<sup>20</sup> For details, see the country expositions below.

<sup>21</sup> Cheffins *Company Law* 54-55.

<sup>22</sup> 54.

<sup>23</sup> See for example Gullifer & Payne *Corporate Finance Law* 11; PL Davies & S Worthington Gower and Davies’ *Principles of Modern Company Law* 9 ed (2012) 868 [23-4].

company at winding-up, after assets are sold and after all other claims against the company have been settled, then any dividends or other distributions made during the lifetime of the company are essentially a reduction or pre-payment of the residual value. The incident of “residuarity” is frequently seen as the distinguishing feature of shares.<sup>24</sup> The International Accounting Standard on financial instruments (IAS 32)<sup>25</sup> reflects the centrality of the residuarity principle in its definition of an equity instrument, being “any contract that evidences a *residual interest* in the assets of an entity after deducting all of its liabilities”.<sup>26</sup> A residual claim is always variable – it fluctuates as the ability of a company to generate profit changes.<sup>27</sup> Associated with residuarity is risk – as residual claimants, shareholders find themselves at the back of the queue both when it comes to receiving dividends and when sharing in the surplus.<sup>28</sup>

Rights to distributions, be it in the form of profit or residual distributions, can be meaningless without the ability to exercise some form of control over the company. Thus, a shareholder also has certain administrative participation rights, most importantly the right to vote at the annual general meeting and on matters affecting shareholders. If one buys into the premise of the constitutional document as a contract, the shareholders can use this contract to assign responsibility for managing the company. In this way the constitutional document delineates the balance of power between the two primary organs of the company – the board and the shareholders.<sup>29</sup> Even if this power is almost invariably delegated to the board of directors, so the argument runs, the shareholders can still elect the members of the board.<sup>30</sup> The board of directors therefore manages the company, but ultimately, control vests in the shareholders.<sup>31</sup> This argument is tenuous, not only due to the lack of bargaining power of the shareholders in determining the contents of the

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<sup>24</sup> A Cahn & DC Donald *Comparative Company Law – Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA* (2010) 261-262; Kershaw *Company Law in Context* 709.

<sup>25</sup> International Accounting Standards Board *IAS 32 Financial Instruments: Presentation*; also see International Accounting Standards Board *International Accounting Standards (IAS) 39 Financial Instruments: Recognition and Measurement* as well as International Accounting Standards Board *International Financial Reporting Standards (IFRS) 9 Financial Instruments*.

<sup>26</sup> International Accounting Standards Board *IAS 32 Financial Instruments: Presentation* 11 (own emphasis).

<sup>27</sup> Kershaw *Company Law in Context* 709.

<sup>28</sup> On shareholder risk see Cheffins *Company Law* 58-61.

<sup>29</sup> Kershaw *Company Law in Context* 80.

<sup>30</sup> Cheffins *Company Law* 61.

<sup>31</sup> 61-62.

constitutional document, but also owing to the lack of actual shareholder involvement.<sup>32</sup> This criticism rings particularly true for public, listed companies in which a considerable number of shareholders vote by proxy, if at all. Shareholder apathy, Berle and Means argue, leads to the separation of ownership and control.<sup>33</sup> Theirs is an early formulation for what is today known as the agency problem.<sup>34</sup> To counter the agency problem and the loss of control by shareholders, legislative measures are put in place, including mechanisms that become part of the constitutional document.<sup>35</sup> What is true is that shareholders have certain “participation rights”, whether these rights give the shareholders control over the entity, is a contentious issue<sup>36</sup> and probably an incorrect assertion in the light of significantly decreasing shareholder involvement and authority in the running of the company. Control rights are, however, commercially valuable for shareholders who own large blocks of shares and have an interest in actively exercising control.

The exercise of these rights is enabled through a number of supporting rights,<sup>37</sup> such as the right to receive and access information of the company.<sup>38</sup> It is not common for burdens to be imposed on shareholders. Usually, the only liability flowing from shares is the duty to pay for the share,<sup>39</sup> if payment has not been made in full

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<sup>32</sup> 62.

<sup>33</sup> In general see AA Berle & GC Means *The Modern Corporation and Private Property* (1932).

<sup>34</sup> For a brief summary of the agency problem see Kershaw *Company Law in Context* 171-188.

<sup>35</sup> These may include regulating the composition of the board of directors and to implement mechanisms to balance the power between management, the board of directors and the shareholders. For a comprehensive list of mechanisms see J Armour, H Hansmann & R Kraakman “Agency Problems and Legal Strategies” in R Kraakman, J Armour, P Davies, L Enriques, H Hansmann, G Hertig, K Hopt, H Kanda, M Pargendler, W-G Ringe & E Rock (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* 3 ed (2017) 29-31. For a summary see Kershaw *Company Law in Context* 185-188.

<sup>36</sup> Also see the discussion of shareholder “ownership” above, 4.3.2 Shareholder ownership and shareholder primacy.

<sup>37</sup> A classification of rights into primary and supporting rights (“Haupt- und Hilfsrechte”) is frequently undertaken by German authors, is however described by Heider as legally irrelevant; see K Heider “§§ 1-14” in W Goette, M Habersack & S Kalss (eds) *Münchener Kommentar zum Aktiengesetz* 4 ed (2016) § 11 [17].

<sup>38</sup> See the South African Companies Act 71 of 2008 s 26 for the right to access company records. What comprises company records is set out in s 25. Also see UK Companies Act 2006 s 32. On US Law see Model Business Corporation Act § 16.01-16.03. German law enables access to information through Aktiengesetz § 131. Furthermore, a company must provide shareholders with certain information without being prompted to do so. Typically this includes, amongst others, annual financial statements; see for example s 31 of the South African Companies Act 71 of 2008 and s 423 of the English Companies Act 2006.

<sup>39</sup> On the duty to pay, see below 6.2 Allotment and issue of shares.

already.<sup>40</sup> Furthermore, shareholders undertake to honour the terms of the constitutional document.<sup>41</sup>

The concept of a share must be understood as constituting a cluster of a variety of very specific rights and duties. For this reason, a share is frequently described as “a bundle of rights”.<sup>42</sup> The law presumes that all shares issued by a company confer the same combination of rights and duties – the principle of equal treatment of shareholders.<sup>43</sup> This presumption can be modified in the constitutional document.<sup>44</sup> The bundle of rights can be varied thereby creating different classes of shares. Most commonly, this is achieved by creating one class with preferential rights. Rights to redeem and convert shares can also be attributed to specific classes of shares only. Class rights are therefore all the rights that attach to a particular class of shares. The creation of classes allows for the customisation of shares to meet the needs of specific investors and the company.<sup>45</sup> In the context of share rights, the constitutional document has two primary functions: to determine rights and duties of shareholder over and above those set by legislation and to bundle these rights and duties.

Across jurisdictions, it is not so much the types of rights and duties that flow from shares that differ, but rather the interaction between the statute and the constitutional document and the flexibility of the company to create rights, duties and classes of shares. Thus, the questions are: Which baseline of rights, duties and terms are set by legislation and how much room is given to the company to add and vary rights and duties? How can the rights be bundled and how creative can a company be in packaging these rights?

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<sup>40</sup> Davies & Worthington *Modern Company Law* 864 [23-5].

<sup>41</sup> HS Cilliers & ML Benade *Company Law* 4 ed (1982) 151.

<sup>42</sup> See for example *Standard Bank of South Africa v Ocean Commodities Inc* 1983 1 SA 276 (A) 288H.

<sup>43</sup> In South African law, this presumption, also known as the doctrine of equality, can be found in s 37(1) of the Companies Act 71 of 2008. See PA Delpont (ed) *Henochsberg on the Companies Act 71 of 2008* (RS 15 2017) 167-168; *South African Mutual Life Assurance Society v Anglo-Transvaal Collieries Ltd* 1977 3 SA 642 (AD) 644H.

<sup>44</sup> This is in line with the freedom to formulate an association document, aptly named “Satzungsautonomie” in German law; see KW Lange “Aktiengesetz §§1-14” in M Henssler & L Strohn *Gesellschaftsrecht* 3 ed (2016) § 11 [1].

<sup>45</sup> Cahn & Donald *Comparative Company Law* 264.

## 5 3 Comparative overview

### 5 3 1 US law

The articles of incorporation are the point of departure for the determination of rights and duties attaching to shares.<sup>46</sup> According to the Model Business Corporation Act, a company's articles of incorporation may authorise shares with the following rights: 1. special, conditional or limited voting rights or no voting rights, 2. rights to redeem or convert shares, 3. distributions, including cumulative, non-cumulative or partially cumulative dividends, 4. preferences to distributions, including distributions at dissolution and 5. terms based on objectively ascertainable facts.<sup>47</sup> Similar provisions can be found in the Delaware Code.<sup>48</sup>

In addition to this broad framework of rights, the Model Business Corporation Act states that "the description of the preferences, rights and limitations... is not exhaustive".<sup>49</sup> The types of rights and restrictions that can be attached to shares are therefore unlimited. At the very minimum, at least one class of shares must have unlimited voting rights<sup>50</sup> and one must be entitled to receive the net assets at liquidation.<sup>51</sup>

The considerable freedom to create different types of rights and duties also extends to the creation of diverse classes and series of shares. All shares of one class or series must have identical terms.<sup>52</sup> Within a class of shares, a company may create series, which may have different characteristics than other series in the same class. Traditionally, a distinction is drawn between common shares (ordinary shares) and preferred shares (preference shares).

A company may also authorise unclassified shares. The terms attaching to such shares must be determined before they can be issued.<sup>53</sup> This determination can be done by the board of directors without shareholder approval.<sup>54</sup> Considering that US

<sup>46</sup> The Delaware Code Title 8 refers to a certificate of incorporation.

<sup>47</sup> Model Business Corporation Act § 6.01(c)-(d).

<sup>48</sup> Delaware Code Title 8 § 151.

<sup>49</sup> Model Business Corporation Act § 6.01(f); See also Delaware Code Title 8 § 151(a).

<sup>50</sup> Delaware Code Title 8 § 151(b); Model Business Corporation Act § 6.01(b)(1).

<sup>51</sup> Model Business Corporation Act § 6.01(b)(2).

<sup>52</sup> § 6.01(a).

<sup>53</sup> Model Business Corporation Act § 6.02; Delaware Code Title 8 §§ 151(a), 151(g).

<sup>54</sup> Model Business Corporation Act § 6.02; Delaware Code Title 8 §§ 151(a), 151(g).

company law is predominantly a loose set of default rules, a company has considerable flexibility in creating share rights and classes or series of shares.<sup>55</sup>

Classes and series of shares and the number of shares in each class or series must be set out in the articles of incorporation.<sup>56</sup> Each class or series must be given a distinguishing designation.<sup>57</sup> Prior to their issue, the terms, preferences, rights and limitations must also be expressly set out in the articles.<sup>58</sup> This is particularly true for rights that distinguish one class or series from another.<sup>59</sup> In the case of unclassified shares, the terms may be specified in a resolution by the board.<sup>60</sup> Only those rights and other terms specified will attach to the shares. Contrary to English law, rights will not be inferred by presumption.<sup>61</sup>

The US legal framework on classes of shares and the rights that attach thereto is particularly wide and flexible. A company may create any number of rights and classes of shares, provided that these are clearly set out in the articles of incorporation. Thus, the legal framework is said to be “strategic rather than compliance oriented”.<sup>62</sup>

### 5 3 2 English law

Contrary to US law, the UK Companies Act does not provide a statutory framework for the type of rights and duties that may be created. Typically, the rights would be the same as those set out above, namely the right to distributions, the right to share in the surplus at liquidation and the right to vote.<sup>63</sup> The same appears from the Model Articles, which determine that “without prejudice to the rights attached to any existing share, the company may issue shares with such rights or restrictions as may be determined by ordinary resolution”.<sup>64</sup>

A company also has considerable creativity to create classes of shares with different combinations of rights, provided that shares of a class all have the same

<sup>55</sup> Cahn & Donald *Comparative Company Law* 274.

<sup>56</sup> Model Business Corporation Act § 6.01(a).

<sup>57</sup> Model Business Corporation Act § 6.01(a); Delaware Code Title 8 § 151(a).

<sup>58</sup> Model Business Corporation Act § 6.01(a); Delaware Code Title 8 § 151(a).

<sup>59</sup> Model Business Corporation Act § 6.01(e).

<sup>60</sup> Model Business Corporation Act § 6.02; Delaware Code Title 8 §§ 151(a), 151(g).

<sup>61</sup> Cahn & Donald *Comparative Company Law* 274. Also see below at 5 3 2 English law.

<sup>62</sup> Cahn & Donald *Comparative Company Law* 274.

<sup>63</sup> See above, 5 2 Rights and duties encapsulated in shares.

<sup>64</sup> Companies (Model Articles) Regulations 2008 Schedule 3 Reg 43(1). As per s 17(b) of the English Companies Act 2006, a resolution determining shareholder rights will become part of the “constitution”.

rights attached to them.<sup>65</sup> Traditionally, English law distinguishes between ordinary shares and preference shares.<sup>66</sup>

Normally, the different classes and the rights and duties attaching to each class will be set out in the articles of association. This is not compulsory, however.<sup>67</sup> If a company assigns a name or designation to a class of shares, it must give notice thereof to the registrar within one month of doing so.<sup>68</sup> The lack of specification of the types of classes and the rights and duties attaching to such classes in the articles of association or other documents, obliges courts to use a variety of canons of construction.<sup>69</sup> Ordinary shares, unless specified otherwise in the articles, carry rights to share in distributions of profit during the lifetime of the company and in distributions of the surplus at its dissolution.<sup>70</sup> Preferences (either to profits, surplus or voting) must be expressly specified, otherwise rights are presumed to be the same as those of ordinary shares.<sup>71</sup> A preference to dividends is presumed to be non-participating, cumulative and payable only once declared.<sup>72</sup>

### 5 3 3 German law

Paragraph 11 of the Aktiengesetz makes provision for a variety of rights; shares with the same rights and duties form a “Gattung” or class.<sup>73</sup> Cahn and Donald find that, although the reference to “various rights”<sup>74</sup> in § 11 indicates substantial freedom in the creation of rights and the bundling of these rights into classes, in reality the bundling exercise is closely regulated.<sup>75</sup> The “Satzung” may deviate from the legislative provisions only where expressly allowed to do so.<sup>76</sup> The focus is on

<sup>65</sup> See Companies Act 2006 s 629(1); also see s 629(2) in terms of which shares are not of a different class “by reason only that they do not carry the same rights to dividends in the twelve months immediately following their allotment”.

<sup>66</sup> For a brief discussion on the distinction between ordinary and preference shares see 5 3 4 South African law.

<sup>67</sup> Davies & Worthington *Modern Company Law* 866 [23-7].

<sup>68</sup> Companies Act 2006 s 636(1).

<sup>69</sup> See Davies & Worthington *Modern Company Law* 867-870.

<sup>70</sup> See the definition of “ordinary shares” in s 560(1) of the Companies Act 2006.

<sup>71</sup> See reference to case law in Davies & Worthington *Modern Company Law* 867-868 [23-8].

<sup>72</sup> 867-869.

<sup>73</sup> Aktiengesetz § 11. Despite only mentioning equal rights in sentence 2, for completeness sake, a class of shares is defined by equal rights and duties; Heider “§§ 1-14” in *Münchener Kommentar zum AktG* § 11 [4], [28].

<sup>74</sup> Aktiengesetz § 11: “Die Aktien können verschiedene Rechte gewähren ...”.

<sup>75</sup> Cahn & Donald *Comparative Company Law* 268. Despite stipulating a possible variation of profit- and surplus-sharing rights, Heider points out that this was not intended to be a conclusive list; see Aktiengesetz § 11 and Heider “§§ 1-14” in *Münchener Kommentar zum AktG* § 11 [3].

<sup>76</sup> Aktiengesetz § 23(5).

compliance and shareholder protection rather than the strategic structuring of shareholding.

The Aktiengesetz contains no list or framework of rights and duties that may be attached to shares, but specific rights are set out in detailed provisions of the Act.<sup>77</sup> They are frequently categorised as follows: First, “Vermögensrechte” (patrimonial rights), namely the right to participate in profits,<sup>78</sup> the right to receive a share of the surplus at liquidation<sup>79</sup> and the right to subscribe to new shares during a rights issue.<sup>80</sup> Any patrimonial rights that go beyond these three categories could be found to be a prohibited refund of the shareholder contribution.<sup>81</sup> The second category of rights is “Mitverwaltungsrechte” (participation and administrative rights), such as the right to vote,<sup>82</sup> the right to attend the annual general meeting<sup>83</sup> and the right to information.<sup>84</sup> Both categories of rights broadly correspond to those typically present in systems of common law.

A basic division of ordinary shares (“Stammaktien”) and preference shares (“Vorzugsaktien”) exists in German law. The rights to share in profits and liquidation surplus can generally be varied, with preference shares usually enjoying a preferential right to profits. Voting rights can only be restricted for a class of shares which have a cumulative preferential right to dividends.<sup>85</sup> Furthermore, a variation of the voting rights of ordinary shares is only possible within the limits set by the Act. Multiple votes per share are prohibited<sup>86</sup> and votes may only be reduced per shareholder.<sup>87</sup> Such a reduction is therefore not a class right and is only possible in the case of unlisted companies.<sup>88</sup>

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<sup>77</sup> These rights are together classified as membership rights (“Mitgliedschaftsrechte”). For an overview of the rights and duties see K Schmidt *Gesellschaftsrecht* 4 ed (2009) 797-803.

<sup>78</sup> Aktiengesetz §§ 58(4) and 60.

<sup>79</sup> § 271.

<sup>80</sup> § 186.

<sup>81</sup> Aktiengesetz § 57. See Heider “§§ 1-14” in *Münchener Kommentar zum AktG* § 11 [12].

<sup>82</sup> Aktiengesetz §§ 12, 133-137.

<sup>83</sup> § 118(1).

<sup>84</sup> § 131.

<sup>85</sup> § 139(1). In the case of non-payment of preference dividends, such preference shareholders have voting rights; § 140(2).

<sup>86</sup> Aktiengesetz § 12(2). See Heider “§§ 1-14” in *Münchener Kommentar zum AktG* § 12.

<sup>87</sup> Aktiengesetz § 134(1).

<sup>88</sup> § 134(1).

If a company has different classes of shares, the classes and the number of shares per class must be set out in the “Satzung” (articles of incorporation).<sup>89</sup> This includes a detailed account of the rights and duties.<sup>90</sup> Information on the different classes of shares is classified as “materielle Satzungsbestimmungen” – being material provisions that regulate the relationship of the company to its founders and shareholders, including future shareholders.<sup>91</sup> Such provisions obtain normative force,<sup>92</sup> provided they are within the requisite legislative boundaries.<sup>93</sup> German law makes no provision for unclassified shares.

#### 5 3 4 South African law

Section 37 of the South African Companies Act authorises the creation of different classes of shares. In section 37(5), a framework of rights, that a company *may* establish, is provided. The framework is based, almost verbatim, on the relevant provisions in the Model Business Corporation Act.<sup>94</sup> Like its US counterpart, the section states that a company, in its memorandum of incorporation, may establish preferences, rights, limitations and other terms that confer voting rights (special, conditional or limited), provide for redemption or conversion of shares, entitle the shareholder to receive distributions, whether cumulative, non-cumulative or partially cumulative or to provide for shares that confer preferential rights to distributions or proceeds upon liquidation. Additionally, the memorandum may provide for rights to vary “in response to any objectively ascertainable external fact or facts”.<sup>95</sup> The Act therefore provides an extensive and flexible list of different types of rights that may be created. In contrast to US law, the Companies Act does not make provision for a catch-all, determining that the list of terms set out above is not exhaustive.<sup>96</sup>

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<sup>89</sup> § 23(3)(4).

<sup>90</sup> Hüffer & Koch *Aktiengesetz* § 23 [29]; Pentz “§§ 23-53” in *Münchener Kommentar zum AktG* § 23 [132].

<sup>91</sup> The counterpart is “formelle Satzungsbestimmungen”. See Pentz “§§ 23-53” in *Münchener Kommentar zum AktG* § 23 [39], [40] and [41]; Hüffer & Koch *Aktiengesetz* § 23 [4].

<sup>92</sup> Rights of the category of “formelle Satzungsbestimmungen”, on the other hand, are only of a contractual nature and therefore do not bind third parties and successors.

<sup>93</sup> See n 76 above and § 23(5) *Aktiengesetz*. If rights are created or bundled in contravention of legislation, they are “formelle Satzungsbestimmungen”. On the normative, objective force of the “Satzung”, see nn 10, 11 and 12 above.

<sup>94</sup> See text to n 47 above. For a brief description of the references, rights or limitations contained in the Companies Act 71 of 2008 s 37(5)(a)-(d), see Delpont *Henochsberg* 172-174(1).

<sup>95</sup> Companies Act 71 of 2008 s 37(6).

<sup>96</sup> See the text to n 49 above.

Considering, that the provision is alterable, the result is probably the same.<sup>97</sup> Furthermore, the memorandum of incorporation may also include such rights and privileges not provided for by the Act.<sup>98</sup>

Companies therefore have the freedom to determine rights and duties within this framework set by the Act, provided that a minimum standard of rights applies.<sup>99</sup> If a company only has one class of shares, the shares must have voting rights and the holders of the shares must be entitled to share in the surplus assets at liquidation.<sup>100</sup>

The content of these rights and duties does not need to be the same for all issued shares. A company may bundle the rights and duties into different classes of shares. Shares with the same rights and duties are treated as a class.<sup>101</sup> At least one of the classes must carry general voting rights<sup>102</sup> and one class must be entitled to receive the surplus assets upon liquidation.<sup>103</sup>

Traditionally a distinction is drawn between ordinary shares and preference shares. Whilst ordinary shares are characterised by full participation in dividends and liquidation surplus as well as general voting rights, preference shares enjoy a preference of some sort over ordinary shares, usually by way of a preferential right to dividends.<sup>104</sup>

A class of shares may also be unclassified<sup>105</sup> or be part of a class with unspecified rights and duties.<sup>106</sup> The company's board must, however, classify the shares or determine their rights and duties before they can be issued.<sup>107</sup> This practice recognises that shares, before being issued, confer no rights.<sup>108</sup>

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<sup>97</sup> An "alterable provision" is defined as "a provision of this Act in which it is expressly contemplated that its effect on a particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by that company's Memorandum of Incorporation"; see s 1 of the Companies Act 71 of 2008; also see s 15(2)(ii).

<sup>98</sup> See s 15(2)(i).

<sup>99</sup> This practice also aligns with US law – see for example the text to nn 50 and 51.

<sup>100</sup> Companies Act 71 of 2008 s 37(3)(b).

<sup>101</sup> Section 37(1).

<sup>102</sup> Section 37(4)(a).

<sup>103</sup> Section 37(4)(b).

<sup>104</sup> Companies Act 71 of 2008 s 37(5)(d); For an overview on preference shares see FHI Cassim, MF Cassim, R Cassim, R Jooste, J Shev & J Yeats *Contemporary Company Law* 2 ed (2012) 216-219.

<sup>105</sup> Companies Act 71 of 2008 s 36(c).

<sup>106</sup> Section 36(d).

<sup>107</sup> See s 36(3)(c) and (d) respectively.

<sup>108</sup> PL Davies *Gower and Davies' Principles of Modern Company Law* 7 ed (2003) 626.

Resembling the legal framework in US law, the memorandum of incorporation is central to determining share terms and classes of shares. The memorandum must set out the different classes of shares,<sup>109</sup> the number of shares of each class,<sup>110</sup> a distinguishing designation of each class<sup>111</sup> and the preferences, rights, limitations and other terms associated with each class.<sup>112</sup>

In comparison to the position in English law, South African law reflects the US arrangement of a legislative framework of default rules, which may be amended and augmented. Davies and Worthington find this indicative of a legislative approach to the creation and bundling of shareholder rights and the structuring of the constitutional document as compared to a shareholder-controlled approach in England.<sup>113</sup> English, US and South African law can all be summarised as follows: rights can be created and bundled as desired, unless prohibited by legislation. German law exhibits far greater statutory control over the classes of shares and the rights and duties attaching to them – a deviation in the “Satzung” is only allowed where legislation expressly provides for it.<sup>114</sup>

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<sup>109</sup> Companies Act 71 of 2008 s 36(1)(a).

<sup>110</sup> Section 36(1)(a).

<sup>111</sup> Section 36(1)(b)(i).

<sup>112</sup> Section 36(1)(b)(ii).

<sup>113</sup> Davies & Worthington *Modern Company Law* 65-66 [3-13]. Although the Model Articles now provide a suggested framework in the UK; see n 64 above.

<sup>114</sup> Aktiengesetz § 23(5). Also see n 76 above. This is known as “Prinzip der Satzungsstrenge” (principle of the strictness of articles of association). See Pentz “§§ 23-53” in *Münchener Kommentar zum AktG* § 23 [6].

## Chapter 6: Issuing shares

### 6 1 Registered and bearer shares

Companies may issue shares either in bearer or in registered form. In the former, a piece of paper serves as the carrier of the rights described above; in the latter, an account entry performs the function of lending some form of “tangibility” to rights. The form, Part 2 will show, has an impact on the relationship between the company and its shareholders and determines how shares are evidenced and transferred.<sup>1</sup>

Central to the notion of a bearer share is a physical certificate. Printed on the certificate is a promise by the issuing company to perform towards or pay the bearer of the instrument.<sup>2</sup> The paper instrument embodies the rights that it represents.<sup>3</sup> This is also known as “reification”. According to this legal fiction the physical share certificate is treated as if it, itself, is the underlying right or claim. Bearer shares are therefore considered to be tangibles and negotiable instruments in the common law.<sup>4</sup> The bearer or holder of the certificate is the person who is in possession of the physical certificate.<sup>5</sup> Bearer shares are simply transferred by physical delivery – in other words by transferring possession from one person to another.<sup>6</sup> The company does not register or record shareholding or ownership of a bearer share. Dividends are paid to the person who presents the company with a physical coupon.

As the holding of bearer shares is not recorded, holding, ownership and therefore transactions in shares can easily be concealed. Hence, bearer shares have frequently been associated with fraud, money-laundering and tax evasion.<sup>7</sup> Bearer shares are also susceptible to theft, as the mere possession of the certificate entitles the possessor or holder to performance from the company. Consequently, bearer shares are not in common use or are even prohibited in some jurisdictions including

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<sup>1</sup> M Yates & G Montagu *The Law of Global Custody: Legal Risk Management in Securities Investment and Collateral* 4 ed (2013) 8 [1.23]; J Benjamin *Interests in Securities: A Proprietary Analysis of the International Securities Markets* (2000) 32.

<sup>2</sup> Benjamin *Interests in Securities* 32.

<sup>3</sup> JS Rogers *The End of Negotiable Instruments: Bringing Payment Systems Law out of the Past* (2012) 45.

<sup>4</sup> Yates & Montagu *The Law of Global Custody* 16 [2.15].

<sup>5</sup> Benjamin *Interests in Securities* 32.

<sup>6</sup> 32.

<sup>7</sup> 32.

England, South Africa and the US. In contrast, not only are bearer shares sanctioned in civil law jurisdictions such as Germany,<sup>8</sup> they are also more commonplace.<sup>9</sup>

Before the dematerialisation of shares, certificates were also issued for registered shares and in fact, are still issued for immobilised registered shares. What distinguishes bearer shares from registered shares is not the presence or absence of a certificate, but rather the function performed by the piece of paper. Whereas the certificate embodies the rights and therefore constitutes the bearer share, the certificate merely evidences the rights and therefore only represents the registered share.<sup>10</sup> Physical delivery of the certificate thus does not suffice to transfer the rights and physical possession of the certificate is not necessarily indicative of the identity of the shareholder. The additional act of registration is required. A list of all holders of shares, known as a register, is maintained by the issuer<sup>11</sup> and amended upon each transfer. Although both the certificate and register are simply evidentiary, the register is decisive. Registered securities are thus intangibles. In practice, shares in South Africa, the UK and the US are primarily in registered form.

In the US, registered shares are also regarded as negotiable instruments, making them look a lot like bearer shares. Indeed, negotiability in this sense achieves the “reification of abstract rights into pieces of paper”.<sup>12</sup> Whereas bearer shares are transferable by mere delivery, however, registered shares are transferable by delivery and indorsement and the transfer must be registered by the issuer.<sup>13</sup> Unlike bearer shares, which facilitate anonymity, registered shares, even if in negotiable form, do not.

In Germany, shares may take the form of either “Inhaberaktien” (bearer shares) or “Namensaktien” (registered shares).<sup>14</sup> Before the amendment of the Aktiengesetz in 2015, a company could freely choose between the two types provided the form was

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<sup>8</sup> See Aktiengesetz § 10(1), § 23(3)(5). Bearer shares are known as “Inhaberaktien”. Registered shares, on the other hand are “Namensaktien”.

<sup>9</sup> E Micheler *Property in Securities: A Comparative Study* (2007) 145. Shares and securities are simultaneously categorised as “Wertpapiere”. This includes bearer as well as registered shares.

<sup>10</sup> See Benjamin *Interests in Securities* 32.

<sup>11</sup> Frequently, the register is maintained by a registrar on behalf of the company.

<sup>12</sup> Rogers *End of Negotiable Instruments* 49; in general see 49-53. Also see JS Rogers “Negotiability, Property and Identity” (1991) 12 *Cardozo LR* 471.

<sup>13</sup> See the distinction between “bearer form” and “registered form” in UCC §§ 8-102(a) and (13). Also see UCC Parts 3 and 4.

<sup>14</sup> The provision that the company has to stipulate the form in its constitutional document remains; Aktiengesetz § 23(3)(5).

stated in its constitutional document. Paragraph 10(1) of the amended version, however, favours “Namensaktien”, stating that “Inhaberaktien” may only be issued if certain conditions are met, namely if the company is publicly listed or the issuance of individual share certificates (as opposed to global certificates) is excluded and if the shares are held in collective deposit.<sup>15</sup> Furthermore, shares must be issued as “Namensaktien” if the share has been issued before the shareholder has performed in full<sup>16</sup> or if share scrip is issued.<sup>17</sup> If certificates are issued for “Namensaktien” they are typically held in collective deposit in the same manner as “Inhaberaktien”.<sup>18</sup> Furthermore, in certificated form, both registered and bearer shares are “Wertpapiere”. Despite the rise of registered shares in Germany,<sup>19</sup> they are still of minor importance compared to bearer shares.<sup>20</sup>

## 6 2 Allotment and issue of shares

Section 35(4) of the South African Companies Act reads: “An authorised share of a company has no rights associated with it until it has been issued”.

The exchange of monetary capital for shares is said to be the result of a contract. The normal contractual rules of offer and acceptance apply.<sup>21</sup> In *Moosa v Lalloo*<sup>22</sup> the

<sup>15</sup> § 10(1).

<sup>16</sup> § 10(2).

<sup>17</sup> § 10(3)-(4).

<sup>18</sup> See P Stein *Die Aktiengesellschaft: Gründung, Organisation und Finanzverfassung* (2016) 6-7.

<sup>19</sup> See for example U Hüffer & J Koch *Aktiengesetz* 13 ed (2018) § 67 [3]; Stein *Aktiengesellschaft* 6-7; K Heider “§§ 1-14” in W Goette, M Habersack & S Kalss (eds) *Münchener Kommentar zum Aktiengesetz* 4 ed (2016) § 10 [18]. This trend is also described by D Meppen *Das Inhaberpapier: Von der Verbriefung zum unverbrieften Wertrecht?* (2014) 162-163, who reasons that first, companies want to manage the relationship with their members more efficiently and second, globalisation increasingly causes an interaction with foreign capital markets, particularly the US market, where registered shares dominate. The dominance of bearer shares in Germany only developed during the second half of the 19<sup>th</sup> century, prior to which registered shares were more common. In fact, bearer shares required special regulatory permission. This only changed with the coming into force of the General German Commercial Code of 1861 (“Allgemeines Deutsches Handelsgesetzbuch”, the predecessor of the “Handelsgesetzbuch”) and the 1<sup>st</sup> “Aktienrechtsnovelle” of 1870; see Meppen *Inhaberpapier* 81-83. The Aktiengesetz of 1937 contained a provision stipulating that, unless determined otherwise in the constitutional document, shares would be issued as “Namensaktien”; see § 17 Aktiengesetz of 1937; Meppen *Inhaberpapier* 160. “Namensaktien” will not be analysed in any detail, but see below, 8 2 1 The functions of registration n 17.

<sup>20</sup> D Einsele *Wertpapierrecht als Schuldrecht: Funktionsverlust von Effektenurkunden im internationalen Rechtsverkehr* (1995) 10; A Hueck & C-W Canaris *Recht der Wertpapiere* 12 ed (1986) § 25 I 2 a-b; K-H Gursky *Wertpapierrecht* 3 ed (2007) 154; Heider “§§ 1-14” in *Münchener Kommentar zum AktG* § 10 [18].

<sup>21</sup> *Moosa v Lalloo* 1957 4 SA 207 (N) 219; *McKenzie v Farmers’ Co-Operative Meat Industries Ltd* 1922 AD 16 22; FHI Cassim, MF Cassim, R Cassim, R Jooste, J Shev & J Yeats *Contemporary Company Law* 2 ed (2012) 240. On English law see *In re Florence Land and Public Works Company*; *Nicol’s Case v Tufnell & Ponsonby’s Case* (1885) 29 ChD 421 426; D French, SW Mayson & CL Ryan *Mayson, French & Ryan on Company Law* 31 ed (2014-2015) 166.

court explains that “[n]o ceremonious ritual, nor any magic formula, is required for the process of allotting the share”<sup>23</sup> and in *In re Florence Land and Public Works Co, Nicol’s Case v Tufnell & Ponsonby’s Case*,<sup>24</sup> allotment was described as “neither more nor less than the acceptance of the company of the offer to take shares”.<sup>25</sup> In effect the offer-acceptance construction can take two forms.<sup>26</sup> Listed companies most frequently issue a prospectus, inviting the general public to subscribe to shares in the company.<sup>27</sup> The subscriber offers to take up shares in the company and the company subsequently accepts the offer by allotting shares to the subscriber.<sup>28</sup> Allotment is particularly relevant where the demand for a particular issue of shares exceeds the number of shares being issued (oversubscription). The prospectus does not constitute an offer, because it does not set out all the terms of the proposed contract; most notably the identity of the prospective shareholder as well as the number of shares he will take up, are unknown at that stage.<sup>29</sup> Alternatively, the company makes the offer through a provisional letter of allotment or allocation pending acceptance of the offer by the addressee of the letter.<sup>30</sup> This is the typical procedure for a rights offer, which is an offer to existing shareholders to take up additional shares.<sup>31</sup> Regardless of the form, an offer to take up shares can be withdrawn at any time before acceptance.<sup>32</sup> Required, for the conclusion of a binding contract, is mutual assent between the subscriber offering to take up the shares and the company wishing to issue them. A communication of the acceptance by the company

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<sup>22</sup> 1957 4 SA 207 (N).

<sup>23</sup> 219B.

<sup>24</sup> (1885) 29 ChD 421.

<sup>25</sup> 426.

<sup>26</sup> See French et al *Mayson Company Law* 166. Also see *Moosa v Lalloo* 1957 4 SA 207 (N) 219B-C.

<sup>27</sup> This is known as a public offer of shares. Public offers of shares are extensively regulated. For the regulation of public offerings of shares and other securities in South Africa see ch 4 of the Companies Act 71 of 2008.

<sup>28</sup> See s 107 of the Companies Act 71 of 2008 which uses the terminology of allotment or acceptance of the subscription. See Cassim et al *Contemporary Company Law* 240-241; RR Pennington *Pennington’s Company Law* 8 ed (2001) 346.

<sup>29</sup> Pennington *Company Law* 346.

<sup>30</sup> See the definitions “letter of allocation” and “rights offer” in the Companies Act 71 of 2008.

<sup>31</sup> In certain circumstances companies are obliged to first offer shares to existing shareholders in terms of a rights issue so that shareholders proportion of total equity remains constant. See definitions in s 95(1) of the Companies Act 71 of 2008.

<sup>32</sup> *In re London and Northern Bank, Ex parte Jones* [1900] 1 Ch 220. This is also generally true for South African law, see MS Blackman, RD Jooste, CK Everingham, JL Yeats, FHI Cassim & R De La Harpe *Commentary on the Companies Act* (2002) (RS 9 2012) 5-242 and the cases cited in n 3. It is not true for German law, where an offer is generally irrevocable.

to the subscriber is therefore ordinarily required, but acceptance can similarly be communicated by conduct,<sup>33</sup> or it can be dispensed with entirely.<sup>34</sup>

The contract concluded between the company and the subscriber to the shares creates reciprocal duties: The company undertakes to issue the shares, whilst the subscriber undertakes to take up a particular number of shares and pay for these.<sup>35</sup> In line with these duties, the contract of allotment creates personal rights – the right to demand the issue of the shares and the right to demand payment – provided that the time for performance has arrived. Any remedies for non-performance are contractual.

It is said that the allotment of shares cannot be equated to their issue. Allotment and issue are not defined by the South African Companies Act, yet, it is frequently said that the act of registration completes the issue after the allotment of shares.<sup>36</sup> In England the Companies Act determines that “shares in a company are taken to be allotted when a person acquires the unconditional right to be included in the company’s register of members”.<sup>37</sup> Allotment merely gives the subscriber the right to have his name inserted on the share register. In the English case of *National Westminster Bank plc v Inland Revenue Commissioners*<sup>38</sup> the court determined that “[t]he applicant is neither a member nor a shareholder while his rights rest in contract and until the issue of the shares has been completed by registration” and “[a]llotment confers a right to be registered. Registration confers title”.<sup>39</sup> The right to be entered on the register must be unconditional. Thus, any conditions, such as the duty of the applicant to pay a determined amount for the shares, must be fulfilled before shares are regarded to be allotted.<sup>40</sup> Yet, before registration (but after the fulfilment of conditions), equitable title is conferred. This view is by no means undisputed. On the basis of case law<sup>41</sup> Pennington argues that allotment occurs when the directors of a company apportion shares to the subscriber (thus taking the form of a tacit

<sup>33</sup> *Pretorius v Natal South Sea Investment Trust Ltd* 1965 3 SA 410 (W) 413-414.

<sup>34</sup> *McKenzie v Farmers’Co-Operative Meat Industries Ltd* 1922 AD 16 22.

<sup>35</sup> *In re Florence Land and Public Works Company; Nicol’s Case v Tufnell & Ponsonby’s Case* (1885) 29 ChD 421 426-427; also quoted in *Moosa v Lalloo* 1957 4 SA 207 (N) 221C.

<sup>36</sup> Cassim et al *Contemporary Company Law* 241. Also see Companies Act 71 of 2008 s 35(4), which states that authorised shares only obtain rights once they have been issued.

<sup>37</sup> Companies Act 2006 s 558.

<sup>38</sup> [1995] 1 AC 119 123-124 (Lord Templeman).

<sup>39</sup> 126 (Lord Templeman).

<sup>40</sup> French et al *Mayson Company Law* 165.

<sup>41</sup> See the cases listed by Pennington in *Company Law* 363 n 17 and 18.

acceptance), whereas the issue of shares takes place when the company informs the subscriber of the allotment and provides evidence of his shareholding.<sup>42</sup> The tacit acceptance of an offer proposed by Pennington is certainly contrary to ordinary principles of offer and acceptance in English contract law, which typically requires that the acceptance be communicated to the offeror.<sup>43</sup> Uncontested, however, is that the issue of a share certificate is not necessary for shares to be regarded as issued.<sup>44</sup>

The origins of the distinction between allotment and issue of shares can thus clearly be traced to English law. The act of registration is frequently described as “a mere matter of form” and a “ministerial act”.<sup>45</sup> Nonetheless, under English law the Companies Act is said to draw a distinction between the enforceable contract for the issue of shares and the actual issue of shares.<sup>46</sup> Only registration is considered to perfect the title of a shareholder and to make him a member. Therefore, “[a] person who has been allotted shares is in as good a position in equity as a person to whom shares have been issued”.<sup>47</sup> Yet, only registration makes him “a complete master of the shares”.<sup>48</sup> This view is in line with the concept of “membership”, as well as the acquisition of full legal title, both of which require registration.<sup>49</sup>

Similar terminology can be encountered in German law. A subscription of shares is known as “Zeichnung”, which is construed as an offer (“Zeichnungsangebot”). In line with the general approach in German law, the subscriber is bound to his offer, which is thus irrevocable.<sup>50</sup> The contract (“Zeichnungsvertrag”) comes into existence as soon as the issuer accepts the offer. Whereas the offer typically has to comply with certain formalities,<sup>51</sup> acceptance is frequently construed tacitly, the receipt of the

<sup>42</sup> Pennington *Company Law* 363-366. Also see the dissenting judgment of Lord Jauncey of Tullichettle in *National Westminster Bank plc v Inland Revenue Commissioners* [1995] 1 AC 119.

<sup>43</sup> *Carlill v Carbolic Smoke Ball Co* [1893] 1 QB 256 262. In general see J Beatson, A Burrows & J Cartwright *Anson's Law of Contract* 30 ed (2016) 45-46. The requirement of communication can however be waived – see 47-48.

<sup>44</sup> *Re Heaton's Steel and Iron Co, Blyth's Case* (1876) 4 ChD 140 142.

<sup>45</sup> *In re Florence Land and Public Works Company; Nicol's Case v Tufnell & Ponsonby's Case* (1885) 29 ChD 421 426.

<sup>46</sup> See *National Westminster Bank plc v Inland Revenue Commissioners* [1995] 1 AC 119 126.

<sup>47</sup> 126.

<sup>48</sup> 128.

<sup>49</sup> Pennington's approach can be explained with reference to his opinion that full legal title is transferred (by analogy therefore also when first issued) prior to registration; see Pennington *Company Law* 416.

<sup>50</sup> BGB § 145.

<sup>51</sup> See in general Aktiengesetz § 185.

acceptance by the offeror being dispensable.<sup>52</sup> The allotment of shares (“Zuteilung”) is sometimes construed as a form of tacit acceptance. Issuing shares (“Ausgabe”) additionally requires the issuance of the certificate. Being classified as a “Wertpapier”, a share is said to come into existence through making out and properly signing the share certificate (“Ausstellung der Urkunde”) in combination with the delivery of the certificate to the subscriber as the first purchaser.<sup>53</sup> What is required is a “Begebungsvertrag”, an implied agreement devoid of formalities but rather based on the specific act of delivery.<sup>54</sup> Instead of drawing a distinction between the allotment and issue of shares along the lines of registration, as is customary in English law, German law demands that the share certificate be issued and delivered to the shareholder.

Both, the English and German approaches accommodate the fact that (full) title only vests, and a share is therefore only issued once an additional act has been performed, whereas the binding contract of allotment is concluded at an earlier date. Whether the issuing of shares is construed as performance of the contract of allotment, as a separate, tacit contract, or a combination thereof, what these theories have in common is that through issuing, (full) title vests for the first time, in other words, shares are created. The importance of contemplating the proper meaning of allotment and issue lies in determining when a share is created. Shares are said to only come into existence upon being issued.<sup>55</sup> As a result, a subscriber is said not to purchase the shares from the company.<sup>56</sup>

Taking their cue from English law, most South African authors find that the issue of shares is distinct from allotment and requires entry in the share register.<sup>57</sup> In *Moosa v Lalloo*, Caney, J finds, however, that a share comes into existence independently of the act of registration:

<sup>52</sup> G Apfelbacher & G Niggemann “§ 185” in W Hölter (ed) *Aktiengesetz: Kommentar* 3 ed (2017) [5]. This follows the general rules for acceptance of an offer – see BGB § 151 sentence 1.

<sup>53</sup> H-P Westermann “Allgemeine Vorschriften §§ 1-29” in T Bürgers & T Körber (eds) *Aktiengesetz* 4 ed (2017) 25 [8].

<sup>54</sup> Gursky *Wertpapierrecht* 17.

<sup>55</sup> *Moosa v Lalloo* 1957 4 SA 207 (N) 219. *Bavasah v Stirton* 2014 JDR 0230 (WCC) 44.

<sup>56</sup> *Moosa v Lalloo* 1957 4 SA 207 (N) 219.

<sup>57</sup> See for example, Cassim et al *Contemporary Company Law* 241; PA Delpont (ed) *Henochsberg on the Companies Act 71 of 2008* (RS 15 2017) 163, 175: “‘issue’ must be taken as meaning something distinct from allotment and as importing that some subsequent act has been done whereby the title of the allottee becomes complete”; Blackman et al *Commentary on the Companies Act 5-256-4*: “Although the right to a share springs from the offer and acceptance, a share is created and comes into existence as an item of property upon its original issue by the company, and not before”. Also see *Bavasah v Stirton* 2014 JDR 0230 (WCC) 39-40.

“[I]t seems to me that it would be a negation of realities to hold that such a right [a *jus in personam*]<sup>58</sup> did not come into existence in the circumstances of the present case, merely because the company’s officers have failed to perform the ministerial act of placing the plaintiff’s name on the Company’s register of members”.<sup>59</sup>

At the same time, the court recognises that membership (today shareholding) hinges on registration.<sup>60</sup> Registration enables the company to know towards whom it must perform. Although a person may acquire the title to the shares before registration (if the finding in *Moosa v Lalloo* is followed), companies and other persons are entitled to only recognise the registered shareholder as having rights in respect of a security.<sup>61</sup> Full control over the shares can therefore only be obtained through the last step of registration.

According to section 35(4) of the South African Companies Act “[a]n authorised share ... has no rights associated with it until it has been issued”. The Act does not, however, define or describe what the act of issuing constitutes. Whereas section 37(9) indicates that rights in shares are acquired only upon registration,<sup>62</sup> section 50(2) of the Companies Act, obliges a company to make an entry in its register “[a]s soon as practicable *after issuing any securities*”.<sup>63</sup>

The contract of allotment does confer a right to be registered and, traditionally at least, a right to demand a share certificate. At The separate act of registration functions to establish control (more specifically the power to enforce rights) over a share vis-à-vis the issuer. A proper understanding of this functional difference is what matters – placing the various stages of contracting into compartments of “allotment” or “issue” is a mere matter of terminology.

<sup>58</sup> The court refers here to the personal rights which make up shares, not the personal rights of the contract of allotment set out above namely the right to demand issue of the shares.

<sup>59</sup> *Moosa v Lalloo* 1957 4 SA 207 (N) 219 222A-B. On the distinguishing facts in *Moosa v Lalloo*, see *Bavasah v Stirton* 2014 JDR 0230 (WCC) 41-44

<sup>60</sup> *Moosa v Lalloo* 1957 4 SA 207 (N) 219 221G.

<sup>61</sup> *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 1 SA 441 (A) 453A; *Standard Bank of South Africa Ltd v Ocean Commodities Inc* 1983 1 SA 276 (A) 289.

<sup>62</sup> See RD Jooste “Capitalisation of Profit Companies (ss 35-48)” in JL Yeats (ed) *Commentary on the Companies Act of 2008* (OS 2018) 2-274 2-304, who comments on the interaction between s 37(9) and s 35(4) that before registration “the rights can exist even though they are not held by anyone”.

<sup>63</sup> Companies Act 71 of 2008 s 50(2), (own emphasis). The English Companies Act requires the registration of an allotment of shares as soon as practicable and within two months; see Companies Act 2006 s 554(1). Rather than setting a definite time limit for registration, the South African Companies Act sets a limit of four months for acceptance of the offer; see Companies Act 71 of 2008 s 107.

### 6 3 The obligatory realms of shares and some conclusions

The obligatory realm of shares is multifaceted. It consists in the first place of the capital that underlies the issue of shares. Secondly, it incorporates the rights that make up shares and particularly also dictates the way in which these rights are combined. Lastly, it necessitates an apportionment of rights to specific persons.

The authorised share capital (be it in the form of a monetary aggregate or a number of shares) can be said to be created upon the successful registration of a company (pursuant to lodging a memorandum of association or the like) or the approval of an application for a capital increase.<sup>64</sup>

Similarly, the rights underlying shares come into existence upon registration of the company or later classification of unclassified shares.<sup>65</sup> Rights, as illustrated above, have their origin in the constitutional document. Whether the constitutional document and therefore the rights established therein are contractual in nature has been considered above.<sup>66</sup> Critics of the contractual notion have noted that the creation of the constitutional document does not evidence contractual mechanisms and is contingent on regulatory approval.<sup>67</sup> In addition, the content and grouping of rights is regulated by legislation and the common law.<sup>68</sup> This leaves little scope for bargaining.<sup>69</sup>

The creation of shares takes place in another obligatory realm than the creation of capital or rights. In addition to the underlying capital and rights it is premised on an apportionment of the rights and the underlying capital value. In the first place, a contract of allotment is central to the creation of a share.<sup>70</sup> Furthermore, the brief overview of commercial and economic terminology above has shown that shares and financial instruments are perceived to be contractual in nature.<sup>71</sup> Moreover, the contractual notion resonates with the economic theory of the firm as a nexus of contracts.

<sup>64</sup> See above, 3 2 Capital in legislation.

<sup>65</sup> See above, 5 1 Contract, bargaining and the origin of rights.

<sup>66</sup> Above, 5 1 Contract, bargaining and the origin of rights.

<sup>67</sup> Above, 5 1 Contract, bargaining and the origin of rights n 13, 14.

<sup>68</sup> Above, 5 1 Contract, bargaining and the origin of rights n 13.

<sup>69</sup> Above, 5 1 Contract, bargaining and the origin of rights n 17, 18.

<sup>70</sup> See above, 6 2 Allotment and issue of shares.

<sup>71</sup> See above, 2 3 Economic descriptions and commercial realities. See for example the definition of “financial instruments” in IAS 32 at n 39.

According to Jensen and Meckling “[t]here is in a very real sense only a multitude of complex relationships (i.e. contracts) between the legal fiction (the firm) and the owners of labour, material and capital inputs and the consumers of output”.<sup>72</sup> A company, rather than being a distinct entity, is characterised as a pivot on which a series of contracts are hinged. One of these contracts defines the relationship between the company and the shareholders as the owners of capital inputs. The theory therefore makes two assertions: that the company is created through contracting and that the issuer-investor relationship is created by contract.

Implicit in the notion of the company as a creature of contract is the idea of contractual freedom.<sup>73</sup> Companies, it is argued, should not be unduly constrained by regulation. Companies should be free to create their own rules and define the terms of their relationships – in this case the terms of the relationship with the shareholders. At the least, companies should be able to opt out of legal rules.<sup>74</sup> Much criticism has, however, been directed at the idea that a company is created through contracting only. Critics have pointed out that a company is not a creature of contract as the law continues to play a significant role in its creation.<sup>75</sup> Furthermore, the tendency of nexus of contracts scholars to eschew mandatory legal rules has been reproved.<sup>76</sup> In this context it must be mentioned that an economist’s understanding of a contract is considerably more expansive than a lawyer’s. In law, a contract gives rise to legally enforceable rights and duties, while to economists, a contract is any voluntary arrangement between economic actors that results in reciprocal rights and duties, which may or may not be legally enforceable and do not have to display the indicia of

<sup>72</sup> MC Jensen & WH Meckling “The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structures” (1976) 3 *J Finan Econ* 305 311.

<sup>73</sup> In general see LA Bebchuk “Foreword: The Debate on Contractual Freedom in Corporate Law” (1989) 89 *Columbia LR* 1395.

<sup>74</sup> Bebchuk (1989) *Columbia LR* 1395-1396. cf MA Eisenberg “The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm” (1999) 24 *J Corp L* 819 824, who argues that the positive assertion that the company is a nexus of contracts has no implications for mandatory legal rules.

<sup>75</sup> GM Hayden & MT Bodie “The ‘Unincorporation’ and the Unraveling of ‘Nexus of Contracts’ Theory” (2011) 109 *Michigan LR* 1127 1130.

<sup>76</sup> Eisenberg (1999) *J Corp L* 823-825; S Deakin, D Gindis, GM Hodgson, K Huang & K Pistor “Legal Institutionalism: Capitalism, and the Constitutive Role of Law” (2017) 45 *J Comp Econ* 188 196. Even nexus of contracts scholars have recognised the existence of mandatory rules but downplay their importance – example FH Easterbrook & DR Fischel “The Corporate Contract” (1989) 89 *Columbia LR* 1416 1444-14445, state that such rules are always supplementary but never displace the contractual bargain; JR Macey “Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective” (1999) 84 *Cornell LR* 1266 1270, recognises the influence of corporate law, but argues that it is enabling rather than mandatory. Lastly it is criticised that the nexus of contracts theory is a theory of agency costs rather than a theory of the firm – Hayden & Bodie (2011) *Michigan LR*, n 8 and the sources cited there.

contracts usually required by the law.<sup>77</sup> According to Brudney, the theory “stretches the concept ‘contract’ beyond recognition”;<sup>78</sup> and Easterbrook and Fischel postulate that the “corporate contract” may be no more than a “construct” or a “rhetorical device”.<sup>79</sup>

What does this reveal about the contractual nature of the share itself? Without doubt, the rights that make up shares and their bundling are subject to significant statutory control and cannot be explained with reference to ordinary rules of contracting only. Apportioned to a particular person, however, they form an obligatory nexus between the issuer and the holder. Between an issuer and a holder of securities, there exists a personal relationship. This nexus is the result of a complex process of contracting. Contracts are legal instruments that evidence incredible flexibility. They can and in fact regularly accommodate and incorporate rights and duties significantly shaped by legislation and the common law or set out in external documents such as the company constitution. In the same vein they may be subject to statutory formalities. That one or more of the contracting parties lack bargaining power is also a phenomenon not unique to shares and financial instruments. In fact, this is the price that must be paid for contracts that are at once extraordinarily mobile and perpetual in duration.

The rights, viewed individually, also have contractual character, particularly the right to distributions. Nonetheless, there is an understanding that some of the rights transcend a purely contractual or “claim-based” paradigm. This primarily includes control- and other participation rights. The aim is to distinguish shares from mere debts.<sup>80</sup>

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<sup>77</sup> JN Gordon “The Mandatory Structure of Corporate Law” (1989) 89 *Columbia LR* 1549 1549-1150; O Hart “An Economist’s Perspective on the Theory of the Firm” (1989) 89 *Columbia LR* 1757 1764, n 30; BR Cheffins *Company Law: Theory, Structure, and Operation* (1997) Introduction, text to n 7 and 8. In fact, Eisenberg finds that the theory is more accurately described as a “nexus of reciprocal arrangements”, see Eisenberg (1999) *J Corp L* 822-823.

<sup>78</sup> V Brudney “Corporate Governance, Agency Costs, and the Rhetoric of Contract” (1985) 85 *Columbia LR* 1403 1412

<sup>79</sup> Easterbrook & Fischel (1989) *Columbia LR* 1428-1429. Also see J Armour & MJ Whincop “The Proprietary Functions of Corporate Law” (2007) 27 *Oxf J Leg Stud* 420 430, who state that “the economic theory of the firm has never sought to be anything but instrumental... For corporate lawyers applying this theory, the goal is to understand how particular patterns of corporate law may affect these processes [when and why firms come into existence], so as to inform debate about how best it might achieve regulatory or facilitative goals”.

<sup>80</sup> Also see below, 15 2 Why the issue of property arises.

The idea that the rights, once bundled together, are unique finds expression in German legal theory. In German law the aggregate of rights is known as “Mitgliedschaftsrechte” (“membership rights”), which are construed as forming the basis for the existence of shares. “Mitgliedschaft” is described as both a legal relationship from which rights and duties flow as well as a subjective right.<sup>81</sup> As a subjective right, it is not simply a bundle of subjective rights and duties, but rather a “coherent whole” (“geschlossenes Ganzes”).<sup>82</sup> The share is regarded as the embodiment of all the rights and duties that accrue to the shareholder as a result of his membership and participation in a company.<sup>83</sup> “Mitgliedschaftsrechte” are conceptually distinct from mere rights to claim (“Forderungsrechte”) and even if they are perceived to be subjective rights, they are clearly distinguishable from the other, more common types of subjective rights.<sup>84</sup> Membership rights come into existence upon the initial entry of the company in the “Handelsregister” (register of companies), respectively upon the entry of a capital increase.<sup>85</sup> This entry is constitutive for the creation of membership rights; the issue of share certificates merely has declaratory effect in relation to the creation of rights.<sup>86</sup>

Such a concept is useful for holistically drawing together the different obligatory realms, not all of which are purely contractual. It further reiterates that shares exist as both personal relationships and as highly mobile incorporeal assets that can be conceptualised as bundles of rights, independent units of capital and contracts.

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<sup>81</sup> See K Schmidt *Gesellschaftsrecht* 4 ed (2009) 549 and the references provided there.

<sup>82</sup> 550.

<sup>83</sup> Heider “§§ 1-14” in *Münchener Kommentar zum AktG* §10 [5].

<sup>84</sup> M Habersack *Die Mitgliedschaft – subjektives und ,sonstiges‘ Recht* (1996) 28 § 5 I.

<sup>85</sup> Heider “§§ 1-14” in *Münchener Kommentar zum AktG* §10 [5]; Hueck & Canaris *Wertpapiere* § 25 II 1. In fact membership rights are created through entry in the register of companies and a take-over declaration (“Übernahmeerklärung”) by the transferee. The third step of certification is optional. See Heider “§§ 1-14” in *Münchener Kommentar zum AktG* [8], [15]. Also see *Aktiengesetz* § 41(4) and § 191.

<sup>86</sup> Heider “§§ 1-14” in *Münchener Kommentar zum AktG* §10 [8]; Gursky *Wertpapierrecht* 153; Meppen *Inhaberpapier* 28.

## Part 2

The external sphere: Holding structures and transfer mechanisms

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## Chapter 7: Introduction and a prospect of the discussion

Shares have been demonstrated to entail a complex symbiosis of rights, which although they lack physical substance, also constitute assets i.e. distinct units of wealth. Between the issuer and the investor exists a personal relationship.<sup>1</sup> This relationship, it has been illustrated in Part 1, primarily falls within the purview of company law.<sup>2</sup> Company law also contains a set of specific rules and provisions that determine how shares pass from one shareholder to another. At the same time, private law is relevant for ascertaining whether and how a transaction between two private parties can result in a transfer of rights.<sup>3</sup> Whereas the former relationship is typically continuous, also described as concrete and active, the latter is traditionally general and latent.<sup>4</sup> The latter relationships arise when shares and securities are transacted with, for example when they are sold or provided as security. Alternatively they are triggered if a third party infringes certain rights flowing from the issuer-investor relationship. Relationships of the second kind are typically restricted in time – they come to an end when the transaction is concluded or the dispute is resolved.

A share or security is anomalous in the sense that it can be held without the company being aware of the identity of its true owner. There is a disconnect between the parties to a personal relationship. A third type of relationship hence plays a pivotal role in the context of shares – that between investors and intermediaries or between intermediaries *inter se*. Like the first type of relationship that exists between issuers and investors, it is apt to characterise intermediary relationships as continuous and active.

Part 2 will focus on relationships of the second and third kind. It will proceed, in chapter 8, with an analysis of the conceptual or doctrinal basis of transfer and holding mechanisms. This will include a description of the functions performed by both certificates and registers. Traditionally, transfer mechanisms range from assignment and cession in English and South African law respectively, to negotiation and delivery

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<sup>1</sup> On the question whether this relationship can be said to be purely contractual, see above, 6.3 The obligatory realms of shares and some conclusions. Also see MF Khimji “The Role of Legal Concepts in Commercial Law: Comments on Spink, Rogers and Scavone” (2007) 45 *Can Bus LJ* 94-96.

<sup>2</sup> MF Khimji “Intermediary Credit Risk: A Comparative Law Analysis of Property Rights in Indirectly Held Securities” (2005) *J Bus L* 287-302.

<sup>3</sup> 302.

<sup>4</sup> M Habersack *Die Mitgliedschaft – subjektives und ‚sonstiges‘ Recht* (1996) 70 § 6 II 2 b.

in US and German law. It is furthermore important to differentiate between the structures, mechanisms and relationships that are relevant when transacting in shares and those that are at play when holding them. Although they are intertwined, they remain conceptually separate. Traditional holding mechanisms include trusts in English law, agency in South African law, the physical possession of certificates in line with the rules of property law and deposit in German law as well as physical possession in the context of the principles governing negotiable instruments and bailment in US law. Even if share certificates and registration have their origin in company law legislation, chapter 8 will demonstrate that underlying these legislative mechanisms are doctrinal mechanisms that have their origin in private law. Micheler, in her detailed exposition on English, German and Austrian securities law, makes a compelling argument for the strong path dependence of legal development.<sup>5</sup> Identifying the underlying doctrinal rules is therefore indispensable for a proper evaluation of the changed commercial and legal environment.

The study will continue in chapter 9 with a consideration of the electronic environment. In commercial practice, mechanisms of transfer and holding have undergone significant transformation. Technology served as the catalyst for the widespread introduction of account-based, book-entry systems, accompanied in some jurisdictions by the abandonment of physical certificates. In other legal systems certificates continue to exist, but their role and functions have been modified. Whereas the former systems are said to have dematerialised securities, the latter have immobilised the certificates. After the two concepts of “dematerialisation” and “immobilisation” are briefly introduced, the focus will shift to intermediation. In particular, it is proposed that the primary progression that accompanied the establishment of electronic, account-based systems lies neither in the development from certificated to uncertificated securities, nor in the change from direct to indirect holding. The essence of the evolution is rather captured by the change from “simple” to “systemic” intermediation. Intermediation in the context of securities is not a new phenomenon. Chapter 8 illustrates this. What chapter 9 attempts to show is that the manner, functions and structures of intermediation have changed. The chapter will draw on the economic theory of intermediation to narrate some of these changes.

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<sup>5</sup> E Micheler *Property in Securities: A Comparative Study* (2007) 225-230.

The characterisation of the share as a highly mobile asset, perpetual in duration and held through an intermediary, necessitates the establishment of a regime of holding and control. Commonly, the term “holding” symbolises having a grasp or grip on something; to physically possess something.<sup>6</sup> In respect of tangible things, the concept of holding and control ordinarily entails possession i.e. physical control of the asset. To hold something can also simply denote power and control in the absence of any physical element.<sup>7</sup> Where the object to be subjected to control is intangible, control and holding consist of legally effective commercial relations which invest a party with control over the intangible asset.

Holding must be understood to signify the ability to enforce the rights that flow from shares. In other words, a holder of shares is one who has a relationship with the issuer or whoever intermediates in such a relationship. This relationship is established either through physical possession of a share certificate or through conceptual control exercised by virtue of being registered. Holding can be direct or indirect.

A special emphasis must be placed on the ability to enforce the rights that flow from shares, because the law in all jurisdictions has developed to accommodate a division between the ability to enforce performance and the entitlement to the same performance. “Ownership” of shares is usually associated with an entitlement to receive certain benefits (whether flowing from a personal or a real right) and with the ability to enforce such an entitlement.<sup>8</sup> The former is potentially meaningless without the latter. For many owners of shares, it is more convenient, however, that another person, acting on their behalf, receives dividends and other distributions from the company, takes receipt of notices and financial statements and possibly even votes on their behalf. This division has implications for how shares are held, transferred and otherwise transacted with.

To determine how systemic intermediation transforms the transfer and holding of shares and securities, chapter 9 concludes with an overview of the commercial environment. To transfer securities, commercial mechanisms are divided into the phases of trading, clearing and settlement and lastly, payment. Commercial

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<sup>6</sup> See Oxford Dictionaries (available online).

<sup>7</sup> See Oxford Dictionaries (available online).

<sup>8</sup> On ownership also see below, 13 2 3 4 Ownership and holding.

mechanisms, the comparative chapters 10 to 13 will show, are constructed on a legal foundation. In commercial practice, transfer and holding have undergone significant transformation. The aim of these chapters is to assess the corresponding transformation in the underlying legal mechanisms (both in commercial and private law). In matters of commerce, the law is said to lag behind the market. Nowhere is this more accurate than in the fast-paced financial and securities markets. The existing legal rules therefore need to be carefully disentangled to clarify legal uncertainties and to provide a solid basis for future development.

## Chapter 8: The conceptual basis

### 8 1 The functions of the share certificate

The common denominator of all shares before the advent of the electronic age was the share certificate. The entanglement of the share with the share certificate has become so complex – and commonplace – that we find it difficult to imagine a world without certificates.

Before the emergence of modern securities settlement systems, the reliance on share certificates was remarkably uniform across disparate jurisdictions and legal families. Whereas share certificates may be comparable in form, they are frequently disparate in function. As described in the previous chapter, the certificate plays a part in delineating the relationship between a shareholder and a company, depending on whether the share is in bearer or registered form.<sup>1</sup> Even beyond the issuer-investor relationship, certificates, although conceptualised to facilitate broadly the same functions as those described above, namely transferability, trust and certainty,<sup>2</sup> can do so in remarkably different ways.

In some jurisdictions the share certificate has always been conceived to be more important than in others. The primary reason for this is that the delivery of the certificate has in these systems traditionally played a more significant role when transacting with shares. This is for example the case in Germany, which traditionally classifies shares as tangibles, and the US, where shares were for a long time considered to be negotiable instruments. As will appear from the description of its functions below, this does not mean that the share certificate plays no role in facilitating these functions in other jurisdictions; its role is just modified by the existence of other mechanisms such as registration. Writing on the role of share certificates in South Africa, Malan finds: “The share certificate is not without importance. It is not merely prima facie evidence of the shareholder’s right ..., but much more. It fulfills an essential role, and plays an integral part, in the transfer of the share from one person to another, and in the existence of the right to be on the register.”<sup>3</sup> It is helpful therefore to set out the functions performed by certificates.

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<sup>1</sup> On registered and bearer shares, see 6 1 Registered and bearer shares.

<sup>2</sup> See above, 1 1 Context.

<sup>3</sup> FR Malan “Share Certificates, Money and Negotiability: Recent Cases” (1977) 94 SALJ 245 252.

Share certificates provide *prima facie* evidence that the person in possession of the certificate is in fact the owner of the rights. This evidence is not conclusive and may be rebutted – a rule that applies not only to registered shares,<sup>4</sup> but also to bearer shares and those shares that are in negotiable form. In German law, for example, a certificate is subject to a rebuttable presumption of correctness and completeness (“*Vermutung der Richtigkeit und Vollständigkeit*”), provided its content is clear and unambiguous.<sup>5</sup> In US law, a certificate is likewise proof “in the absence of evidence to the contrary”.<sup>6</sup> Acting as evidence, the certificate is particularly important in facilitating the mobility of shares by providing an indication of ownership that may be relied upon by a third party entering into a transaction in connection to that share. Physical possession functions to reduce information costs.<sup>7</sup>

In all jurisdictions compared, a distinction is drawn between the paper evidencing the share and the share itself. The only difference is that in some jurisdictions, the certificates are treated in ordinary transactions as *if* they are the thing symbolised. Yet, there is recognition that shares themselves are abstract and not susceptible to physical possession. The “object” of value is the share, not the share certificate. Legal systems consistently classify shares as intangibles.

The most important function of certificates is their ability to enhance the transferability of incorporeal rights, known in German law as the “*Transportfunktion*”. This function is of particular importance in German and US law, where the delivery of the certificate is required for a valid legal transfer of shares. Indeed, in the German system, it is the delivery of the certificate that satisfies the publicity requirement for a transfer of tangibles. In England and South Africa, on the other hand, delivery of the share certificate is not required. This was long contested in South Africa and finally

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<sup>4</sup> See the South African Companies Act 71 of 2008 s 51(1)(c). Also see the UK Companies Act 2006 s 768.

<sup>5</sup> See D Meppen *Das Inhaberpapier: Von der Verbriefung zum unverbrieften Wertrecht?* (2014) 31. Also see § 1006 BGB, which creates a presumption of ownership in favour of the possessor of movable tangibles.

<sup>6</sup> See the definition of “security certificate” in UCC article 8 § 8-102(a)(16) as well as the definition of “security” in UCC § 8-102(a)(15)(i); also see Model Business Corporation Act § 6.25(a) and Delaware Code § 158. For case law, see *Pierpoint v Hoyt* 260 N.Y. 26 (1932) 28-29; *Jermain v The Lake Shore and Michigan Southern Railway Company* 91 N.Y. 483 (1883) 492; *Lockwood v United States Steel Corp.* 209 N.Y. 375 (1913) 380. Further, JW Daniel *The Elements of the Law of Negotiable Instruments* (1903) 27, § 45: “The certificate of stock is the customary and convenient evidence of the holder’s interest in the corporation which issues it, but in the absence of legal provisions requiring it, no certificate of stock is necessary to attest the rights of the shareholder.”

<sup>7</sup> TW Merrill “Ownership and Possession” in Y Chang (ed) *Law and Economics of Possession* (2015) 9 9.

settled only by the court in *Botha v Fick*,<sup>8</sup> confirming that delivery of the certificate is not necessary for the valid transfer of rights.<sup>9</sup> Instead, delivery of a “proper instrument of transfer” is required for a passing of both legal and equitable title in English law. The certificate nonetheless plays a vital role in facilitating the ease of transfer. This purpose is recognised in *Re The Bahia & San Francisco Railway Co Ltd*<sup>10</sup> finding that the “power of granting certificates is to give the shareholders the opportunity of more easily dealing with their shares in the market, and to afford facilities to them of selling their shares by at once showing a marketable title, and the effect of this facility is to make the share of greater value”.<sup>11</sup>

The function of certainty and finality of transfer is much less clear-cut. Good-faith acquisition (“gutgläubiger Erwerb”) in German law flows from the classification of shares as tangible movables and therefore from the characterisation of certificates as physical embodiments of rights. Similarly, in US law, the embodiment of rights in certificates leads to the creation of negotiable instruments with all their typical characteristics, including good faith acquisition. Good-faith acquisition of shares is traditionally not recognised in either English or South African law.<sup>12</sup> This stems from the fact that shares are neither movable property nor negotiable instruments.<sup>13</sup> In these legal systems, certificates are not the primary tool used to enhance the certainty of transfer – a solution is rather found in the doctrine of estoppel. The delivery of a share certificate to an unauthorised agent or a representation made by a company on a share certificate may give rise to a reasonable expectation on the part of a party who, acting to its detriment on such conduct, may be protected by a reliance on estoppel.<sup>14</sup>

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<sup>8</sup> 1995 2 SA 750 (A).

<sup>9</sup> Until the decision in *Botha v Fick* 1995 2 SA 750 (A), it was unclear whether a document that evidences a right (such as a share certificate) must be delivered for a valid cession to take place. For the historic development and an overview of the case law, see MR Vermaas *Aspekte van die Dematerialisasie van Genoteerde Aandele in die Suid-Afrikaanse Reg* LLD thesis University of South Africa (1995) 56-79. For delivery as a requirement for a valid cession, see *Jeffrey v Pollak and Freemantle* 1938 AD 1 14 and 22.

<sup>10</sup> (1868) LR 3 QB 584.

<sup>11</sup> 594-595.

<sup>12</sup> On South African law, see LF van Huyssteen, MFB Reynecke & GF Lubbe *Contract: General Principles* 5 ed (2016) 437 [12.11] n 62.

<sup>13</sup> A classification of shares as movable property in English and South African law would, naturally, not result in good faith acquisition.

<sup>14</sup> See below, 8 4 4 Estoppel and the protection of bona fide purchasers in English law and 8 4 5 Estoppel and the protection of bona fide purchasers in South African law.

A certificate (or in the case of bearer shares, the coupons attached to it) entitles, even mandates, the company to render performance only to the holder of the certificate, a function known in German law as the legitimating or liberating function in favour of the issuer (“Legitimations- und Liberationsfunktion zugunsten des Ausstellers”). In England, South Africa and the United States this function is performed by the register, not the certificate. The delivery of the certificate or transfer instrument by the seller to the company, however, ordinarily provides important evidence as to who is entitled to be registered.

The counterpart to the legitimating function of the certificate in favour of the issuer, is its legitimating function in favour of the possessor of the certificate. Only the person in possession of the certificate can enforce rights against the issuer. Again, this function is performed by the register in English and South African law.

## 8 2 Registration

### 8 2 1 The functions of registration

When shares are issued in registered form, the share register plays an important part in facilitating efficient transactions in, and holding of shares. The obligation placed on an issuer of shares to maintain a share register is particularly pertinent in England, South Africa and the United States. Registration traditionally plays only a negligible role in German law, which is a system dominated by bearer shares.<sup>15</sup> Owing to the advantages of increased transparency, ease of communications between the issuing company and its shareholders as well as the adjustment to international custom, many authors consider registered shares to be on the rise.<sup>16</sup> Due to the continued dominance of bearer shares and the similarity between the two in respect of both their character as “Wertpapiere” and their treatment as “things” susceptible to collective deposit, German registered shares will, however, not be considered in any further detail.<sup>17</sup>

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<sup>15</sup> See above, 6 1 Registered and bearer shares.

<sup>16</sup> See above, 6 1 Registered and bearer shares n 19.

<sup>17</sup> Only so much: Like US registered shares, “Namensaktien” are typically transferred by delivery and indorsement; Aktiengesetz § 68(1). The entry on the share register is therefore merely a declaratory act in relation to the transfer of the share – see K Schmidt *Gesellschaftsrecht* 4 ed (2002) 777, § 26 IV. Both bearer shares and registered shares are therefore “Wertpapiere”, the former payable to bearer and the latter to order (like their US counterparts).

Like the share certificate, the register functions as *prima facie* evidence of the facts recorded in it. In the revised South African Companies Act for example, a securities register is deemed to be “sufficient proof of the facts recorded in it, in the absence of evidence to the contrary”.<sup>18</sup> The change of wording from “*prima facie* evidence”<sup>19</sup> to “sufficient evidence” appears to be without consequence. A register provides *prima facie*, as opposed to conclusive proof of all the recorded facts.<sup>20</sup> The register performs this evidentiary function both in relation to the issuer and in relation to third parties.<sup>21</sup> In relation to third parties, the certificate is more readily accessible. It follows, that the evidentiary value of the register is the same as that of a share certificate. In English and South African law, there is consensus, however, that where there is a conflict between the certificate and the register, the register trumps the share certificate.<sup>22</sup>

The record of shareholders is primarily aimed at determining towards whom a company may and in fact must perform. A key characteristic of shares is the ease with which they can be transferred from one person to another. Where the company cannot rely on an external token such as the share certificate, it is imperative that it keeps track of the movement of shares for the purpose of rendering performance. To enable a company to render performance, shares must be recorded on the register when first issued. For the same reason, every transfer of shares must be recorded. The share register does not circulate in the market in the same way as certificates do. Thus, it does not perform the same function of enhancing the liquidity and marketability of shares as the certificate does.

In legal systems designed to facilitate the division of the enforcement of rights and their entitlement, the register becomes the relevant record for determining who holds shares; in other words, who can enforce the rights that flow from shares. At the same time, the register is construed as *prima facie* evidence of the identity of the person who is entitled to the benefits of shares. Where the ability to enforce and the entitlement to receive the benefits diverge, this presumption can be rebutted.

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<sup>18</sup> Companies Act 71 of 2008 s 50(4). For English law, see the Companies Act 2006 s 127.

<sup>19</sup> Companies Act 61 of 1973 s 109.

<sup>20</sup> *Randfontein Estates Ltd v The Master* 1909 TS 978 980; also *Standard Bank of SA Ltd v Ocean Commodities Inc* 1980 2 SA 175 (T) 181: “The fact, therefore, that the shares are registered in the name of Standard Bank Nominees does not mean that it is the actual owner or that one cannot look behind the register to ascertain the identity of the true owner”.

<sup>21</sup> *Farrar’s Estate v Commissioner for Inland Revenue* 1926 TPD 501 508.

<sup>22</sup> PL Davies & S Worthington *Gower & Davies’ Principles of Modern Company Law* 9 ed (2012) 986 [27-5].

## 8 2 2 Registration in English law

The primary relationship flowing from English company law revolves around the idea of membership. A member is either 1. a subscriber to the company's memorandum who became a member at incorporation; or 2. every other person who agrees to become a member and whose name is entered in the register of members.<sup>23</sup> Membership hinges on registration. In terms of section 113(1) of the Companies Act 2006, every company is obliged to keep a register of its members.

To enable the effective distribution of dividends and notices and the exercise of voting rights, amongst other rights and entitlement, a company must maintain an updated record of its members. For this reason, an allotment of shares must be entered on the register "as soon as practicable and in any event within two months after the date of the allotment".<sup>24</sup> The registration of a transfer of shares or refusal thereof must likewise take place as soon as practicable and within two months after being lodged with the company.<sup>25</sup> In the context of certificated shares, a company may not register a transfer unless it has received a proper instrument of transfer.<sup>26</sup> A delivery of the share certificate to the company is not required.

Registration is frequently said to result in a transfer of the legal title to shares. The distinction between legal and equitable title becomes relevant only where the member is not the person entitled to the benefits that flow from shares. Where this happens the member is said to hold the interest of the beneficial owner on trust. From a functional perspective, the division between legal and equitable title is another way of describing the distinction between the ability to enforce rights and the entitlement to benefit from them. If a share is held in trust, the Act determines that such trusts shall not be entered on the register.<sup>27</sup> The company thus strictly renders performance to members only.

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<sup>23</sup> Companies Act 2006 s 112.

<sup>24</sup> S 554.

<sup>25</sup> S 771(1).

<sup>26</sup> S 770(1)(a).

<sup>27</sup> S 126.

### 8 2 3 Registration in US law

The Model Act similarly compels companies to maintain a record of its shareholders.<sup>28</sup> A “shareholder” is defined as “the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation”.<sup>29</sup> The definition links shareholding to registration. At the same time, it recognises that the shareholder may be a mere nominee acting for a “beneficial owner”. Ordinarily it is the shareholder that enforces the rights against the company.<sup>30</sup> The definition provides a measure of flexibility by allowing the beneficial owner to enforce some of the rights him- or herself. In addition, a company may under certain circumstances recognise beneficial owners as shareholders.<sup>31</sup> Where the shareholder and the beneficial owner are different persons, the basic distinction between a shareholder’s ability to enforce rights and a beneficial owner’s entitlement to the benefits that flow from these rights is maintained.

Although the terminology of the “beneficial owner” has been retained, it no longer has the same effect as in English law. It has been found in *Jones v Central State Investment Co*,<sup>32</sup> that “[a] book transfer speaks only to the issues of record ownership, and not of *legal or equitable title* and is not a condition precedent to a valid transfer as between the parties to the transaction”.<sup>33</sup>

### 8 2 4 Registration in South African law

In terms of section 50(1) of the Companies Act, every company must establish and maintain a securities register.<sup>34</sup>

To fully appreciate the purpose and ambit of registration, it is necessary to have an understanding of the parties involved. Prior to the significant changes introduced by the Companies Act of 2008, South African company law, taking its cue from English

<sup>28</sup> Model Business Corporation Act § 16.01(c).

<sup>29</sup> § 1.40 (21)

<sup>30</sup> It is for example the shareholder that receives notices of annual and special meetings and attends these - §§ 7.01, 7.02, 7.05. It is also the shareholder who votes at these meetings - §§ 7.21 and 7.22.

<sup>31</sup> § 7.23.

<sup>32</sup> 654 P.2d 717 (1982). See below, 8 3 3 2 Negotiation, assignment and the transfer of shares.

<sup>33</sup> *Jones v Central State Investment Co* 654 P.2d 717 (1982) 733 (own emphasis).

<sup>34</sup> Also see Companies Act 71 of 2008 s 24(4)(a); Companies Regulations, 2011 GN R 619 in GG 36759 of 20-08-2013 reg 32.

law, made provision for members of a company.<sup>35</sup> In contrast, a shareholder was not defined by the Act and the terms “member” and “shareholder” were frequently used interchangeably. Depending on the context, shareholding, however, did not necessarily imply registration.<sup>36</sup>

In South Africa, the concept of membership in addition to shareholding has now been abandoned. The revised legislative regime has replaced the idea of membership with that of shareholding.<sup>37</sup> The definition of a “shareholder” has two parts: A shareholder is “the holder of a share issued by a company”. In addition, he is the person “who is entered as such in the certificated or uncertificated securities register”.<sup>38</sup> The Act therefore sets two requirements for qualification as a shareholder, the material requirement of being the holder of securities and the formal requirement of registration.<sup>39</sup>

The Act does not clarify who it envisages to be holders of securities. A holder cannot be equated to an owner, however. Nominees are also defined as holders.<sup>40</sup> Such an interpretation would imply that in the case of nominee holdings, neither the nominee nor the owner would meet the definition of a shareholder – the nominee because he is not the owner and the owner because he is not recorded on the register.<sup>41</sup> One of the aims of registration is to enable the company to determine the identity of the person towards whom it must render performance. The company will perform towards the holder. This construction gives the shareholder the ability to enforce the rights that flow from shares.

This leads to a few conclusions: 1. Shareholding and ownership of shares do not necessarily coincide. 2. A shareholder is nothing more than a member under the previous regime. 3. Shareholding is primarily concerned with the fact of registration, which establishes a direct relationship between the shareholder and the company. The frequent use of the term “registered shareholder” in case law and literature

<sup>35</sup> Companies Act 61 of 1973 s 103(1)-(2).

<sup>36</sup> See MS Blackman, RD Jooste, CK Everingham, JL Yeats, FHI Cassim & R De La Harpe *Commentary on the Companies Act* (2002) (RS 9 2012) 5-174.

<sup>37</sup> The term “member” is now only applied to non-profit companies; See the definition of member in s 1 of the Companies Act 71 of 2008.

<sup>38</sup> S 1.

<sup>39</sup> JC de Wet & AH van Wyk *De Wet en Yeats – Die Suid-Afrikaanse Kontrakereg en Handelsreg* 4 ed (1978) 613; this statement was made in relation to “membership” in the Companies Act 61 of 1973, but can be equally applied to the definition of a “shareholder” as it is now.

<sup>40</sup> See n 43 below.

<sup>41</sup> Also see R Rachlitz “Disclosure of Ownership in South African Company Law” (2013) 3 *Stell LR* 406 410.

creates the impression that a “registered shareholder” must be distinguished from a “shareholder”. This is not the case. A shareholder as defined is always registered.

This construction makes it possible for an investor to hold and register the shares, not in his own name, but in the name of an agent, commonly known as a nominee.<sup>42</sup> The drawback of this structure: it creates opportunities for abuse by both the nominee and the owner. The relationships between an owner and his nominee and between ownership and registration therefore need to be carefully regulated.

A “nominee” is a person that “act[s] as the holder of securities or of an interest in securities on behalf of other persons”.<sup>43</sup> The descriptor “*registered* holder”, included by the Securities Services Act, the predecessor of the Financial Markets Act, is now omitted; a correction that makes provision for tiers of nominees. As a result, not every nominee is also a shareholder. A nominee acts as an agent of the owner.<sup>44</sup> He enforces the rights attached to shares on behalf of the owner, who is the beneficiary of the rights.

The purpose of registration is twofold: It provides *prima facie* evidence of title, but also recognises that such title may vest in a person other than the shareholder, in the case of which shareholding and ownership are separate enquiries.<sup>45</sup> In an environment of increasing nominee holdings coupled with a rapid turnover of shares, registration enables a company to easily determine the person to whom performance must be tendered, regardless of her status as nominee or owner. Section 37(9) of the Companies Act provides that “a person- acquires the rights associated with any particular security of a company- (i) when that person’s name is entered in...the securities register”. This provision places an obligation on the company to only recognise and render performance to shareholders.<sup>46</sup> The purpose of registration, therefore, does not differ from that in English and US law. South African law achieves

<sup>42</sup> Companies Act 71 of 2008 s 56(1).

<sup>43</sup> Companies Act 71 of 2008 s 1 as based on s 1 of the Financial Markets Act 19 of 2012 (and its predecessor, the Security Services Act s 1).

<sup>44</sup> *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 1 SA 441 (A) 453; *Sammel v President Brand Gold Mining Co Ltd* 1969 3 SA 629 (A) 666C-F; *Standard Bank of South Africa Ltd v Ocean Commodities Inc* 1983 1 SA 276 (A) 289. Also see below, 8 3 5 4 Agency, representation and mandate.

<sup>45</sup> See for example *Verrin Trust & Finance Corporation (Pty) Ltd v Zeeland House (Pty) Ltd* 1973 4 SA 1 (C) 13 where the court clearly distinguishes “the question of title to the shares” from “title to be on the register”. Also, *Jeffrey v Pollak and Freemantle* 1938 AD 1 at 18: “the right to be on the register may be independent of ownership”.

<sup>46</sup> Also see *Sammel v President Brand Gold Mining Co Ltd* 1969 3 SA 629 (A) 666: “a company shall concern itself only with the registered holder and not the owner or beneficial owner of the shares”.

the distinction between the ability to enforce rights and the entitlement to those rights without having to resort to a dual concept of legal and beneficial ownership. Any reference to a “beneficial owner” in the South African context is therefore misplaced.<sup>47</sup> The correct construction in South African law is that both the entitlement to benefits and the ability to enforce them, vest in the owner, who can subsequently contract out, whether expressly or tacitly, the ability to enforce the rights to an agent.

### **8 3 Transfer and holding in paper-based environments**

#### **8 3 1 Introductory remarks**

It has been repeatedly emphasised that it is crucial for the company to know who its shareholders are. It is essential that some mechanism exists for the company to ascertain their identity. This mechanism may be registration or it may be possession of the share certificate. Ordinarily, both the entitlement to benefits and the ability to enforce these benefits are part and parcel of owning an asset and would usually be transferred together. What both mechanisms have in common, from a functional perspective, is that the entitlement to benefits can be construed as vesting separately from the ability to enforce them.

This makes transfer a difficult concept in the context of shares. A change in registration is known in ordinary parlance as a transfer, is described as such by writers and courts, but it is subject to “transfer rules” that differ from a transfer of the share as an asset. It is therefore useful to distinguish between the concepts of a change in registration and a transfer in the narrow sense.

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<sup>47</sup> Blackman et al *Commentary on the Companies Act* 5-172. Also see the statement made by Corbett JA in *Standard Bank of South Africa Ltd v Ocean Commodities Inc* 1983 1 SA 276 (A) 289: “The term ‘beneficial owner’ is, juristically speaking, not wholly accurate, but it is a convenient and well-used label to denote the person in whom, as between himself and the registered shareholder, the benefit of the bundle of rights constituting the share vests.” A Borrowdale “The Transfer of Proprietary Rights in Shares: A South African Distillation out of English Roots” (1985) 18 *CILSA* 36 37, 40. The term “beneficial owner” differs from that of a holder of a “beneficial interest”; see the definition of the term “beneficial interest” in Companies Act 71 of 2008 s 1 as read with s 56(2); also see the discussion below at 13 2 4 Registration. The latter is much wider and is further broadened by the categories of persons “deemed” to be beneficial interest holders in s 56, including but not limited to persons married or related to holders of a “beneficial interest”. Whereas a “beneficial owner” in terms of the common law was simply the ultimate “owner” of all of the rights that attach to securities, the holder of a “beneficial interest” appears to be a person that is entitled to any one or more of these rights. This results in a multiplication of “beneficial interest” holders; see See PA Delpont (ed) *Henochsberg on the Companies Act 71 of 2008* (RS 15 2017) 220.

## 8 3 2 Transfer and holding in English law

### 8 3 2 1 General remarks

It is commonly assumed that a transfer of shares takes place in three stages: 1. an agreement; 2. delivery of the transfer form and certificate by the seller as well as payment of the agreed price by the buyer; 3. lodgement of the instrument of transfer and registration by the company.<sup>48</sup> English law is premised on the distinction between legal title and beneficial interest. Where these do not diverge, the legal owner is the absolute owner and no distinction is drawn between his legal and beneficial interest.<sup>49</sup> All three of these steps are part and parcel of becoming an absolute owner. Only where legal and beneficial ownership vest separately, does it become necessary to carefully unpick them and to draw a distinction between the mechanisms available to bring about their transfer.

As illustrated above, registration is essential for becoming a member of a company and therefore for vesting legal title. In *J Sainsbury Plc v O'Connor (Inspector of Taxes)*,<sup>50</sup> it was held, for example, that “[t]here is no difficulty in ascertaining the legal ownership in shares, which is invariably vested in the registered holder.”<sup>51</sup>

Beneficial ownership, on the other hand, already passes at stage two or even one. As much becomes clear from the following passage quoted from *Société Générale de Paris v Walker*.<sup>52</sup>

“Such a transfer [unregistered] might, indeed, give a legal right of action against the company if they, without just cause, refused to register it; it might also be a good

<sup>48</sup> See Davies & Worthington *Modern Company Law* 991 [27-8].

<sup>49</sup> See the dictum of Lord Browne-Wilkinson in *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669 (HL) 706: “A person solely entitled to the full beneficial ownership of money or property, both at law and in equity, does not enjoy an equitable interest in that property. The legal title carries with it all rights. Unless and until there is a separation of the legal and equitable estates, there is no separate equitable title.” Also see *J Sainsbury Plc v O'Connor (Inspector of Taxes)* [1991] 1 WLR 963 (CA) 978B-C: “It means ownership for your own benefit as opposed to ownership as trustee for another. It exists either where there is no division of legal and beneficial ownership or where legal ownership is vested in one person and beneficial ownership or, which is the same thing, the equitable interest in the property in another.”

<sup>50</sup> [1991] 1 WLR 963 (CA).

<sup>51</sup> 977.

<sup>52</sup> (1885) App Cas 20.

foundation for an application to a competent Court to rectify the register. But it could not ... confer (while unregistered) a legal title to the shares themselves”.<sup>53</sup>

### 8 3 2 2 Choses in action

Under English law, shares are choses in action. Following the characterisation of shares in *Bligh v Brent* as personal property,<sup>54</sup> courts have commonly described shares as “choses in action”,<sup>55</sup> which according to Pennington “does nothing more than assure us that they are personality, and are not tangible chattels, which is self-evident”.<sup>56</sup> A “chose in action”, Gower states, “is a notoriously vague term used to describe a mass of interests which have little or nothing in common”.<sup>57</sup> Holdsworth concludes that the category of choses in action “cover[s] a miscellaneous mass of very difficult things”,<sup>58</sup> and Pretto-Saakman finds that they, “[f]or purposes of classification ... are best encouraged to slip into obsolescence”.<sup>59</sup>

Today, the category of choses in action comprises a list as variable as debt, bank deposits, company shares and goodwill. To understand how shares came to be classified as choses in action, a brief historic excursion must be embarked upon.<sup>60</sup>

Initially, the category of choses in action referred simply to rights which can only be enforced by action.<sup>61</sup> Although an action can be personal or real, in its original form a chose in action seems to refer chiefly to personal actions.<sup>62</sup> A personal action is enforced by a specific plaintiff against a specific defendant.<sup>63</sup> It is this personal nature of choses in action that rendered them incapable of being alienated, be it by

<sup>53</sup> 28.

<sup>54</sup> The term “personal property” is still used in the Companies Act 2006 s 541 to describe shares.

<sup>55</sup> *Humble v Mitchell* (1839) 11 Ad & El 205; *Colonial Bank v Whinney* (1886) 11 App Cas 426; *Harrold v Plenty* [1901] 2 Ch 314 316; *Re VGM Holdings Ltd* [1942] Ch 235 241.

<sup>56</sup> RR Pennington *Pennington’s Company Law* 8 ed (2001) 56.

<sup>57</sup> Davies & Worthington *Modern Company Law* 860 [23-1].

<sup>58</sup> WS Holdsworth “The History of the Treatment of ‘Choses’ in Action by the Common Law” (1920) 33 *Harvard LR* 997 1029.

<sup>59</sup> A Pretto-Sakmann *Boundaries of Personal Property: Shares and Sub-Shares* (2005) 65.

<sup>60</sup> A comprehensive presentation of the historical origins of choses in action can be found in Holdsworth (1920) *Harvard LR*.

<sup>61</sup> This appears from the definition in *Torkington v Magee* [1902] 2 KB 427 430, describing choses in action as “all personal rights of property which can only be claimed or enforced by action, and not by taking physical possession”. Also see C Sweet “Choses in Action” (1894) 10 *LQR* 303 304; Holdsworth (1920) *Harvard LR* 998-999, 1001.

<sup>62</sup> Holdsworth (1920) *Harvard LR* 1001.

<sup>63</sup> 1000, 1003.

assignment or will.<sup>64</sup> Personal actions typically derive from obligations in the form of contracts or torts.

Subsequent developments saw the erosion of the common denominator, namely that the category of choses in action encompassed only rights that could be enforced by instituting an action. In due course, documents evidencing rights in action were taken to be choses in action as well; over the course of the next centuries many instruments of commercial practice thus came to be classified as choses in action, including bonds, shares and negotiable instruments.<sup>65</sup> Particularly the characteristic of non-assignability lead to further extensions of the concept of choses in action, including within its ambit any rights which were incapable of being assigned.<sup>66</sup> These rights, at most, were analogous to rights of action. Illustrated with obligations arising from contract, this means: Initially, only rights of action arising from contract were choses in action, typically arising only when a contract had been breached. Later, however, any contractual right was regarded to be a chose in action, even if not giving rise to a right of action, in other words even if the contract had not been breached. Likewise, future debts were regarded as choses in action.<sup>67</sup>

All the choses in action considered thus far derived from the common law. They are therefore legal choses in action. When the category of choses in actions began to expand, it was asserted that equitable interests, including interests in a trust, were essentially personal, being enforced between specific parties only and were non-assignable to discourage maintenance.<sup>68</sup> The courts of equity only exercised jurisdiction over persons, not over property; thus, equity is said to always act *in personam*.<sup>69</sup> Again, it was the desired non-assignability that acted as a prominent

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<sup>64</sup> Holdsworth (1920) *Harvard LR* 1000, 1003; M Smith & N Leslie *The Law of Assignment* 2 ed (2013) 26, [2.56].

<sup>65</sup> Holdsworth (1920) *Harvard LR* 1011. Also see Sweet (1894) *LQR* 303, who strongly opposed the classification of shares as choses in action.

<sup>66</sup> Holdsworth (1920) *Harvard LR* 1013.

<sup>67</sup> Smith & Leslie *Assignment* 28-29 at [2.59]-[2.60]. This is the basis upon which Sweet (1894) *LQR* 303 viewed the classification of shares as choses in action with scepticism: "A share in a company is an interest in a certain property or undertaking; it gives a right to participate in the management, profits and assets of the company, but it need not, and in the majority of cases never does, give rise to any right of action against the company to recover what the share represents." (footnotes omitted).

<sup>68</sup> Holdsworth (1920) *Harvard LR* 1014-1015.

<sup>69</sup> This is one of the maxims of equity; see R Clements & A Abass *Equity and Trusts: Text, Cases, and Materials* 4 ed (2015) 37-38; PH Pettit *Equity and the Law of Trusts* 11 ed (2009) 27-28. Equity is enforced against a person, not against an object. Equity, unlike law, therefore appeals to a person's conscience. The maxim, must not, however distract from the fact that an equitable right to property may be a proprietary right.

factor in the classification of equitable interests as choses in action.<sup>70</sup> These interests came to be classified as equitable choses.

It is abundantly clear that the category of choses in action has become a disparate mass of legal rights and interests, historically joined primarily by their inability to be assigned. Despite the rule against maintenance, courts began to articulate the practical obsolescence of the non-assignability of choses in action.<sup>71</sup> Whereas assignments of choses in action were initially not possible in the common law, they could be assigned in equity.<sup>72</sup> Such equitable assignments are relatively weak as the assignee acquires only equitable, not legal title and thus may be subjected to adverse claims.<sup>73</sup> Statutory or legal assignments of choses in action were only made possible in 1873 by what is today section 136 of the Law of Property Act 1925.<sup>74</sup>

### 8 3 2 3 Registration and the passing of legal title

Today, the characterisation of shares as choses in action has little relevance for the passing of the legal title to shares. This makes it increasingly difficult to treat shares in the same fashion as other choses in action. Transfer mechanisms for shares are today primarily determined by statute. According to Millet J in *MacMillan Inc v Bishopsgate Trust (No 3)*,<sup>75</sup> shares “form a special sub-species of choses in action with its own rules. No one seeking to discover the rules relating to the transfer of shares would look for them under the heading ‘assignment of choses in action’”.<sup>76</sup>

<sup>70</sup> Holdsworth (1920) *Harvard LR* 1015.

<sup>71</sup> See for example *Master v Miller* (1791) 4 Term Rep 320 at 340 per Buller J: “It is laid down in our old books, that for avoiding maintenance, a chose in action cannot be assigned ... The good sense of that rule seems to me to be very questionable; and in early as well as modern times it has been so explained away, that it remains at most only an objection to the form of the action in any case”.

<sup>72</sup> See for example *Balfour v The Official Manager of the Sea Fire Life Assurance Company* (1857) 3 Common Bench Reports (New Series) 300 at 308 per Willes J, which was decided before the courts at common law and the equity courts merged: “I should have thought a much better authority might have found for the proposition that a court of equity would prevent a party from suing upon a security the consideration for which had failed. The court there seems to have considered that there could not be an assignment of a debt. That doctrine has, as everyone must know, long long since exploded”. Also see *Fitzroy v Cave* [1905] 2 KB 364 at 371-372.

<sup>73</sup> *Warner Bros Records Inc v Rollgreen Ltd* [1976] QB 430 at 443-444. A detailed description of the operation of equitable choses can be found in Smith & Leslie *Assignment* 218-244. See in general the difference between law and equity below, 8 3 2 6 Equity and trusts.

<sup>74</sup> The predecessor being the repealed Supreme Court of Judicature Act 1873, s 25(6).

<sup>75</sup> [1995] 1 WLR 978 992 (The statement was made in the context of a dispute regarding the legal situs of shares in private international law).

<sup>76</sup> *MacMillan Inc v Bishopsgate Trust (No 3)* [1995] 1 WLR 978 at 992; also quoted in Smith & Leslie *Assignment* 154 [6.216].

On the transferability of shares, the Companies Act merely states that “[t]he shares, or other interest of any member in a company, are transferable in accordance with the company’s articles”.<sup>77</sup> The formal procedure to transfer a certificated share is set out in the Stock Transfer Act 1963. The transfer of shares is facilitated by a stock transfer form, which must be executed by the transferor only and which must include details of the consideration paid, the description and number of securities transferred, the particulars of the transferor as well as the full name and address of the transferee.<sup>78</sup> The execution of the form need not be attested<sup>79</sup> and it is valid as long as it complies with the requirements of the Act, regardless of its form.<sup>80</sup> The stock transfer form serves as the “proper instrument of transfer” without which a company may not register the transfer.

The stock transfer form (or other instrument of transfer) must be delivered to the transferee and in the ordinary course of events the transferee lodges the form and other documents<sup>81</sup> with the company for registration.<sup>82</sup> This can also be done by the transferor.<sup>83</sup> Registration is generally considered to be necessary to vest legal title.<sup>84</sup>

#### 8 3 2 4 Novation and assignment

The historic classification of shares as choses in action suggests that they should pass from one person to another by assignment. Assignment is understood to be the transfer of a right or interest in intangible property owned by the assignor, from the assignor to the assignee.<sup>85</sup> Briefly stated, the requirements for an effective statutory assignment today are as follows:<sup>86</sup> 1. the assignment must be absolute; meaning that it must be unconditional<sup>87</sup> as well as encompass the entire debt, not just a part of it,<sup>88</sup>

<sup>77</sup> Companies Act 2006 s 544(1).

<sup>78</sup> Stock Transfer Act 1963 s 1(1).

<sup>79</sup> S 1(2).

<sup>80</sup> S 1(3).

<sup>81</sup> This usually includes the share certificate. Although the share certificate is not required, the company may refuse to register the transfer unless the certificate is supplied or accounted for. See Pennington *Company Law* 341 n 8.

<sup>82</sup> Companies Act 2006 s 770.

<sup>83</sup> S 771.

<sup>84</sup> But cf Pennington *Company Law* 416-417, who argues that legal title passes prior to registration.

<sup>85</sup> YK Liew *Guest on The Law of Assignment* 3 ed (2018) 1 [1-01].

<sup>86</sup> S 136(1) of the Law of Property Act 1925. For more detail see J Beatson, A Burrows & J Cartwright *Anson’s Law of Contract* 30 ed (2016) 699-701.

<sup>87</sup> In other words, future choses in action cannot be assigned; see *Durham Brothers v Robertson* [1898] 1 QB 765 at 773; *Raiffaisen Zentralbank Österreich AG v Five Star General Trading LLC* [2001] EWCA Civ 68, [2001] QB 825 at 850.

<sup>88</sup> See *Durham Brothers v Robertson* [1898] 1 QB 765 at 772; *In Re Steel Wing Co, Limited* [1921] 1 Ch 349 at 352; *Jones v Humphreys* [1902] 1 KB 10.

2. it must be in writing and signed by the assignor; and 3. notice must be given to the debtor.<sup>89</sup> The notification requirement poses no problems in the context of certificated shares, as the company must be informed of the transfer for purposes of registration. Likewise, the stock transfer form required by the Stock Transfer Act 1963 satisfies the prerequisite of writing. The requirement of notice only captures the act of giving notice, not the actual recording of the notice required to pass legal title. From this perspective, novation, discussed below, provides the better explanatory basis.

An assignment is a transfer in the true sense of the word, as the interest (debt) in the hands of the assignee is the same interest that the assignor held.<sup>90</sup> There are two notable characteristics of assignment: First, the assignee always takes “subject to equities”, meaning “subject to all such defences as might have prevailed against the assignor”.<sup>91</sup> Second, only a benefit, not a burden can be assigned.<sup>92</sup> The reason for this rule is that a person should be able to choose his debtor freely.<sup>93</sup> Considering the paucity of shareholder duties, this requirement is, however, devoid of much practical relevance in the context of shares.

If an assignment does not comply with all of these requirements it may still be an equitable assignment.<sup>94</sup> Equitable assignments will be considered in more detail below.<sup>95</sup>

An increasing number of authors see the statutory method described above, not as an example of an assignment, but rather a type of novation.<sup>96</sup> Novation is a technique by which both benefits and burdens, or rights and obligations, can be transferred to a third party.<sup>97</sup> The cooperation of all three parties is required for a

<sup>89</sup> The notice requirement is construed strictly and only takes effect once the notice is received by the debtor; see *Holt v Heatherfield Trust Ltd* [1942] 2 KB 1 at 5-6.

<sup>90</sup> See Beatson et al *Anson's* 705 for a contrary position in respect of equitable assignments.

<sup>91</sup> 705.

<sup>92</sup> See *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] 1 AC 85 at 103B, per Lord Browne-Wilkinson: “It is trite law that it is, in any event, impossible to assign “the contract” as a whole, i.e. including both burden and benefit. The burden of a contract can never be assigned without the consent of the other party to the contract in which event such consent will give rise to a novation”.

<sup>93</sup> See *Robson and Sharpe v Drummond* (1831) 109 ER 1156.

<sup>94</sup> *Warner Bros Records Inc v Rollgreen Ltd and Others* [1976] QB 430 at 441. Beatson et al *Anson's* 701.

<sup>95</sup> See below, 8 3 2 7 Equitable assignment.

<sup>96</sup> See E Micheler *Property in Securities: A Comparative Study* (2007) 30, J Benjamin *Interests in Securities: A Proprietary Analysis of the International Securities Markets* (2000) 64-65 [3.05]-[3.06], Pennington *Company Law* 398-399, Liew *Guest on Assignment* 18 [1-28], Petto-Sakmann *Boundaries of Personal Property* 117-121.

<sup>97</sup> Beatson et al *Anson's* 712; *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] 1 AC 85 at 103B.

valid novation.<sup>98</sup> Technically, a novation is not a transfer, because it leads to the creation of a new contract.<sup>99</sup> The reasons advanced to support the novation argument vary.

It is firstly suggested, that registration is an implicit approval by the issuer of the member. The default rule in modern company law is of course that shares are freely transferable, unless stated otherwise in the articles of association.<sup>100</sup> Free transferability is a key characteristic of public listed companies and is required by stock exchange listing rules. It is therefore unlikely that public listed companies will restrict the transferability of shares in any way. This means that the issuer's consent is technically not a requirement for transfer to take place. Benjamin nonetheless argues that through the required involvement of the issuer in registering shares, the issuer implicitly agrees to the "transfer".<sup>101</sup>

Pennington and Micheler argue that the central role played by registration in English law can be traced back to the origin of the company in the law of partnerships.<sup>102</sup> Partnerships (like early joint stock companies) do not confer limited liability on the partners or shareholders. Thus, every change of partnership or shareholding had an impact on the funds and the administration of the company. Existing partners or shareholders would therefore want a say in the admission of new partners. This was initially achieved by limiting the transferability of shares. Every transfer would be decided on individually; a certificate would be issued and the transfer would be entered on a register. In a system where the identity of its shareholders was of cardinal importance, it follows that it is not the delivery of the certificate to a purchaser of shares, but rather the change in the register that caused shares to be transferred. Even as shares became freely transferable as a general rule,<sup>103</sup> English law has maintained the practice of issuing shares in registered form.<sup>104</sup> The purpose of registration no longer lies in approving a suitable transferee,

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<sup>98</sup> Beatson et al *Anson's* 712; E Peel *Treitel on the Law of Contract* 14 ed (2015) 798 [15-003].

<sup>99</sup> Peel *Treitel* 798 [15-003], 835 [15-078].

<sup>100</sup> See Companies Act 2006 s 544(1).

<sup>101</sup> Benjamin *Interests in Securities* 64 [3.05]-[3.06]. Free transferability is of course a key characteristic of public listed companies and the ability of the issuer to refuse registration is limited. But see s 63(5) of the Companies (Model Articles) Regulations 2008, which allows directors to refuse registration in certain cases.

<sup>102</sup> Micheler *Property in Securities* 21-25; Pennington *Company Law* 399.

<sup>103</sup> Restrictions on the transfer of shares are prohibited in the case of listed public companies.

<sup>104</sup> Micheler *Property in Securities* 24-25.

but rather in receiving the required instruments of transfer, to issue certificates once these instruments are deemed to be proper and lastly by registering the transfer.<sup>105</sup>

According to Micheler, “[t]he legal environment that existed when securities first became widespread shaped the formalities of the transfer process, and these formalities continued to develop in a path-dependent manner”.<sup>106</sup> Micheler further argues that the initial unavailability of assignment to bring about a transfer of a chose in action could have caused the law to instead utilise novation as a method of transfer.<sup>107</sup>

In addition, it is argued that shares consist of benefits and burdens. As the transfer of burdens is generally not captured by an assignment, novation seems more fitting. Petto-Sakmann explains that the issuer is simultaneously a debtor (in respect of dividends for example) and a creditor (in respect of the payment payable for the shares).<sup>108</sup> Although unusual, it is possible that other duties are attached to shares<sup>109</sup> and it is undeniable that assignment indeed has a problem with liabilities.

### 8 3 2 5 *The creation and transfer of equitable title*

The statutory mechanism of registration applies only to the passing of legal title. Where legal and beneficial ownership do not coincide, the latter can be subject to the rules and mechanisms of equity, including trusts and equitable assignments.<sup>110</sup> These mechanisms of transfer are not subject to the statutory provisions set out in the Companies Act and elsewhere. In *MacMillan v Bishopsgate* Millet J stated clearly that:

“The corporate rights [including the right to be registered] of the transferee depend entirely on the law of incorporation. But the effect of a transfer on the company and its effect on the transferor and persons claiming under him are two different questions, and there is no rational basis for applying the law of incorporation to a question of the second kind”.<sup>111</sup>

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<sup>105</sup> 25.

<sup>106</sup> 25.

<sup>107</sup> Micheler *Property in Securities* 24.

<sup>108</sup> Petto-Sakmann *Boundaries of Personal Property* 119.

<sup>109</sup> See Benjamin *Interests in Securities* 67-68 [3.18].

<sup>110</sup> Liew *Guest on Assignment* 17-18 [1-29], 170-171 [6-38].

<sup>111</sup> *MacMillan Inc v Bishopsgate Trust (No 3)* [1995] 1 WLR 978 993-994.

It is important, also, to distinguish the vesting of a trust from an assignment.<sup>112</sup> The creation of a trust creates new rights in favour of a beneficiary. Assignment transfers existing rights from one person to another. Should an absolute owner, for example, decide to sell her shares to a purchaser, this will vest in the purchaser, pending registration, an equitable interest in the shares. In the meantime, the seller will retain legal ownership, holding the shares on trust for the purchaser. There is no transfer, but rather the creation of a beneficial interest. The same applies where a purported transfer of the full, legal title falls short of the requirements for a legal assignment. As a result, a beneficial interest may arise in certain circumstances, not by virtue of an equitable assignment, but rather through the creation of a trust.<sup>113</sup> Where, however, legal and beneficial ownership are already vested in different persons, such an equitable interest is transferred from one person to another by an equitable assignment. If, on the other hand, a beneficiary of a trust declares that he in turn holds for another beneficiary, the result is the creation of a sub-trust, not an assignment.<sup>114</sup> The difference, broadly speaking, is between the creation of vertical structures of holding (trusts) and horizontal transfers (assignment). The creation of a trust and the assignment of a chose in action can of course not always be neatly separated. Depending on the situation, a transfer of property may precede the declaration of a trust.

### 8 3 2 6 *Equity and trusts*

A comparative study of the structure of English law will inevitably lead to the discovery of a legal concept that is foreign to both South African law and continental legal systems, namely that of equity.<sup>115</sup> A comprehensive analysis of equity and its nature is beyond the scope of this thesis, but a brief sketch is required to understand the structure of shareholding in English law.

English law is premised on the dualistic model of law and equity. This division is particularly prominent in the area of property law. The courts of equity developed to

<sup>112</sup> Liew *Guest on Assignment* 39-40 [1-70], who however recognises that the two concepts overlap significantly – see 58-60; J Edelman & S Elliot “Two Conceptions of Equitable Assignment” (2013) <[http://www.supremecourt.wa.gov.au/\\_files/Two\\_Conceptions\\_Equitable\\_Assignment\\_%20EdelmanJ.pdf](http://www.supremecourt.wa.gov.au/_files/Two_Conceptions_Equitable_Assignment_%20EdelmanJ.pdf)> (accessed 01-03-2018).

<sup>113</sup> See Liew *Guest on Assignment* 83 [3-26].

<sup>114</sup> See below, 10 5 Equity and trusts.

<sup>115</sup> For a brief overview of law and equity see A Hudson *Understanding Equity and Trusts* 3 ed (2008) 1-3 and Micheler *Property in Securities* 26-29.

provide exceptions to the rigid application of the law by the courts at common law.<sup>116</sup> The courts of equity developed out of petitions brought to the Chancery, initially a department of state, in cases where the parties felt that justice had not been done by the common law courts.<sup>117</sup> The precedent developed by the courts at common law became known as “law”, whilst the body of case law and rules of procedure formulated by the equity courts became known as “equity”. As a result, the judiciary and the administration of justice stood on two legs: law and equity. Although the two branches of the judiciary have long merged,<sup>118</sup> the difference between law and equity continues to shape the structure of English law. The distinction between law and equity is not one based along the lines of substantive private law, but rather originates out of case law developed either by the courts of law or equity.<sup>119</sup> Hence, English property law knows two concepts of ownership – legal and equitable or beneficial ownership.<sup>120</sup> Legal title is ordinarily said to pass from one person to another when all the requirements set by the law have been met. Equitable title, on the other hand, passes when a transfer falls short of the legal requirements, but it is just, as between the parties to recognise that a transfer has taken place. This is, stated in broad terms, the basic operation of equity. Although the courts at equity developed an array of claims, remedies and legal rules not available at common law, one of the most important equitable concepts is the construct of trusts.<sup>121</sup> The trust has historically played a significant role in structuring the holding of shares and continues to influence the re-imagining of legal structures pursuant to the significant changes that have taken place in the area of securities law in the last decades.

Trust law, a notion created by the equity courts, is the mechanism used by the law to confer beneficial ownership. The trust is a legal construct in terms of which a person (the trustee) is obliged to deal with property (real or personal), as owner,<sup>122</sup> in such a manner that it benefits another person or persons (the beneficiaries)<sup>123</sup> or

<sup>116</sup> Hudson *Understanding Equity & Trusts* 2; also see *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669 (HL) 692B.

<sup>117</sup> A Hudson *Equity and Trusts* 8 ed (2015) 18; Hudson *Understanding Equity & Trusts* 2; Micheler *Property in Securities* 26-27. For a brief history of the Court of Chancery see Pettit *Equity* 2-8; Hudson *Equity and Trusts* 16-18.

<sup>118</sup> The courts were merged by the Judicature Acts of 1873 and 1875. On the fusion see Pettit *Equity* 8-12.

<sup>119</sup> Micheler *Property in Securities* 27.

<sup>120</sup> 28-29.

<sup>121</sup> Hudson *Equity & Trusts* 45.

<sup>122</sup> A trustee can either be legal or beneficial owner (in the case of a sub-trust). See Pettit *Equity* 30 n 2.

<sup>123</sup> *Ayerst (Inspector of Taxes) v C&K (Construction) Ltd* [1976] AC 167 at 177G-H.

fulfils another purpose as determined.<sup>124</sup> Provided that the requirements for a trust are met, the legal owner (in the case of shares the member) will act as a trustee for the beneficial owner, who becomes the beneficiary of the trust. The trustee may simultaneously be a beneficiary of the trust.<sup>125</sup> The trustee is not entitled to enjoy the fruits of the shares or dispose of them for his own benefit.<sup>126</sup> Dividends and other profits are collected by the trustee on behalf of the beneficial owner. Hudson describes the trust as a construct “under which a beneficiary is able to assert equitable rights to particular property held by a trustee and thus control the way in which the trustee of that property is entitled to deal with it”.<sup>127</sup> A trust is created over “property” - contractual rights, licences, intangible property, such as copyright as well as equitable proprietary interests can all be property for purposes of a trust.<sup>128</sup> It is said that for a valid trust to be created, the three certainties of words (intention), subject matter (trust property) and object (beneficiary) have to be present.<sup>129</sup>

A trust may be express, meaning that it is deliberately established by the trustee for beneficiaries that are clearly identifiable.<sup>130</sup> In addition, the trust property must be sufficiently identifiable.<sup>131</sup> In the context of shares an express trust can serve many purposes: It allows control and management to be divorced from the benefits that flow from owning certain property; the benefits of shareholding may be split amongst several beneficiaries; and the identity of the beneficial owner may be obscured.

Apart from the express trust, a trust can also arise by operation of law. Such a trust is known as a constructive trust. Instead of being established through express agreement between the parties, a constructive trust is inferred by the courts from the conduct of the parties.<sup>132</sup> Although a constructive trust cannot be defined with any precision, the general tenor is that a constructive trust arises where a person holds property in such a way that it would be unconscionable or contrary to equity for him to

<sup>124</sup> This may for example be a charitable purpose. See the definition in Pettit *Equity* 30.

<sup>125</sup> Provided that he is not the only trustee; Pettit *Equity* 30.

<sup>126</sup> *Ayerst (Inspector of Taxes) v C&K (Construction) Ltd* [1976] AC 167 at 177G-H.

<sup>127</sup> Hudson *Equity & Trusts* 12.

<sup>128</sup> See for example *Swift v Dairywise Farms Ltd* [2000] 1 WLR 1177 at 1184, in which a milk quota was held to be property under a trust; *Lord Strathcona Steamship Co v Dominion Coal Co Ltd* [1926] AC 108 at 124 and *Don King Productions, Inc v Frank Warren* [1998] RPC 817 at 825, where the court confirmed that a contract could be property held on trust.

<sup>129</sup> *Knight v Knight* (1849) Beav 148, 49 ER 58 at 63. For further detail on these certainties see Pettit *Equity* 47-57.

<sup>130</sup> See Hudson *Equity & Trusts* 49 and the cases cited there.

<sup>131</sup> 49 and the cases cited there.

<sup>132</sup> 50.

deny that another person holds a beneficial interest in the same property.<sup>133</sup> English law concerns itself with institutional constructive trusts, in terms of which a court recognises and declares that the conduct of the parties and the surrounding circumstances are such that a trust has arisen on the date of such conduct i.e. the declaration of the court has retrospective effect.<sup>134</sup>

There is some debate in English law as to the circumstances under which a constructive trust can arise in the context of a sale.<sup>135</sup> It seems clear that a trust can arise where a contract of sale is specifically enforceable.<sup>136</sup> Specific performance is not the default remedy in English contract law.<sup>137</sup> It is subject to the discretion of the courts, but is granted in accordance with well-established requirements.<sup>138</sup> First, there must be an enforceable contract – being a valid as well as an unconditional contract.<sup>139</sup> Second, the claimant must have either already performed or be ready and able to perform. Third, the subject matter of the contract (and the resulting constructive trust) must be specific or ascertained.<sup>140</sup> This requirement reflects the importance of certainty of subject matter that applies to trusts in general.<sup>141</sup> Last, the default remedy of damages is insufficient or inadequate.<sup>142</sup> Where specific performance is available, a constructive trust is said to arise at the moment of

<sup>133</sup> See for example *James v Williams* [2000] Ch 1 at 10: “as a general rule, a constructive trust attaches by law to property which is held by a person in circumstances where it would be inequitable to allow him to assert full beneficial ownership of the property”. Similar, *Paragon Finance plc v DB Thakerar and Co* [1999] 1 All ER 400; *In Re Montagu’s Settlement Trusts, Duke of Manchester v National Westminster Bank Ltd* [1987] Ch 264 at 277; *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] A.C. 669 at 705. On the central idea of “unconscionableness” in the context of constructive trusts also see Hudson *Equity & Trusts* 95-107. Micheler *Property in Securities* at 34 however points out that “[t]he original basis of the enforcement, that of unconscionable conduct by the second buyer, has long since given way to the rule that everybody except the buyer of the legal estate without notice is bound”.

<sup>134</sup> See *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] A.C. 669 at 714G-H. The alternative is a remedial constructive trust, which is popular in the US and is not automatically retrospective; see Clements & Abass *Equity and Trusts* 476-480; Pettit *Equity* 69-70.

<sup>135</sup> For more detail see Micheler *Property in Securities* 37-57.

<sup>136</sup> *Oughtred v Inland Revenue Commissioners* [1960] AC 206 at 240; *J Sainsbury Plc v O’Connor (Inspector of Taxes)* [1991] 1 WLR 963 (CA) at 972; *Wood Preservation Ltd v Prior (Inspector of Taxes)* [1969] 1 WLR 1077 at 1094.

<sup>137</sup> See E Fry & GR Northcote *A Treatise on the Specific Performance of Contracts* 6 ed (1921) 21.

<sup>138</sup> Micheler *Property in Securities* 38-48 examines the requirements for an order of specific performance to be granted in more detail.

<sup>139</sup> But see *Wood Preservation Ltd v Prior (Inspector of Taxes)* [1969] 1 WLR 1077 at 1094 where the court held, that a condition that solely benefits the purchaser and can therefore be waived by him at any time before its fulfilment does not prevent a claim for specific performance by the purchaser. In these cases, a constructive trust therefore arises upon conclusion of the contract and not only upon fulfilment of the condition.

<sup>140</sup> Also see M Chen-Wishart “Specific Performance and Injunction” in HG Beale (ed) *Chitty on Contracts* 32 ed (2015) 1961-1970 [27-014].

<sup>141</sup> See the three certainties above.

<sup>142</sup> Chen-Wishart “Specific Performance” in *Chitty on Contracts* 1963-1969 [27-005]-[27-012].

conclusion of the contract, otherwise from the moment the contract becomes specifically enforceable. A contract for shares, in particular, may be specifically enforceable – a purchaser may therefore compel the seller of the shares to furnish him with the documents of transfer and undertake all steps necessary to effect registration.<sup>143</sup> In the case of listed shares, identical shares are readily available in the market and damages will therefore be a sufficient remedy, barring, in most cases, a claim for specific performance.<sup>144</sup>

Secondly, a constructive trust is said to arise where a donor or seller of shares has done everything in his power to divest himself of the shares.<sup>145</sup>

A third context which may lead to the creation of a constructive trust, independently of a claim for specific performance, is where the subject matter of the trust is appropriated to the contract.<sup>146</sup> The trust therefore arises as soon as the subject matter of the contract has been identified. In the context of certificated shares, the shares are usually specified by number and quantity when the instrument of transfer is handed to the purchaser.<sup>147</sup> Other commentators argue that in addition to the specification of the subject matter of the contract, the purchase price must also have been paid for a constructive trust to arise.<sup>148</sup>

In the context of certificated shares, a constructive trust could arise where a purchaser of shares failed to have her name inserted on the register. A constructive trust could also arise where there was a delay between the sale of shares and the insertion of the transferee's name on the register of members. This delay was frequently substantial before the introduction of electronic settlement systems.<sup>149</sup>

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<sup>143</sup> Fry & Northcote *Specific Performance of Contracts* 678 [1497].

<sup>144</sup> See for example *Cud v Rutter* (1719) 24 ER 521; Fry & Northcote *Specific Performance* 33-34 [73]; Micheler *Property in Securities* 45. If the contract is, however, for the particular shares held by the seller and not any shares of the same kind, specific performance is considered to be available; see *In Re A Debtor* [1943] Ch 213; Micheler *Property in Securities* 46-47.

<sup>145</sup> See *In Re Rose, Midland Bank Executor and Trustee Company Limited v Rose* [1949] Ch 78; *In Re Rose, Rose v Inland Revenue Commissioners* [1952] Ch 499 and the more recent case of *Pennington v Waine* [2002] 2 BCLC 448 in relation to a donation of shares; Micheler *Property in Securities* 52-57; Davies & Worthington *Modern Company Law* 993 [27-9]; Pennington *Company Law* 354-355, 402-404. This requirement is discussed in more detail below, 8 3 2 7 Equitable assignment.

<sup>146</sup> See Pennington *Company Law* 374-375. Micheler *Property in Securities* 48-52 provides a brief summary of the debate.

<sup>147</sup> Micheler *Property in Securities* 49.

<sup>148</sup> Micheler *Property in Securities* 50-52. S Worthington "Proprietary Remedies: The Nexus between Specific Performance and Constructive Trusts" (1996) 11 *J Con L* 1 7, on the other hand, finds that no constructive trust can arise if a contract is not specifically enforceable.

<sup>149</sup> In terms of the Companies Act 2006 s 554 and s 771, the company has up to 2 months to effect the registration.

The division of full ownership into legal and beneficial ownership takes place when the trust is created.<sup>150</sup> The trust construct allows two or more people to hold rights in respect of the same item of property at the same time.<sup>151</sup> Whereas legal ownership is fairly straightforward, the gist of beneficial ownership is not quite as easy to pinpoint with precision. Pettit formulates the conundrum succinctly:

“It may seem strange, although it is not untypical of English law, that although the trust is so highly developed an institution, it is impossible to say with assurance what is the juristic nature of the interest of a *cestui que trust*.”<sup>152</sup>

It is frequently said that a trust vests proprietary rights in the beneficiary against the trust itself as well as personal rights against the trustee for the proper administration of the trust.<sup>153</sup> Maitland, however, was adamant, that the beneficial interest in a trust is a right *in personam*.<sup>154</sup> He describes the rights of a trust as “the benefit of an obligation”,<sup>155</sup> albeit ones that have “come to look so very like real proprietary rights”.<sup>156</sup> Maitland examines beneficial interests from an internal and external perspective. Internally (as regards their duration, transmission and alienation), he describes them as analogous to rights in land or goods.<sup>157</sup> Beneficial interests are rights in “the use” of land, a thing or other.<sup>158</sup> “We might say that ‘the use’ is turned into an incorporeal thing ... and in this incorporeal thing you may have all those rights ... which you could have in a real tangible piece of land [or in movable goods or obligations held in trust].”<sup>159</sup> Externally, the question is against whom the rights in a trust can be enforced. The beneficial interests in a trust can be enforced against anyone, except a *bona fide* purchaser for value, who did not have notice of the trust, either actual or constructive.<sup>160</sup> Maitland therefore concludes that equitable interests in a trust are personal rights, but also recognises the tension between purely personal and proprietary interests when writing “though we must not call it a true *dominium rei*, [the right of the beneficiary] is far more than the mere benefit of a

<sup>150</sup> Hudson *Equity & Trusts* 15, 17; *Ayerst (Inspector of Taxes) v C&K (Construction) Ltd* [1976] AC 167 at 177G-H.

<sup>152</sup> Pettit *Equity* 83.

<sup>153</sup> Hudson *Equity & Trusts* 16.

<sup>154</sup> See FW Maitland *Equity – A Course of Lectures* 2 ed (1936) (revised by J Brunyate) 106-136.

<sup>155</sup> 112.

<sup>156</sup> 112.

<sup>157</sup> 112.

<sup>158</sup> FW Maitland *Selected Essays* (1936) (edited by HD Hazeltine, G Lapsley & PH Winfield) 164.

<sup>159</sup> 164-165.

<sup>160</sup> *Pilcher v Rawlins* (1872) LR 7 Ch App 259.

promise”.<sup>161</sup> A similar opinion was asserted by Langdell, who recognises that a beneficial interest is applied analogous to rights *in rem*, but remains personal, for “the moment it reaches a purchaser for value and without notice, equity stops short: for otherwise it would convert the personal obligation into a real obligation or into ownership”.<sup>162</sup> At the same time, Langdell illustrates that the equitable interest in relation to the trust property as its subject must be conceptually separated from the equitable interest as a subject in itself. While an equitable interest in trust property confers only rights *in personam*, the equitable interest itself is a *res* that can be owned and that creates rights *in rem* between the beneficiary and the rest of the world, but not between the beneficiary and the trustee.<sup>163</sup> Scott, however, reasons that the beneficiary of a trust does have rights *in rem* – not only in the equitable obligation itself, but also in the trust property.<sup>164</sup> The controversial question, therefore, is whether there is a tangible link between the beneficiary and the trust property. He views the doctrine of the *bona fide* purchaser, construed by Maitland and Langdell, amongst others, as the main obstacle against the recognition of rights *in rem*, as a mere limitation to the rights of a property owner.<sup>165</sup> The argument in favour of rights *in rem* receives support from case law. In *Tinsley v Milligan*,<sup>166</sup> the court found that the property, whether consisting of a legal or an equitable interest, confers a right *in rem* and not only a right *in personam*.<sup>167</sup> In *Baker v Archer-Shee*,<sup>168</sup> the court found that “the respondent’s wife was sole beneficial *owner* of the interest and dividends of all the securities, stocks and shares forming part of the trust fund”,<sup>169</sup> which was interpreted by the court in *Archer-Shee v Garland*<sup>170</sup> to mean a “property interest in the *income* arising from the securities, stocks and shares”.<sup>171</sup> Part of the problem is without doubt the tension between law and equity. Considerably more significant,

<sup>161</sup> Maitland *Selected Essays* 174.

<sup>162</sup> CC Langdell *A Brief Survey of Equity Jurisdiction* 2 ed (1908) 6. Langdell, as an American jurist, is cited here for the congruence with Maitland’s perspective.

<sup>163</sup> See especially 5, n 1 and 6, n 1. This corresponds to the internal perspective of Maitland.

<sup>164</sup> AW Scott “The Nature of the Rights of the *Cestui Que Trust*” (1917) 17 *Columbia LR* 269 274-275.

<sup>165</sup> Scott (1917) *Columbia LR* 280; see especially the quote from CA Huston *The Enforcement of Decrees in Equity* (1915) 127-128: “The basis of the doctrine of bona fide purchaser is not a principle confined to its recognition in court of equity, and availing to cut off equitable titles only, but one which runs through the whole fabric of modern law: - an effort to ensure security in commercial transactions and acquisitions by imposing certain responsibilities on owners of property with respect to that property as a price of legal protection to their interests in it”.

<sup>166</sup> [1994] 1 AC 340.

<sup>167</sup> 371.

<sup>168</sup> [1927] AC 844.

<sup>169</sup> 870 (own emphasis).

<sup>170</sup> [1931] AC 212.

<sup>171</sup> 222 (own emphasis).

however, is the fact that English law neither defines property in the same fashion as civilian legal systems do, nor does it attach the same meaning and significance to the distinction between rights *in rem* and *in personam*.<sup>172</sup> In effect, whether a right is classified as *in rem* or *in personam* depends to a large degree on the facts of a specific case.<sup>173</sup> The dispute may in fact largely be one revolving around terminology – all authors, including Maitland and Langdell, seem to agree on the content of the beneficiary’s rights in the trust property. Much can in fact be said for the view that equitable rights are more than rights *in personam*, but less than rights *in rem* - in fact, being rights *sui generis*.<sup>174</sup>

### 8 3 2 7 Equitable assignment

Equitable assignment can play a role in transferring both legal and equitable choses in action. Equitable assignments of legal choses, such as shares, originally developed to counter the non-assignability of choses in action at law.<sup>175</sup> Today, legal choses can be assigned in law;<sup>176</sup> where a statutory assignment of shares fails there is a possibility that a valid equitable assignment took place. An equitable assignment takes effect in equity, not in law. It cannot bring about the transfer of legal ownership. Whether this “assignment” is correctly construed as an equitable assignment or as the creation of a trust depends on the specific context.<sup>177</sup>

Equitable choses, such as beneficial interests in shares, can likewise be the subject of both a statutory and an equitable assignment. A beneficiary of a trust can therefore assign her equitable interest to another or can approximate the effects of an assignment by declaring to hold on trust for another. To achieve the same result, a beneficiary can also request a trustee to hold for a third party instead of him.

<sup>172</sup> See J Garton, G Moffat, G Bean & R Probert *Moffat’s Trust Law: Text and Materials* 6 ed (2015) 273, who describe the classification as “an inadequate straightjacket”.

<sup>173</sup> The type of trust may for example be a decisive factor. To determine the nature of a beneficiary’s interest in the trust property of a discretionary trust in which the trustees may have wide powers to distribute or apply trust proceeds and in which the class of beneficiaries may not be identifiable in a conclusive fashion, see the discussion in Garton et al *Moffat’s Trust Law* 273-276. On the flexible terms of a trust and the implications thereof, see Garton et al *Moffat’s Trust Law* 276-278. The nature of the claim will also determine its classification, see for example *Webb v Webb* [1994] QB 696; ECJ, 17.05.1994 – C-294/92.

<sup>174</sup> Pettit *Equity* 84; Garton et al *Moffat’s Trust Law* 273.

<sup>175</sup> See above, 8 3 2 2 Choses in action, n 72. Also see Liew *Guest on Assignment* 67-70, who points out that the assignability of equitable and legal choses in equity developed differently.

<sup>176</sup> On statutory assignments, see above, 8 3 2 4 Novation and assignment.

<sup>177</sup> See Liew *Guest on Assignment* 39-41.

An equitable assignment is less formal than a statutory assignment and it should therefore not be allowed to sidestep a legal assignment through an equitable assignment.<sup>178</sup> Notice to the debtor is not required.<sup>179</sup> An equitable assignment of an equitable chose must, however, be effected in writing.<sup>180</sup> The requirement of writing neither extends to an equitable assignment of a legal chose, nor to a valid declaration of trust.<sup>181</sup>

Another requirement of a valid equitable assignment is said to be that “the assignor must have done everything necessary according to the nature of the chose in question to transfer title to the assignee”.<sup>182</sup> A number of cases, most prominently *In Re Fry, Chase National Executors and Trustees Corporation v Fry*,<sup>183</sup> *In Re Rose, Midland Bank Executor and Trustee Company Limited v Rose*<sup>184</sup> and *In Re Rose, Rose v Inland Revenue Commissioners*<sup>185</sup> illustrate how difficult it is to determine the exact meaning of that requirement. Whereas the court in *Re Fry* formulated a strict test, in terms of which the transferor (a deceased testator in this case), must have “done everything that was required to be done by him at the time of his death”, the court in *Re Rose* (1949) and *Re Rose* (1952) required only execution and delivery of the documents of transfer.<sup>186</sup> Although the rule developed in relation to donations, Micheler finds that it can be applied by analogy to sales transactions.<sup>187</sup>

### 8 3 3 Transfer and holding in US law

#### 8 3 3 1 General remarks

Shares are choses in action. This statement is not surprising considering their common law classification and is particularly evident from the older cases decided

<sup>178</sup> Smith & Leslie *Assignment* 252 [11.88].

<sup>179</sup> See Liew *Guest on Assignment* 98 n 270 and the cases cited there.

<sup>180</sup> Law of Property Act 1925 s 53(1)(c).

<sup>181</sup> Liew *Guest on Assignment* 83-84.

<sup>182</sup> Smith & Leslie *Assignment* 252 and the cases cited in n 166 and 167. Also see the cases cited above at 8 3 2 6 Equity and trusts, n 145. If this requirement is satisfied, a constructive trust arises.

<sup>183</sup> [1946] Ch 312.

<sup>184</sup> [1949] Ch 78.

<sup>185</sup> [1952] Ch 499.

<sup>186</sup> For more detail on the requirement and the surrounding debate see Micheler *Property in Securities* 52-57; Smith & Leslie *Assignment* 251-264.

<sup>187</sup> Micheler *Property in Securities* 53.

before the promulgation of the Uniform Stock Transfer Act in 1910.<sup>188</sup> The share itself was considered to be the chose and the certificate was merely the evidence of it.<sup>189</sup>

### 8 3 3 2 Negotiation, assignment and the transfer of shares

The early history of US shares aptly illustrates that share certificates, despite being virtually identical to their English counterparts in form and function, were conceptualised to play a more significant role from the outset. Even before the promulgation of the Uniform Stock Transfer Act, shares were frequently described by courts and commentators alike as quasi-negotiables. In reality, the situation was summed up by Justice Davies in the 1870 case of *Bank v Lanier*.<sup>190</sup> “Although neither in form or character negotiable paper, they approximate to it as nearly as practicable”.<sup>191</sup> In a 1903 treatise on the law of negotiable instruments, Daniel writes that “[t]he phrase *quasi-negotiable* has been termed an unhappy one; ... [b]ut still it describes better than any other short-hand expression the nature of those instruments which, while not negotiable in the sense of the law merchant, are so framed and so dealt with, as frequently to convey as good a title to the transferee as if they were negotiable”.<sup>192</sup> True negotiability status was only conferred by the promulgation of the Uniform Stock Transfer Act.<sup>193</sup> At the same time it was still recognised that share certificates are in their essence merely evidence of choses in action.<sup>194</sup>

The Uniform Stock Transfer Act sought especially to standardise the modes of transferring shares. In doing so, it was said to have simply confirmed the common law position.<sup>195</sup> Shares were transferrable by delivery of the share certificate together with a written record of the transfer. This written record could be in the form of an endorsement in blank or to a specific person made on the back of the certificate, or it

<sup>188</sup> See for example *Allen v Pegram* 16 Iowa 163 173; *Slaymaker v Bank of Gettysburg* 10 Pa. 373 (1849) 374; *Leyson v Davis* 17 Mont. 220 (1895); *First National Bank of Richmond v Holland* 99 Va. 495 (1901).

<sup>189</sup> *Slaymaker v Bank of Gettysburg* 10 Pa. 373 (1849) 374; *Winslow v Fletcher* 53 Conn. 390 (1886) 253; *First National Bank of Richmond v Holland* 99 Va. 495 (1901) 504.

<sup>190</sup> 78 U.S. 369 (1870).

<sup>191</sup> 377.

<sup>192</sup> Daniel *Negotiable Instruments* 26 § 44 (emphasis in original).

<sup>193</sup> CG Ehrle “The Uniform Stock Transfer Act” (1921) 5 *Marquette LR* 91 94; JS Rogers “Negotiability, Property, and Identity” (1991) 12 *Cardozo LR* 471 478.

<sup>194</sup> *Blodgett v Silberman* 277 U.S. 1 (1928) 14-15. It is useful to remember the words of WS Holdsworth “The Origins and Early History of Negotiable Instruments, Part 1” (1915) 31 *LQR* 12 13 “Even in modern times the legal consequences of negotiability are exceptions to the ordinary rules of law.”

<sup>195</sup> *Davis Laundry & Cleaning Co v Whitmore* 92 Ohio St. 44 (1915) 54; Ehrle (1921) *Marquette LR* 96.

could be a separate written assignment.<sup>196</sup> The old common law concept of assignment was therefore retained. The change from the common law was that the default method was no longer the delivery of the “proper instrument of transfer”, as it was known in English law, but rather the delivery of the share certificate. The implications, it was argued, “was that the indicia of stock ownership now centered in the stock certificates”.<sup>197</sup> The change reflected a practice that had been recognised by the courts for decades. In *First National Bank of Richmond v Holland*, the court clearly stated that “[t]he delivery therefore of a certificate of stock ... with intent to transfer title ... is effectual as an equitable assignment”.<sup>198</sup>

The other significant change was the point in time at which legal title was said to vest. Prior to the commencement of the Uniform Stock Transfer Act, legal title was said to pass following registration on the books of the issuer.<sup>199</sup> This followed the cue of English law. The Act, however, was said to make “legal title to the shares inseparable from legal title to the certificate evidencing the shares”.<sup>200</sup> Between the parties to the transfer, equitable title thus transferred once the parties reached agreement to that effect and intended the transfer to take place. Legal title however passed upon delivery of either the endorsed certificate or another agreement in writing.<sup>201</sup>

Once the negotiability of shares and securities had been established by the Uniform Stock Transfer Act, the concept took hold and was replicated in the Uniform Commercial Code.<sup>202</sup> Article 8 of the UCC established a separate negotiability regime

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<sup>196</sup> Uniform Stock Transfer Act 1910 s 1.

<sup>197</sup> *Reynolds v Reynolds* 54 Cal. 2d 669 (1960) 676.

<sup>198</sup> *Winslow v Fletcher* 53 Conn. 390 (1886) 398; *First National Bank of Richmond v Holland* 99 Va. 495 (1901) 502. Also see Daniel *Negotiable Instruments* 27 § 46: “As between transferrer and transferee of a stock certificate, it is very well settled that, in the absence of statutory restrictions, the beneficial interest passes by assignment, and delivery of the certificate ...”.

<sup>199</sup> *First National Bank of Richmond v Holland* 99 Va. 495 (1901) 502, 503.

<sup>200</sup> HD Crotty “California and the Uniform Stock Transfer Act” (1931) 19 *California LR* 150 151.

<sup>201</sup> *Stuart v Sargent* 283 Mass. 536 (1933) 541; Anonymous “Notes: Reconsideration of Share Certificate Negotiability” (1940) 7 *Uni Chicago LR* 497 499 n 7. Also see Uniform Stock Transfer Act s 1(2). Also see the later case of *In the Matter of the Succession of Dunham* 408 So. 2d 888 (1981) 893, 896-897: “The sale is considered to be perfect between the parties and the property is of right acquired to the purchaser with regard to the seller, as soon as there exists an agreement for the object and for the price thereof, although the object has not yet been delivered, nor the price paid.”

<sup>202</sup> The original Article 8 dates back to 1952 with amendments being made 1962 and 1977. A complete overhaul of Article 8 resulted in the current 1994 version.

for equity securities, distinct from the ordinary provisions on negotiable instruments.<sup>203</sup>

Negotiability is aimed at enhancing the ease of transfer of abstract rights in two ways. It is a concept that denotes that the rights embodied in specific instruments are transferable by mere delivery or indorsement and delivery.<sup>204</sup> The central notion underlying the negotiability idea is that the certificate is a complete reification of the rights – that is, the piece of paper is fused with the rights; it turns abstract rights into physical objects, or as Rogers aptly describes it, it is “[t]he idea that the paper on which words are written has significance beyond the words themselves”.<sup>205</sup> Shares can therefore be transferred in the same manner as physical goods, namely by delivery.<sup>206</sup> Transferability of course, can be achieved in a myriad of ways, assignment being the typical mode in English law. However, reification means that a bill, note or certificate can be passed from one person to another by simply handing it over – more convenient and concrete than an assignment of abstract rights. Consequently, ownership is evidenced by possession of the certificate.<sup>207</sup> The second central premise of negotiability is that the transferee who obtains the rights in good faith does so without any defects in title.<sup>208</sup> This is known in US law as the “holder in due course” doctrine.<sup>209</sup> Ordinarily, a transfer of goods under the law of property does not protect the purchaser from adverse claims; the purchaser cannot receive a better title than the seller had. The same can be said of rights transferred by means of an assignment. The purchaser of a negotiable instrument can, however, acquire it without having to enquire about its previous holders and, provided he acts in good faith, is not affected by them.

The nature of negotiable instruments is quite complex – in fact, negotiable instruments are said to have dual characteristics: They are both chattels (movable

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<sup>203</sup> Negotiable instruments are the subject of UCC Articles 3 and 4. Securities were however clearly described as negotiable instruments – see for example UCC § 8-105(1) in the 1972 Official Text with Comments.

<sup>204</sup> Daniel *Negotiable Instruments* 1 § 1; J McLoughlin *Introduction to Negotiable Instruments* (1975) 28.

<sup>205</sup> JS Rogers *The End of Negotiable Instruments: Bringing Payment Systems Law out of the Past* (2012) 64.

<sup>206</sup> JS Rogers “An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision” (1995) 31 *Idaho LR* 689 693.

<sup>207</sup> The certificate is prima facie proof of ownership. On the other hand, the registered holder has a direct relationship with the issuer by virtue of being recorded on the register maintained by the issuer.

<sup>208</sup> Daniel *Negotiable Instruments* 2 § 1; McLoughlin *Introduction to Negotiable Instruments* 28.

<sup>209</sup> See UCC Articles 3 and 4.

property) and choses in action.<sup>210</sup> The physical document that “reifies” the rights is a chattel and the rights themselves are choses in action. As choses in action, shares do not have to be negotiated – they can also be transferred from one person to another by assignment. Not only does the mode of transfer under an assignment differ, but also, the transferee will not be protected from adverse claims. If negotiated, the mode of transfer is determined by the type of negotiable instrument: bearer instruments are transferred by delivery alone, while negotiable instruments payable to order are transferable by indorsement in addition to delivery.<sup>211</sup>

### 8 3 3 3 *The change in registration*

Most company law statutes retained the provision that, as against the company, only the registered owner is entitled to receive benefits. Registration remains a convenient determinant of entitlement. Nevertheless, a change in registration can no longer be equated to a passing of legal title.<sup>212</sup> At most, it may serve as rebuttable evidence of ownership, and to establish a structure of holding shares.<sup>213</sup>

### 8 3 3 4 *Deposit and bailment*

Functionally, the ability to exercise and enforce the rights that flow from shares and the right to benefit from them are separated in the same way as in English law – the dividing line is drawn by the entry on the register. English law has traditionally managed this discrepancy by making use of the trust concept. The fusion of the rights with the paper, inherent in negotiable instruments, has the effect that the symbol can be used as if it is the real thing; it has a physical existence. As a consequence, another method became available following the classification of shares as negotiable instruments: bailment or deposit.

The safe custody of movable things was already known in Roman law. Schulz describes contracts of *depositum* as “among the earliest legal institutions in all systems”.<sup>214</sup> A deposit was a contract in terms of which one person (the depositor) handed over a movable thing to another person (the depositee) for safekeeping.<sup>215</sup> The contract was strictly gratuitous – the depositee was therefore not remunerated

<sup>210</sup> See Z Chafee, Jr “Rights in Overdue Paper” (1918) 31 *Harvard LR* 1104 1109.

<sup>211</sup> In general, see UCC Article 3.

<sup>212</sup> See above, 8 3 3 2 Negotiation, assignment and the transfer of shares.

<sup>213</sup> See above, 8 2 1 The functions of registration.

<sup>214</sup> F Schulz *Classical Roman Law* (1951) 518.

<sup>215</sup> *Papinianus* D.16.3.24.

for his services.<sup>216</sup> The depositary did not acquire ownership or possession of the deposited thing, only mere *detentio*.<sup>217</sup> He was not permitted to use the thing<sup>218</sup> and had to return the thing on demand<sup>219</sup> and in the same condition as received,<sup>220</sup> excusing reasonable wear and tear.<sup>221</sup> In performance of this duty of safekeeping, the depositary had to act in good faith and was generally considered to be liable only for *dolus*.<sup>222</sup> Return of the thing deposited as well as damages for wrongdoing could be claimed by the depositor with the *actio depositi*,<sup>223</sup> whereas the depositary had available the *actio depositi contraria* to recover any expenses incurred.<sup>224</sup> Over time, the claim was transformed from a delictual to a contractual one.<sup>225</sup> The essence of an ordinary deposit was therefore that the exact same thing was restored to the depositor. The depositary was not allowed to use the thing and merely restore a thing of the same kind.

The default position was challenged by the practice of depositing money and other fungible things. The existence and treatment of what later became known as *depositum irregulare*, is marred by controversy. Leading authors agree that the most likely construction under classical Roman law was as follows: A deposit of money only qualified as such if the same coins were eventually returned.<sup>226</sup> If the recipient was permitted to use the money and return only an equivalent, he acquired ownership and the contract was one of *mutuum* rather than *depositum*.<sup>227</sup> The

<sup>216</sup> If remuneration was received by the depositary, it was considered a contract of hire (*locatio conductio*). See *Ulpianus* D.16.3.1.8; P du Plessis *Borkowski's Textbook on Roman Law* 5 ed (2015) 308. The depositor however had to reimburse the depositary for any expenses incurred.

<sup>217</sup> *Florentinus* D.16.3.17.1; Schulz *Roman Law* 517; M Kaser *Das Römische Privatrecht I* (1971) § 126 I 3; Du Plessis *Textbook on Roman Law* 308.

<sup>218</sup> *Gaius Institutiones* 3, 196; Kaser *Das Römische Privatrecht I* § 126 I 3.

<sup>219</sup> *Papinianus* D.16.3.24; *Gaius* D.44.7.1.5.

<sup>220</sup> *Ulpianus* D.16.3.1.16.

<sup>221</sup> Du Plessis *Textbook on Roman Law* 308.

<sup>222</sup> See *Ulpianus* D.16.3.1; *Ulpianus* D.16.3.1.23 (on good faith); *Ulpianus* D.16.3.1.8; *Gaius* D.44.7.1.5 (on *dolus* and bad faith). The parties could agree to a stricter standard, but they could not agree to exclude liability based on fraud; see Du Plessis *Textbook on Roman Law* 308.

<sup>223</sup> On the development of the *actio depositi*, see Kaser *Das Römische Privatrecht I* § 126 I 1 and the sources cited there; Schulz *Roman Law* 518; Du Plessis *Textbook on Roman Law* 309. For a contract of depositum, a formula in law (*in ius concepta*) and in fact (*in factum*) was permitted; see *Gaius Institutiones* 4, 47; P Birks & E Descheemaeker (ed) *The Roman Law of Obligations* (2014) 136, 142-143; R Zimmermann *The Law of Obligations: Roman Foundations of the Civilian Tradition* (1996) 206 n 140.

<sup>224</sup> *Modestinus* D.16.3.23; Schulz *Roman Law* 518; Du Plessis *Textbook on Roman Law* 309.

<sup>225</sup> Kaser *Das Römische Privatrecht I* § 126 I 1.

<sup>226</sup> Schulz *Roman Law* 519; Birks & Descheemaeker *Roman Law of Obligations* 144.

<sup>227</sup> Schulz *Roman Law* 520; Birks & Descheemaeker *Roman Law of Obligations* 144; Kaser *Das Römische Privatrecht I* § 126 II. Somewhat ambiguous are the passages from *Papinianus* D.16.3.24. as well as *Paulus* D.16.3.26.1. On the moment at which a contract of *mutuum* comes into existence, see the contradicting passages in *Ulpianus* D.12.1.9.9 and *Ulpianus* D.12.1.10. For a critical overview

classification as a contract of *mutuum* had certain disadvantages. Under a contract of *mutuum* things in kind could be restored, but any agreement on interest was unenforceable, except if concluded separately by *stipulatio*.<sup>228</sup> Conceptualising such a transaction as *depositum* had the advantage that the action would be based on *bona fides* and interest agreed to informally could be claimed.<sup>229</sup> Such a construction, particularly in the context of deposit banking, is believed to have originated in Hellenistic law, being subsequently recognised by Roman jurists of the late classical period.<sup>230</sup> The *depositum irregulare* is therefore generally considered to be a later development in terms of which, along with the intention that the depositor may use the thing deposited, ownership passed to him.

To conclude the brief excursion into the Roman law of deposit, it is remarkable, that even in Roman law, provision was made for tiered deposits:

“If he with whom you deposit property deposits it with someone else and that person is guilty of any fraud on account of the fraud of him with whom the deposit was afterward made, he with whom you deposit is liable to the extent that he must assign his actions to you.”<sup>231</sup>

Derived from Roman law, a relationship of deposit is known in English law as bailment.<sup>232</sup> Bailment is considered to be a *sui generis* claim that may lie in property, contract, tort or unjustified enrichment.<sup>233</sup> It does not have to be gratuitous and is frequently divided into five or six different classes,<sup>234</sup> including classes such as *mandatum* and *commodatum*, which were still considered to stand separate from *depositum* in Roman law. The goods to be delivered under bailment are personal chattels, being tangible movable objects; more specifically, the actual or constructive possession of the goods has to be delivered,<sup>235</sup> and the goods have to be returned

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of the passages, see WM Gordon *Roman Law, Scots Law and Legal History: Selected Essays* (2007) 61.

<sup>228</sup> On the contract of *mutuum* see Schulz *Roman Law* 508-512.

<sup>229</sup> Birks & Descheemaeker *Roman Law of Obligations* 144; Schulz *Roman Law* 520; Zimmermann *Obligations* 216-217.

<sup>230</sup> Zimmermann *Obligations* 216-216; Kaser *Das Römische Privatrecht I* § 126 III.

<sup>231</sup> *Africanus* D.16.3.16 translated by A Watson *The Digest of Justinian II* (1985).

<sup>232</sup> For a definition of bailment see “Bailment” in JPH Mackay of Clashfern (ed) *Halsbury’s Laws of England* 3(1) 4 ed (2005 Reissue) 3 [1] as well as n 1. Halsbury, however, defines bailment as a kind of trust.

<sup>233</sup> “Bailment” in *Halsbury’s Laws of England* 3(1) 4 ed (2005 Reissue) 3 [1], 74 [86].

<sup>234</sup> For the classes see *Coggs v Bernard* (1703) 2 Ld Raym 909 at 912-913; “Bailment” in *Halsbury’s* 3(1) 6 at [2].

<sup>235</sup> “Bailment” in *Halsbury’s* 3(1) 3 at [1].

“in either their original or altered form”.<sup>236</sup> Bailment deviates from its Roman law origins in that it does not have to be gratuitous. Traditionally, bailment played a negligible role in English law in relation to shares. Only bearer shares were held by intermediaries through bailment.<sup>237</sup> Registered shares, being incorporeal, were and are not susceptible to an analysis according to the rules on bailment. Where registered, certificated shares are held through a nominee, the relationship is rather analysed through trust law.

The opposite is true when looking to US law. Negotiable instruments are susceptible to fraud and theft, necessitating some form of safekeeping. Courts have analysed these relationships in terms of the common law principles of bailment.<sup>238</sup> In terms of the principles of bailment, a bailee owes a duty of care to the bailor in respect of the object of deposit. The bailee comes into possession of the object while the bailor retains ownership.<sup>239</sup> A separation between ownership and control is therefore achieved by splitting ownership and possession.

In 1973 the Depository Trust Company (DTC) was established as a centralised institution for retaining possession of securities certificates, which enabled trading without the physical movement of certificates. This spawned the development of a number of intermediaries. Investors would deposit certificates with a broker or custodian bank, who would in turn deposit them with a participant of the DTC, who would deposit it with the DTC. These chains of deposit continued, until the 1994 revision of Article 8 of the UCC, to be analysed in terms of the principles of the law of bailment.<sup>240</sup> In addition to bailment, the law of agency traditionally played an important role in delineating many of these relationships.<sup>241</sup>

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<sup>236</sup> [1] n 1.

<sup>237</sup> Benjamin *Interests in Securities* 40 [2.36].

<sup>238</sup> See for example *Pattison v Syracuse National Bank* 80 N.Y. 82 (1880) and *Ouderkirk v Central National Bank of Troy* 119 N.Y. 263 (1890), which analyse the relationship between a depositor of certificates and a bank for purposes of safekeeping as bailment. Also see JS Rogers “Policy Perspectives on Revised U.C.C Article 8” (1996) 48 *UCLA LR* 1431 1505.

<sup>239</sup> M Dubovec *The Law of Securities, Commodities and Bank Accounts: The Rights of Account Holders* (2014) 31-32.

<sup>240</sup> See *Shields v Newbridge Securities Inc* No. 90-0985S; 1992 Bankr. LEXIS 1706 (1992), which applies principles of bailment to a customer-broker/custodian relationship. Also see Rogers (1996) *UCLA LR* 1505; JL Schroeder “Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street” (1994) *Columbia Bus LR* 291 328-331.

<sup>241</sup> According to CH Meyer *The Law of Stockbrokers and Stock Exchanges, and of Commodity Brokers and Commodity Exchanges I* (1931, supplemented 1936) as quoted by CW Mooney “Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by

## 8 3 4 Transfer and holding in German law

### 8 3 4 1 *General remarks*

Not being part of the common law family, concepts such as legal and beneficial title, equity and trusts will not be matched by equivalent institutions in German law. Nevertheless, many of the concepts and mechanisms that developed in response to commercial demands are remarkably similar to concepts of negotiability and deposit that dominated US law for decades.

### 8 3 4 2 “Wertpapiere” and the materialisation of intangible rights

The foundation of German capital markets is the so-called “Wertpapierrecht”. A “Wertpapier”, literally a paper of value, can be defined as any document that embodies a private law right in such a way that the enforcement of the right depends on the possession of the certificate. At the core of the concept lies the embodiment of private law rights in a certificate. These can be obligatory, proprietary or membership rights. A simple recording of rights in the certificate is not sufficient; essential is rather their embodiment or materialisation, aptly described in German as “Verkörperung”. The paper becomes the bearer of the rights and the operation of this area of the law is entirely aimed at determining the effects of this tie between right and paper.

One facet of this relationship is worthy of advance mention: Two rights must be distinguished, the right embodied in the paper (“Recht aus dem Papier”) and the right to the paper (“Recht am Papier”).<sup>242</sup> According to Hueck and Canaris, it is desirable that both rights accrue to the same person; an objective that can be achieved in more than one way.<sup>243</sup> First, the owner of the paper can simultaneously receive the rights embodied in the paper.<sup>244</sup> In this case the physical paper and therefore the rules relating to tangible things take precedence. Second, the holder of the rights embodied in the paper can simultaneously be regarded as the owner of the paper.<sup>245</sup> In this construction, the intangible rights are paramount, thereby necessitating a predominantly obligatory perspective.

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Intermediaries” (1990) 12 305 377 nn 259 and 260, a stockbroker holding as an intermediary for another is not a trustee, but rather an agent.

<sup>242</sup> A Hueck & C-W Canaris *Recht der Wertpapiere* 12 ed (1986) § 1 I 4(a).

<sup>243</sup> § 1 I 4(a).

<sup>244</sup> § 1 I 4(a).

<sup>245</sup> § 1 I 4(a).

The choice between the two constructions determines how shares and other “Wertpapiere” circulate. In the course of the 19<sup>th</sup> century a lively debate among legal academics ensued surrounding the transfer mechanisms of certain rights embodied in instruments of paper. During large parts of the 19<sup>th</sup> century, “Wertpapiere” were considered in legislation and by authors to be intangibles close in character to debt instruments.<sup>246</sup> The default position was therefore that securities should be transferred by cession. To circumvent the shortcomings of a cession, a number of alternative propositions were made: While some advocated in favour of novation, other authors resorted to characterising securities as a legal category of its own or argued that certain rules on cession could be contracted out of.<sup>247</sup> All these theories indicate that scholars identified not only the deficiencies of the law of cession, but also the complexity of the relationship between the rights and the paper.

It was in this context that Friedrich Carl von Savigny grappled with the treatment and transfer of rights embodied in certificates as movable, tangible things although contractual claims should ordinarily be transferred by cession.<sup>248</sup> New modes of treating contractual claims, he found, may be recognised if the exigencies of the economy demand it.<sup>249</sup> He identified two problematic aspects of a cession, namely the requirement of the debtor’s consent and secondly, that the transferee must, in theory, prove all the (possibly numerous) cessions that have taken place in the past.<sup>250</sup> What differentiates such rights from otherwise similar claims, according to Savigny, is the presence of the certificate. The certificate is a corporeal thing, an object capable of being possessed and owned.<sup>251</sup> In embodying the claim in a certificate, the proprietary characteristics of the certificate can be extended to the otherwise incorporeal rights;<sup>252</sup> the certificate becomes the carrier or bearer of the

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<sup>246</sup> See for example Preussisches Allgemeines Landrecht (the predecessor of the BGB), which states in part 1, title 2, s 12: “Die auf jeden Inhaber lautende Papiere, z. B. Banknoten, Pfandbriefe, Aktien u. s. w., sie mögen Zinsen tragen, oder nicht, werden, *gleich andern Schuldinstrumenten*, zum Kapitalsvermögen gerechnet” (own emphasis). Also see JC Bluntschli *Deutsches Privatrecht II* (1854) 21. For a brief summary see Micheler *Property in Securities* 150-164.

<sup>247</sup> For a brief summary of the diverging positions see Meppen *Inhaberpapier* 94-95; Micheler *Property in Securities* 157-160.

<sup>248</sup> FC von Savigny *Das Obligationenrecht als Theil des Heutigen Römischen Rechts II* (1853). Note that Savigny’s discussion focuses specifically on “Papiere auf den Inhaber”.

<sup>249</sup> 94, 97.

<sup>250</sup> 98.

<sup>251</sup> 99.

<sup>252</sup> Savigny *Obligationenrecht* terms this the embodiment or materialisation of an obligation, see 99, further 130 where Savigny describes “Verkörperung” as follows: “Die Anknüpfung des Forderungsrechts an das Verhältnis der Person zum Papier”. The concept of “Verkörperung” can be traced to other authors before Savigny; see W Zöllner “Zurückdrängung des Verkörperungselements

right and the claim morphs into a tangible thing, if not for the eye, then for legal thinking.<sup>253</sup>

The theory developed by Savigny became known as the “Verkörperungstheorie”. Lehmann describes the materialisation theory as convincing in its simplicity, at least at first glance.<sup>254</sup> Tying the intangible rights to a tangible object provided a convenient way of explaining the already-existing, “thing-based” mechanisms of treating transactions in shares without having to modify the well-established boundaries between rights and things.<sup>255</sup> In addition, the theory suggested a solution to the shortcomings of cession. Lastly, the reasons for tying the “rights embodied in the paper” to the “rights to the paper” lie in the structure of German private law, particularly the limitation of the law of things to tangible objects<sup>256</sup> as well as the protection of *bona fide* purchasers in terms of the law of things, but not the law of obligations.<sup>257</sup> It is not surprising therefore, that in time the proprietary notion gained widespread popularity.

The “propertiness” of securities is a mere fiction. Such fictions dot the legal landscape but they have an uncanny habit of gaining considerable momentum.<sup>258</sup> Lehmann therefore warns that it is useful to recall that the rights and the certificate are not identical.<sup>259</sup> The embodiment (“Verkörperung”) and securitisation (“Verbriefung”) of rights (in the case of shares membership rights) has the effect of both reifying (“versachlichen”) and mobilising these rights. What it does not do, Canaris cautions, is to convert these personal rights into real rights.<sup>260</sup> He argues that subjecting personal rights to the rules of property law is neither sufficient nor

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bei den Wertpapieren” in L Raiser & F Baur (eds) *Funktionswandel der Privatrechtsinstitutionen: Festschrift für Ludwig Raiser zum 70. Geburtstag* (1974) 249 n 1.

<sup>253</sup> See C von Schwerin *Recht der Wertpapiere (einschließlich Wechsel- und Scheckrecht)* (1924) 3. This statement is criticised by Zöllner “Zurückdrängung” in Raiser & Baur *Festschrift für Ludwig Raiser* 250 n 1 because it negates the importance of the intangible rights.

<sup>254</sup> M Lehmann *Finanzinstrumente: Vom Wertpapier- und Sachenrecht zum Recht der unkörperlichen Vermögensgegenstände* (2009) 180.

<sup>255</sup> 180. For Lehmann’s proposition on how the boundary between rights and things can be redrawn, see below, 16 3 4 Matthias Lehmann.

<sup>256</sup> 171.

<sup>257</sup> Micheler *Property in Securities* 149,156-157, points out that securities or “Wertpapiere” were only classified as tangible property once the legal framework of the numerous German nation states developed to accommodate good faith acquisition of tangible property.

<sup>258</sup> See Lehmann *Finanzinstrumente* (2009) 182.

<sup>259</sup> 182.

<sup>260</sup> C-W Canaris “Die verdinglichung obligatorischer Rechte” in HH Jakobs, B Knobbe-Keuk, E Picker & J Wilhelm (eds) *Festschrift für Werner Flume zum 70. Geburtstag I* (1978) 371 374-375.

necessary to transform the personal rights to real ones.<sup>261</sup> It is furthermore impossible to convert an intangible right to a tangible thing – the right is merely treated as *if* it is a thing.<sup>262</sup> This construction subjects intangible rights to the regime of the law of things without changing the nature of such rights.

In light of the above, it follows that Savigny's idea, although hugely influential, has not been without its critics. Brunner questioned whether it is wise or even possible to describe rights as corporeal.<sup>263</sup> He argues that all rights are essentially intangible and criticises Savigny's theory as "legal imagery".<sup>264</sup> The value, he cautions, does not lie in the certificate, but in the rights.<sup>265</sup> Bluntschli similarly observed the tension between the tangible properties of the certificate and the intangible nature of rights, describing bearer securities as a "special type of obligation",<sup>266</sup> intangible, but transferred by delivery, not assignment.<sup>267</sup> Hueck and Canaris caution that the connection between the rights and the paper should not be unduly exaggerated. Possession of the paper is only required for the enforcement of the rights, not necessarily for the creation and continued existence of the rights.<sup>268</sup> This can best be illustrated in relation to shares. As recounted above,<sup>269</sup> the membership rights embodied in a share certificate are created upon entry in the register of companies and therefore exist independently of the certificate and continue to exist even if the certificate is lost or destroyed.<sup>270</sup> In this instance they are incapable of being enforced until the certificate is declared invalid.<sup>271</sup> The certificate is not decisive for the creation of rights that flow from shares – these rights come into existence independently of the

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<sup>261</sup> 374-375.

<sup>262</sup> Lehmann *Finanzinstrumente* 182.

<sup>263</sup> H Brunner "Die Werthpapiere" in W Endemann (ed) *Handbuch des Deutschen Handels-, See, und Wechselrechts II* (1882) 140 142-143.

<sup>264</sup> 143.

<sup>265</sup> 144.

<sup>266</sup> Bluntschli *Deutsches Privatrecht II* 22: "Sie bilden um der Form willen eine besondere Gattung von Obligationen mit einem eigenthümlichen Charakter."

<sup>267</sup> Bluntschli *Deutsches Privatrecht II* 21-27; Micheler *Property in Securities* 152.

<sup>268</sup> Hueck & Canaris *Wertpapiere* § 1 I 5; Meppen *Inhaberpapier* 29. The distinction between three types of functions that may be performed by certificates was already drawn by Brunner. He distinguished between the role of the certificate 1. to create the rights; 2. to transfer the right; and 3. to enforce the right; see Brunner "Wertpapiere" in *Handbuch des Deutschen Handelsrechts II*.

<sup>269</sup> See above, 6 3 The obligatory realms of shares and some conclusions, n 85.

<sup>270</sup> This was also emphasised by Savigny *Obligationenrecht* 179, who writes that these certificates have no value in themselves. The continued existence of the obligation is therefore completely independent of the physical existence of the paper. He describes these papers as merely evidentiary certificates.

<sup>271</sup> See Aktiengesetz § 72; BGB § 799 and 800.

certificate.<sup>272</sup> The share certificate is therefore known as a declaratory certificate (“deklaratorisches Wertpapier”).<sup>273</sup> From the declaratory character of the certificate in relation to the creation of membership rights does not follow, however, that the share certificate plays an insignificant role in the German legal discourse. It is the certificate that allows certain rules of the law of things to apply to “Wertpapiere”, particularly transfer- and *bona fide* acquisition rules.<sup>274</sup> In relation to the creation and continued existence of the membership rights, a certificate is merely evidentiary in nature (“Beweisurkunde”). However, a certificate can, in addition, perform core private law functions, specifically in relation to a transfer and enforcement of a right.<sup>275</sup> A transfer of possession is not a necessary concomitant requirement of the transfer of all types of “Wertpapiere”.<sup>276</sup> In relation to bearer shares, a transfer of possession of the share certificate is, however, ordinarily required for a transfer of the share.<sup>277</sup> The specific attribute of the general concept of “Wertpapiere” lies in the fact also captured by the definition, namely that the *enforcement* (and at times the transfer) of the right depends on the possession of the certificate.<sup>278</sup> The well-known maxim of “Das Recht aus dem Papier folgt dem Recht am Papier” (the rights flowing from the paper follow the rights to the paper) is therefore not wholly accurate, or is at least too narrow.<sup>279</sup>

The category of “Wertpapiere” is an impossibly broad notion and several classifications can be undertaken. “Wertpapiere” can be classified according to their economic function. “Effekten” or capital markets instruments would be one category under this classification, specifically being fungible instruments designed to be traded.<sup>280</sup>

<sup>272</sup> In this context, also see Brunner “Wertpapiere” in *Handbuch des Deutschen Handelsrechts II* 144-149; K-H Gursky *Wertpapierrecht* 3 ed (2007) 12-13.

<sup>273</sup> This is not true for all certificates – some are constitutive, meaning that the rights are only created when the certificate is issued. This is the case, for example, for cheques and debentures in bearer form (“Inhaberschuldverschreibung”) – see Gursky *Wertpapierrecht* 13.

<sup>274</sup> See above, 8 1 The functions of the share certificate.

<sup>275</sup> Brunner “Wertpapiere” in *Handbuch des Deutschen Handelsrechts II* 146.

<sup>276</sup> Hueck & Canaris *Wertpapiere* § 1 I 5.

<sup>277</sup> See below, 8 3 4 3 The transfer of shares.

<sup>278</sup> Hueck & Canaris *Wertpapiere* § 1 I 4(b).

<sup>279</sup> For the maxim see J von Gierke *Das Recht der Wertpapiere* (1954) 2; see Gursky *Wertpapierrecht* 2-3 for a brief summary of the two concepts or definitions. For criticism, see for example Hueck & Canaris *Wertpapiere* § 1 I 4(a). Also critical is Zöllner “Zurückdrängung” in Raiser & Baur *Festschrift für Ludwig Raiser* 249 n 1, who describes the maxim as “verfehlt” and “unbrauchbar” (misplaced and without use). Than however points out that for purposes of capital market practice the narrower maxim is both sufficient and easier to grasp; see J Than “Wertpapierrecht ohne Wertpapiere?” in N Horn, H-J Lwowski & G Nobbe (eds) *Bankrecht- Schwerpunkte und Perspektiven: Festschrift für Herbert Schimansky* (1999) 821 823-824.

<sup>280</sup> See Hueck & Canaris *Wertpapiere* § 2 I 2; Gursky *Wertpapierrecht* 10-14.

An alternative method of classification is according to the nature of the rights embodied in the paper. The categories under this classification include “Wertpapiere” of an obligatory, proprietary as well as membership-based nature.<sup>281</sup> Whereas, debentures would be obligatory in nature, shares are clearly based on rights of membership.<sup>282</sup>

The most common classification is according to the means of determining the beneficiary, including “Rektapapiere”, “Orderpapiere” as well as “Inhaberpapiere”. German bearer shares (“Inhaberaktien”) are, as the name suggests, “Inhaberpapiere”. “Namensaktien”, on the other hand, are “Orderpapiere”.

“Inhaberpapiere” are those instruments where the possessor (“Inhaber”) of the certificate can enforce the rights embodied in the certificate. The rights therefore accrue to the person who exercises control over the certificate through possession; no specific person or beneficiary is named on the certificate. The exercise of the rights therefore necessitates possession of the certificate. This does not mean that any possessor automatically becomes the legally recognised beneficiary of the rights; the position is rather that the possessor does not have to prove his entitlement (“Rechtsschein”) and the issuer has to perform towards the possessor, unless he can prove that the possessor is not entitled.<sup>283</sup> Ultimately, only the owner is entitled, there merely exists a rebuttable presumption in favour of the possessor.

An “Orderpapier”, on the other hand, is one where the issuer promises to perform towards a specific, named person or towards another person indicated by the first person through endorsement.<sup>284</sup> “Namensaktien” are an example of instruments issued to order.

Comparable to the position concerning property interests, “Wertpapiere” are subject to a *numerus clausus*. The materialisation of rights in certificates is only possible where provided for by the law (“Typenzwang”). The law will also determine the form that the instrument will take i.e. whether it is “Inhaber-“, “Rekta-“ or “Orderpapier” (“Typenfixierung”).<sup>285</sup>

<sup>281</sup> “Schuldrechtliche Wertpapiere”, “Sachenrechtliche Wertpapiere” and “Mitgliedspapiere”.

<sup>282</sup> See Hueck & Canaris *Wertpapiere* § 2 II.

<sup>283</sup> BGB § 793(1), also see § 1006; Hueck & Canaris *Wertpapiere* 24 § 2 III 3, 33-35; Gursky *Wertpapierrecht* 13.

<sup>284</sup> Hueck & Canaris *Wertpapiere* 22-23 § 2 III 2; Gursky *Wertpapierrecht* 11-12.

<sup>285</sup> Gursky *Wertpapierrecht* 14-15; Lehmann *Finanzinstrumente* 13, 176.

### 8 3 4 3 *The transfer of shares*

The embodiment of rights in a share certificate has implications for their transfer. As set out above, the share certificate is a thing (“Sache”), more specifically a movable thing (“bewegliche Sache”). § 90 of the BGB restricts “things” to corporeal objects. Shares of public listed companies that are traded on a stock exchange are furthermore fungibles (“vertretbare Sachen”), being movable things that are usually specified in business dealings according to their number, measure or weight.<sup>286</sup>

The law of things is the doctrinal foundation on which the law relating to the transfer and holding of “Wertpapiere” is constructed.<sup>287</sup> An investor becomes owner (“Eigentümer”) of the thing. For the enforcement of the rights embodied in the certificate, possession (“Besitz”) of the certificate is more significant than ownership. Ownership and possession are closely related. Possession is the foundation of the presumption of ownership,<sup>288</sup> plays a vital role in the transfer of ownership and the protection of the *bona fide* purchaser. In summary, possession fulfills the function of publicity.<sup>289</sup>

The prerequisites for a valid transfer of ownership of a movable thing are delivery of the thing as well as an agreement that ownership shall pass (“Übergabe” and “Einigung”).<sup>290</sup> Delivery is a real act, not a legal transaction.<sup>291</sup> Delivery of possession of the thing publicises the transfer. The acquisition of actual control over a thing constitutes possession.<sup>292</sup> For delivery, the transition of actual, physical control i.e. possession over the movable object to the buyer is insufficient; it must be accompanied by an actual consensus to give up or alternatively to obtain possession.<sup>293</sup>

Delivery of possession alone does not suffice to transfer ownership; additionally the parties must agree that ownership shall pass from the transferor to the transferee.

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<sup>286</sup> BGB § 91.

<sup>287</sup> Lehmann *Finanzinstrumente* 171.

<sup>288</sup> BGB § 1006.

<sup>289</sup> See F Baur, JF Baur & R Stürmer *Sachenrecht* 18 ed (2009) § 4 II [9].

<sup>290</sup> BGB § 929 sent 1; also see FC von Savigny *System des heutigen römischen Rechts* II (1840) III 312.

<sup>291</sup> D Leenen *BGB Allgemeiner Teil: Rechtsgeschäftslehre* 2 ed (2015) 31 [5]-[6].

<sup>292</sup> BGB § 854(1).

<sup>293</sup> J Oechsler “§ 929 Einigung und Übergabe” in FJ Säcker, R Rixecker, H Oetker & B Limperg (eds) *Münchener Kommentar zum Bürgerlichen Gesetzbuch VII* 7 ed (2017) [48]. Obtaining possession and delivery are therefore not synonymous. Differentiate here the will of the parties to transfer possession, which is part of delivery and the will to transfer ownership, which constitutes the real agreement.

This agreement constitutes a legal transaction (“Rechtsgeschäft”).<sup>294</sup> German property law is characterised by the principle of separation (“Trennungsprinzip”) and the principle of abstraction (“Abstraktionsprinzip”).<sup>295</sup> Two different legal transactions must be carefully distinguished - the contractual transaction (“Verpflichtungsgeschäft”) and the material transaction (“Verfügungsgeschäft”).<sup>296</sup> The recognition that, even though they may coincide, the material transaction is legally independent of the contractual transaction is the gist of the principle of separation.<sup>297</sup> Underlying the contractual transaction is an obligatory agreement (“obligatorischer Vertrag”) while for the material transaction a real agreement (“dinglicher Vertrag”) is concluded.<sup>298</sup> In an abstract system for the transfer of property, these agreements must be differentiated. While the obligatory agreement (for example a contract of sale) creates an obligation to perform, it does not transfer the real right. For a transfer of real rights an independent agreement is required that is detached and abstracted from the *causa*. The real agreement constitutes the mutual intention of the parties to transfer and receive rights. This intention is abstracted from the *causa* and exists independently of it; this is known as contentional abstraction (“inhaltliche Abstraktion”).<sup>299</sup> Additionally, the validity of the real agreement is not dependent on the existence or validity of the underlying *causa* – an aspect known as external abstraction (“äußerliche Abstraktion”).<sup>300</sup> The obligatory agreement to sell the shares can therefore be invalid as long as the real agreement is valid, i.e. both the seller and the buyer intend to transfer the shares. Provided that this mutual intention is coupled with the delivery of the share certificate, ownership will pass. The real agreement is not subject to any formalities and is frequently entered into tacitly.<sup>301</sup> In addition, the real agreement must specify the subject matter to be transferred

<sup>294</sup> Oechsler “§ 929” in *Münchener Kommentar zum BGB VII* [23].

<sup>295</sup> In general see Baur et al *Sachenrecht* § 5 IV [40]-[43]; HJ Wieling *Sachenrecht* 5 ed (2007) 12-15, 95; A Stadler *Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion: Eine rechtsvergleichende Studie zur abstrakten und kausalen Gestaltung rechtsgeschäftlicher Zuwendungen anhand des deutschen, schweizerischen, österreichischen, französischen und US-amerikanischen Rechts* (1996) 7-8.

<sup>296</sup> Leenen *Rechtsgeschäftslehre* 33-34 [19].

<sup>297</sup> Stadler *Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion* 7.

<sup>298</sup> B Mugdan *Die gesammten Materialien zum Bürgerlichen Gesetzbuch für das Deutsche Reich 1* (1899) 422 [127]-[128]; The idea of the abstract real agreement can be traced back to Savigny, who described the *traditio* as a true contract: “denn sie enthält von beiden Seiten die auf gegenwärtige Übertragung des Besitzes und des Eigenthums gerichtete Willenserklärung, und es werden die Rechtsverhältnisse der Handelnden dadurch neu bestimmt”; Savigny *System* III 312; also see H Coing *Europäisches Privatrecht II* (1985) 393-394.

<sup>299</sup> Baur et al *Sachenrecht* § 5 IV [41]; Oechsler “§ 929” in *Münchener Kommentar zum BGB VII* [8].

<sup>300</sup> Baur et al *Sachenrecht* § 5 IV [41]; Oechsler “§ 929” in *Münchener Kommentar zum BGB VII* [8].

<sup>301</sup> Wieling *Sachenrecht* 95; Baur et al *Sachenrecht* § 51 [7].

(“sachenrechtlicher Bestimmtheitsgrundsatz”/“Spezialitätsgrundsatz”), in other words the specific shares or share certificates to be transferred must be individually identified.<sup>302</sup>

As a default rule, the transfer of physical possession is thus required. If the buyer is already in possession of the certificate, only an agreement that ownership shall pass is required.<sup>303</sup> Should a third party be in possession of the certificate, the seller (and owner) can assign to the buyer the right to claim the certificate from the third party.<sup>304</sup> As a last alternative to the transfer of possession, the seller can remain in possession, provided that the parties agree that the seller now holds the certificates for the buyer and new owner.<sup>305</sup> Possession can also be transferred independently of a transfer of ownership.<sup>306</sup> Through these mechanisms, German law enables ownership and control to be split.

While some authors contend that “Inhaberpapiere” such as bearer shares can only be transferred in accordance with the principles for movable property,<sup>307</sup> it seems relatively uncontroversial that such a transfer can also take place by cession (“Abtretung”) in accordance with §§ 398 and 413.<sup>308</sup> If this mechanism of transfer is used, the rules on the protection of good faith purchasers, set out below,<sup>309</sup> do not apply.

### 8 3 4 4 Deposit

Exercising control through demanding and receiving performance from the issuer depends on possession of the certificate. From the perspective of the company the

<sup>302</sup> Baur et al *Sachenrecht* § 51 [8]; W Wiegand “§ 929 Einigung und Übergabe” in “§ 929 Einigung und Übergabe” in Wiegand W (ed) *J. von Staudingers Kommentar zum Bürgerlichen Gesetzbuch mit Einführungsgesetz und Nebengesetzen* 3(2) (2017) [11]; J Oechsler “Anh. §§ 929-936” in FJ Säcker, R Rixecker, H Oetker & B Limperg (ed) *Münchener Kommentar zum Bürgerlichen Gesetzbuch VII* 7 ed (2017) [5]; BGH (1956) *NJW* 1315, 1316; For the lack of usefulness in distinguishing between the “Bestimmtheitsgrundsatz” and “Spezialitätsgrundsatz” see D Einsele *Wertpapierrecht als Schuldrecht: Funktionsverlust von Effektenurkunden im internationalen Rechtsverkehr* (1995) 40 n 192. But other authors still treat them separately; see for example Oechsler “§ 929” in *Münchener Kommentar zum BGB VII* [6].

<sup>303</sup> BGB § 929.

<sup>304</sup> BGB § 931.

<sup>305</sup> BGB § 930.

<sup>306</sup> BGB § 854.

<sup>307</sup> See for example Wieling *Sachenrecht* 112.

<sup>308</sup> See for example Hueck & Canaris *Wertpapiere* 7, 24-25, who argue that a cession, i.e. a transfer without delivery or constructive delivery, is possible for shares and other securities because the certificate has lost much of its importance; Gursky *Wertpapierrecht* 11; Meppen *Inhaberpapier* 154; Oechsler “§ 929” in *Münchener Kommentar zum BGB VII* [15].

<sup>309</sup> See below, 8 4 2 “Verkehrsschutz” and the protection of bona fide purchasers in German law.

holder of the certificate is the holder of the shares. Despite the advantages of bearer shares, such as easy and convenient transferability and good faith acquisition, significant risks exist, primarily the risk that the certificates get into the wrong hands as well as the inconvenience of having to move certificates between market participants. For reasons of safekeeping and convenience, shareholders began to deposit their certificates with banks and other financial institutions.

A contract of deposit is known in German law as “Verwahrungsvertrag”.<sup>310</sup> According to § 688 BGB, only movable things can be deposited.<sup>311</sup> The depositary (“Verwahrer”) becomes the direct possessor and mediates possession for the depositor, who is the indirect possessor (“mittelbarer Besitzer”) as defined by § 868 BGB. Actual or constructive co-possession has to be delivered to the depositary.<sup>312</sup> A relationship of deposit does not have to be gratuitous. In the case of a regular deposit, the same things have to be returned to the depositor.<sup>313</sup> For shares and securities, a special regime of deposit in the context of systemic intermediation<sup>314</sup> was created in the “Depotgesetz”.<sup>315</sup>

Banks taking deposits of securities became known as “Massenverwahrer” and the practice as “Fremdverwahrung”.<sup>316</sup> The next step in the development of securities deposits was the so-called “Zentralverwahrung”. A centralised depository replaced the numerous individual banks and institutions as a collective depository. Collective custody (“Sammelverwahrung”) means that all securities (“Wertpapiere”) of the same kind, whether they belong to the investor, banks, the depositor or third parties, are deposited together.<sup>317</sup> The first collective depository (“Wertpapiersammelbank”) in Germany was the Berliner Kassenverein founded in 1823.<sup>318</sup> Initially, only the securities belonging to the banks themselves were deposited there.<sup>319</sup> It was only

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<sup>310</sup> See BGB § 688.

<sup>311</sup> Also see M Henssler “§ 688 Vertragstypische Pflichten bei der Verwahrung” in FJ Säcker, R Rixecker, H Oetker & B Limperg (eds) *Münchener Kommentar zum Bürgerlichen Gesetzbuch V(II)* 7 ed (2017) [8].

<sup>312</sup> [17]-[18].

<sup>313</sup> See BGB §§ 695, 696. Distinguish this from an irregular deposit in BGB § 700(1).

<sup>314</sup> On systemic intermediation, see below, 9 3 2 Relationship-based and systemic intermediation.

<sup>315</sup> See below, Chapter 12: The effect of systematic intermediation in Germany.

<sup>316</sup> For a brief historic overview see Lehmann *Finanzinstrumente* 20-22.

<sup>317</sup> See § 5(1) Depotgesetz; T Heinsius, A Horn & J Than *Depotgesetz* (1975) 96.

<sup>318</sup> U Brink *Rechtsbeziehungen und Rechtsübertragung im nationalen und internationalen Effektengiroverkehr* (1976) 23; Heinsius et al *Depotgesetz* 90.

<sup>319</sup> This practice took place from 1882. H Delorme *Die Wertpapiersammelbanken* (1970) 11; Heinsius et al *Depotgesetz* 90.

after the First World War and the inflation of the 1920's that banks began to deposit the securities of their clients centrally and collectively.<sup>320</sup>

Collective custody alone did not solve all the problems brought about by the inflation. The hyperinflation, in conjunction with the increased popularity of shares among ordinary members of society, dramatically increased the volume of shares in circulation and hence the cost of transporting the certificates.<sup>321</sup> Accompanying collective custody was therefore the "stückeloser Effektengiroverkehr", which literally translated means certificateless transfer. As certificates were no longer in the hands of investors, alternatives to physical delivery had to be found. The mechanisms used in cashless payment transactions inspired the development of book-entry transfers of securities without the movement of certificates.<sup>322</sup>

In practice certificates were therefore acquired by banks on behalf of investors and immediately placed into collective custody, as a result of which the certificate was neither required to affect transfer, nor to enforce rights. Certificates therefore played, at most, a subordinate role in practice. In addition, the printing and safekeeping of a large number of certificates became expensive.<sup>323</sup> Hence, individual certificates were eliminated and replaced by global certificates ("Globalurkunde"). Lehmann differentiates this development from immobilisation and terms it "de-individualisation" ("Entindividualisierung").<sup>324</sup> Global certificates first appeared in Germany in relation to government bonds before the Second World War.<sup>325</sup> After the Second World War, global certificates were used on a large scale to replace certificates lost or destroyed during the war.<sup>326</sup> The statutory basis for the use of global certificates only followed with the amendment of the Depotgesetz of 1972.<sup>327</sup>

<sup>320</sup> Delorme *Wertpapiersammelbanken* 11; Lehmann *Finanzinstrumente* 22; Meppen *Inhaberpapier* 172; Brink *Effektengiroverkehr* 25.

<sup>321</sup> Meppen *Inhaberpapier* 172.

<sup>322</sup> Meppen *Inhaberpapier* 172-173; Delorme *Wertpapiersammelbanken* 29; Heinsius et al *Depotgesetz* 91. From payment systems also derives part of the name, namely "Giroverkehr". For a definition or description of "Effektengiroverkehr" see Brink *Effektengiroverkehr* 17; Delorme *Wertpapiersammelbanken* 29, 74.

<sup>323</sup> Zöllner "Zurückdrängung" in Raiser & Baur *Festschrift für Ludwig Raiser* 252-253.

<sup>324</sup> See Lehmann *Finanzinstrumente* 28-29.

<sup>325</sup> Than "Wertpapierrecht ohne Wertpapiere" in *Festschrift Schimansky* 828; Lehmann *Finanzinstrumente* 29.

<sup>326</sup> Lehmann *Finanzinstrumente* 29-30; Meppen *Inhaberpapier* 174; Brink *Effektengiroverkehr* 29.

<sup>327</sup> Novelle zum Depotgesetz vom 24.5.1972, which inserted § 9a; Zöllner "Zurückdrängung" in Raiser & Baur *Festschrift für Ludwig Raiser* 253-254; Meppen *Inhaberpapier* 74; Lehmann *Finanzinstrumente* 31-32; Than "Wertpapierrecht ohne Wertpapiere" in *Festschrift Schimansky* 828.

## 8 3 5 Transfer and holding in South African law

### 8 3 5 1 General remarks

Transfer, as remarked in the opening passages of this chapter, is an elusive concept. In the case of *Inland Property Development Corporation (Pty) Ltd v Cilliers*<sup>328</sup> the court stated that:

“In regard to shares, the word “transfer”, in its full and technical sense, is not a single act but consists of a series of steps, namely an agreement to transfer, the execution of a deed of transfer and, finally, the registration of the transfer”.<sup>329</sup>

At the same time the court remarked that the ordinary meaning of the term “transfer” refers to the transfer of shares excluding registration.<sup>330</sup> Similarly, Borrowdale recognises that “it must always be a matter of construction whether ‘transfer’ refers to the transfer of the registered title or the beneficial ownership”.<sup>331</sup>

### 8 3 5 2 The transfer of shares

In characterising a share, South African law reflects its English heritage – shares are frequently described by courts as “rights of action”, being *ius in personae*.<sup>332</sup> This classification dictates the method of transfer: South African courts have long established that shares pass from one person to another by cession. Indeed, cession plays a pivotal role in modern commerce by “facilitate[ing] the mobility of personal rights as incorporeal assets”.<sup>333</sup> A cession encompasses the transfer of rights from the transferor (the cedent) to a transferee (the cessionary) by mere agreement.<sup>334</sup>

<sup>328</sup> 1973 3 SA 245 (A).

<sup>329</sup> *Inland Property Development Corporation (Pty) Ltd v Cilliers* 1973 3 SA 245 (A) 251B-C; See also *Smuts v Booyensmarkplaas (Edms) Bpk v Booyens* 2001 4 SA 15 (SCA).

<sup>330</sup> *Inland Property Development Corporation (Pty) Ltd v Cilliers* 1973 3 SA 245 (A) 251E. This conclusion, which is *obiter dictum*, was based on the English case of *Lyle and Scott Ltd v Scott's Trustees and British Investment Trust Ltd* 1959 AC 763 at 778.

<sup>331</sup> A Borrowdale “Shares and the Elusive Meaning of ‘Transfer’” (1985) 102 SALJ 277 277.

<sup>332</sup> See for example *McGregor's Estate v Silberbauer* (1891) 9 SC 36; *Randfontein Estates Ltd v The Master* 1909 TS 978; *Liquidators Union Share Agency v Hatton* 1927 AD 240; *Jeffery v Pollak and Freemantle* 1938 AD 1; *Standard Bank of South Africa Ltd v Ocean Commodities Inc* 1983 1 SA 276 (A); *Cooper v Boyes* 1994 4 SA 521 (C).

<sup>333</sup> Van Huyssteen et al *Contract* 430.

<sup>334</sup> *LTA Engineering Co Ltd v Seacat Investments (Pty) Ltd* 1974 1 SA 747 (A) 762; *Johnson v Incorporated General Insurances Ltd* 1983 1 SA 318 (A) 331G-H; *Lynn & Main Inc v Brits Community Sandworks CC* 2009 1 SA 308 (SCA) 311B-C; GF Lubbe & PM Nienaber “Cession” in WA Joubert & JA Faris *LAWSA* 3 3 ed (2013) para 128; Van Huyssteen et al *Contract* 430.

Specifically, cession is frequently described as a “method of transferring incorporeal rights from one person to another”.<sup>335</sup>

Along similar lines as the assignment of choses in action in English law, the possibility of a cession of personal rights was brought about by centuries of legal development. The English concept of assignment of choses in action, however, exerted at most a negligible influence on the development of the South African law of cession.<sup>336</sup> Personal rights are ceded by a real agreement, which need not be in a particular form, unless the parties have agreed otherwise.<sup>337</sup> The real agreement requires consensus. Both parties to the agreement must intend to cede the rights (*animus contrahendi*) – the cedent intends to transfer the rights (*animus transferendi*) and the cessionary intends to receive them (*animus acquirendi*).<sup>338</sup> This intention must be “clear and beyond doubt”; a “loose understanding” does not suffice.<sup>339</sup> Underlying the real agreement is an obligatory agreement, which gives rise to the duty to cede the rights. This is the underlying *iusta causa* of the cession.<sup>340</sup> The obligatory agreement is typically a contract of sale, exchange, donation or the like. Notwithstanding initial ambivalence, cession is today regarded as an abstract legal act.<sup>341</sup> This means that the validity of the cession is not dependent on the validity of the underlying *causa*.<sup>342</sup>

In addition to consensus, the transfer of corporeal property requires delivery in the case of movables or registration in the case of immovables.<sup>343</sup> A contentious issue for many years was thus the question whether the delivery of a share certificate is required for a valid cession of the share. This was answered in the negative by the

<sup>335</sup> *Uxbury Investment (Pty) Ltd v Sunbury Investment (Pty) Ltd* 1963 1 SA 747 (C) 752A; *Lynn & Main Inc v Brits Community Sandworks CC* 2009 1 SA 308 (SCA) 311B.

<sup>336</sup> *Estate Fitzpatrick v Estate Frankel, Denoon v Estate Frankel* 1943 AD 207 at 220; Lubbe & Nienaber “Cession” in *LAWSA* 3 para 142.

<sup>337</sup> *Wright & Co v Colonial Government* 1891 8 SC 260 269; *McGregor’s Trustees v Silberbauer* 1891 9 SC 36 38; *Botha v Fick* 1995 2 SA 750 (A) 762F; *Grobbelaar v Shoprite Checkers Ltd* [2011] ZASCA 11 18; Van Huyssteen et al *Contract* 440.

<sup>338</sup> *McGregor’s Trustees v Silberbauer* 1891 9 SC 36; *Jeffrey v Pollak and Freemantle* 1938 AD 1 6-7; *Johnson v Incorporated General Insurances Ltd* 1983 1 SA 318 (A) 331G-H; Lubbe & Nienaber “Cession” in *LAWSA* 3 para 153.

<sup>339</sup> *Wright & Co v Colonial Government* 1891 8 SC 260 269.

<sup>340</sup> *Johnson v Incorporated General Insurances Ltd* 1983 1 SA 318 (A) 331G-H; Van Huyssteen et al *Contract* 433-436; Lubbe & Nienaber “Cession” in *LAWSA* 3 para 155.

<sup>341</sup> *Grobbelaar v Shoprite Checkers Ltd* [2011] ZASCA 11 17-18; *Rabinowitz v De Beers Consolidated Mines Ltd* 1958 3 SA 619 (A) 637A; Lubbe & Nienaber “Cession” in *LAWSA* 3 para 155; Zimmermann *Law of Obligations* 65 n 229.

<sup>342</sup> *Grobbelaar v Shoprite Checkers Ltd* [2011] ZASCA 11 18.

<sup>343</sup> See for example *Dreyer NNO v AXZS Industries (Pty) Ltd* 2006 5 SA 548 (SCA) 554.

court in *Botha v Fick*.<sup>344</sup> Shares, it was held, exist independently of the document<sup>345</sup> and thus the delivery of the document is not required.<sup>346</sup> The same applies to the so-called “doctrine of all effort”. Early cases such as *McGregor’s Trustees v Silberbauer* held that “when the cedent, the vendor, has done everything in his power to effect the cession of his right of action, the cession is completed”.<sup>347</sup> This doctrine was rejected in *Botha v Fick*.<sup>348</sup>

Being based exclusively on consensus, it follows that a valid cession does not require the cooperation or consent of a third party, most notably the debtor. The debtor, the issuer in the context of shares, need not even be notified of the cession,<sup>349</sup> although notification is advisable in light of the effects of a performance by the debtor to the cedent.<sup>350</sup> Notification not being a validity requirement, the company is not involved in the transfer of rights. It is a well-established principle, therefore, that performance by the debtor to the cedent, without knowledge of the cession or by acting in good faith, discharges the debt and releases the debtor.<sup>351</sup> The notice requirement may also explain the historical status of registration when compared to English law: In English law assignment requires notice to the debtor (but not consent of the debtor),<sup>352</sup> without which a legal (or statutory) assignment has not taken place. Notice is therefore a validity requirement in English law (at least in relation to statutory assignments) as opposed to merely influencing the effectiveness of the cession vis-à-vis the cessionary.<sup>353</sup>

<sup>344</sup> *Botha v Fick* 1995 2 SA 750 (A).

<sup>345</sup> 764 G-I; 769; 778H.

<sup>346</sup> 778H-I.

<sup>347</sup> *McGregor’s Trustees v Silberbauer* 1891 9 SC 36 38; See also *Jeffrey v Pollak and Freemantle* 1938 AD 1 14.

<sup>348</sup> *Botha v Fick* 778H-I.

<sup>349</sup> *Brook v Jones* 1964 1 SA 765 (N) 767A-B, and more recently *National Sorghum Breweries Ltd v Corpcapital Bank Ltd* 2006 6 SA 208 (SCA) 209E-F; *Van Staden v Firstrand Ltd* 2008 3 SA 530 (T) paras 27, 28.

<sup>350</sup> See paragraph immediately below; also see *Van Staden v Firstrand Ltd* 2008 3 SA 530 (T) para 27.

<sup>351</sup> *Brook v Jones* 1964 1 SA 765 (N) 767; *Agricultural and Industrial Mechanisation (Vereeniging) (Edms) Bpk v Lombard* 1974 3 SA 485 (O) 494G-495; *Pillay v Harichand* 1976 2 SA 681 (D) 684; *Lynn & Main Inc v Brits Community Sandworks CC* 2009 1 SA 308 (SCA) para 12. For further details, which cannot be discussed here, see Lubbe & Nienaber “Cession” in *LAWSA* 3 para 175.

<sup>352</sup> On the requirements of a valid assignment in English law, see above, 8 3 2 4 Novation and assignment.

<sup>353</sup> For a comparative overview of the notice requirement, see S Scott “The Comparative Method in Action – Aspects of the Law of Cession (Part 2)” (2001) 34 *De Jure* 1 1-3.

### 8 3 5 3 *The change in registration and holding*

Despite the provision in section 35(1) of the Companies Act pronouncing that a share is “transferable in any manner provided for or recognised by this Act or other legislation”,<sup>354</sup> the Act is mostly silent on the transfer of certificated shares. In section 51, titled “Registration and transfer of certificated securities”, it is merely provided that “a company *must enter in its securities register every transfer of any certificated securities*”.<sup>355</sup> A company may only record such a transfer if “(a) it is evidenced by a proper instrument of transfer that has been delivered to the company; or (b) was effected by operation of law”.<sup>356</sup> What the Act in essence concerns itself with is the registration of shares that have been transferred from one person to another.

Although the Act does not specify this, it is typically the responsibility of the purchaser to ensure registration.<sup>357</sup> The seller only has to deliver the instrument of transfer to the purchaser and do everything necessary to enable the registration of the purchaser.<sup>358</sup> The company need not be handed the share certificate to effect a transfer. Until registration of the purchaser in the place of the seller, it appears that the seller would act as the nominee of the purchaser.<sup>359</sup>

The practical effect of a change in registration is that the name of the previous shareholder is deleted from the register and is replaced with that of the new shareholder. A change in holding takes place. It would be inaccurate to describe this change as a transfer.

### 8 3 5 4 *Agency, representation and mandate*

On nominees, Justice Trollip in *Sammel v President Brand Gold Mining Co Ltd*<sup>360</sup> writes:

“Hence, no one can be registered as holding the shares as the agent for another; he, the agent, must himself appear on the register as the holder of the shares. Consequently,

<sup>354</sup> S 35(1) of the Companies Act 71 of 2008.

<sup>355</sup> S 51(5) (own emphasis added).

<sup>356</sup> S 51(6)(a)-(b).

<sup>357</sup> Delpont *Henochsberg* 210(1)-211, 214; De Wet & Van Wyk *Kontraktereg en Handelsreg* 628.

<sup>358</sup> *Standard Bank of SA Ltd v Ocean Commodities Inc* 1980 2 SA 175 (T) 181; Delpont *Henochsberg* 210(1); De Wet & Van Wyk *Kontraktereg en Handelsreg* 629.

<sup>359</sup> *Moosa v Laloo* 1957 4 SA 207 (N); Delpont *Henochsberg* 211; P Sutherland “Companies and Other Business Entities” in CG van der Merwe & JE du Plessis (eds) *Introduction to the Law of South Africa* (2004) 365 377. In *Standard Bank of SA Ltd v Ocean Commodities Inc* 1980 2 SA 175 (T) 182, the court refers to the transferor as a trustee for the transferee.

<sup>360</sup> 1969 3 SA 629 (A).

such a person came to be known in ordinary commercial parlance as the 'nominee' of the owner of the shares, probably because the word conveniently and usefully synthesized the dual concepts that the person was nominated by the owner to hold the shares for him in his name and that he thus held them only nominally, i.e., in name only."<sup>361</sup>

This passage makes it clear that relationships between investors and nominees or between nominees *inter se* are not traditionally considered in the light of the rules on deposit, but are rather thought to be agency relationships.<sup>362</sup> This is in line with the classification of shares as intangibles.

The meaning of the concept "agency" is manifold.<sup>363</sup> It is therefore suggested that the term agency does not convey the branch of the law applicable to a specific situation.<sup>364</sup> Most commonly, agency describes the situation where one person (the agent) is authorised by another person (the principal) to enter into a transaction with a third party or perform another juristic act on behalf of and in the name of the principal and this transaction will take effect as between the principal and the third party.<sup>365</sup> Thus, the agent acts, but the effects of his action are imputed to the principal. This is a description of agency as representation. Its focus lies on the resulting contractual relationship between the principal and the third party.<sup>366</sup> At the same time, the concept necessarily denotes a contractual relationship (whether express or implied) between the principal and the agent as well as a delineation of the capacity of the agent originating in a grant of authority.<sup>367</sup> The relationship

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<sup>361</sup> 666 F-G.

<sup>362</sup> Blackman et al *Commentary on the Companies Act* 5-169 n 3, 5-172 – 5-172-1. Also see Holmes JA in *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 1 SA 441 (A) 453: "A nominee is an *agent* with limited authority: he holds shares in name only" (own emphasis). The position of the nominee that holds securities must be distinguished from that of a stockbroker that concludes trades in securities. Stockbrokers are generally thought to act as principals. See RA de la Harpe "Securities Registration and Transfer (ss 49-56)" in JL Yeats (ed) *Commentary on the Companies Act of 2008* (OS 2018) 2-506 2-1012–2-1014. Also see below, n 371.

<sup>363</sup> See especially M Dendy & JC de Wet "Agency and Representation" in WA Joubert & JA Faris *LAWSA* 1 3 ed (2014) para 125.

<sup>364</sup> DJ Joubert & DH van Zyl "Mandate and Negotiorum Gestio" in WA Joubert & JA Faris *LAWSA* 17(1) 2 ed (2009) para 1.

<sup>365</sup> G Bradfield "Agency" in F Du Bois Wille's *Principles of South African Law* 9 ed (2007) 983 984; Zimmermann *Law of Obligations* 46; Dendy & De Wet "Agency and Representation" in *LAWSA* 1 para 125, 126.

<sup>366</sup> Bradfield "Agency" in Wille's *Principles* 986. German legal theorists distinguish between the mandate as regulating the internal relationship between the principal and his agent and the grant of authority as determining the scope of the external relationship between the principal and the third party as brought about by the agent – see P Laband "Die Stellvertretung bei dem Abschluss von Rechtsgeschäften nach dem Allgemeinen Deutschen Handelsgesetzbuch" (1866) 10 *ZHR* 183 183-241; also see Zimmermann *Law of Obligations* 57-58.

<sup>367</sup> Dendy & De Wet "Agency and Representation" in *LAWSA* 1 para 125.

between the principal and his agent is contractual, most commonly a contract of mandate coupled with the power of representation.<sup>368</sup> The contract of mandate may relate to the performance of any number of juristic or non-juristic acts, including the conclusion of a contract, its novation or the receipt- or making of performance.<sup>369</sup> Whether a mandate relates to a single act or is more general in nature depends on the agreement between the parties.<sup>370</sup> In share transactions, agency relationships abound. Where a broker, for example, is contracted to bring about a sale and purchase of shares, he acts as an agent. According to Malan, such a broker acts as a mere mandatary, without the power of representation.<sup>371</sup> It is not necessary to test this assertion, as the legal relationships pursuant to the holding of securities are of primary interest.

To determine the precise meaning of the term agency as used in relation to the holding of shares, it may be useful to accurately identify what is being intermediated by a nominee. It is only the power to enforce performance which is held by another person and which enables him to collect performance and generally administer securities on behalf of an investor. The agent does so in his own name, evidenced by registration in his name and the fact that a company is mandated to look only towards such person for performance.<sup>372</sup> Registration is the mere recognition of title and not a requirement for obtaining title to shares.<sup>373</sup> By registration, a shareholder does not enter into a contract with an issuer for obtaining title to shares. Rather, the issuer is statutorily obliged to perform towards the shareholder. Registration relates to holding, not ownership, but the power to hold follows ownership. It is a power that must be either exercised by the owner or conferred by him to be exercised by another person. The holder is an agent with limited authority. An agent contracts with a third party in his own name, or in this case assumes the statutory role of a shareholder, but subject

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<sup>368</sup> Bradfield "Agency" in *Wille's Principles* 986. The contract does not have to be one of mandate however, see AJ Kerr *The Law of Agency* 4 ed (2006) 5-6.

<sup>369</sup> Joubert & Van Zyl "Mandate and Negotiorum Gestio" in *LAWSA 17(1)* para 3.

<sup>370</sup> Para 3.

<sup>371</sup> FR Malan *Collective Securities Depositories and the Transfer of Securities* (1984) 169-160. But see case law describing brokers as "agents" – *Koenigsberg's Trustees v Taylor* 1925 TH 277 284. See FR Malan & MJ Oosthuizen "Brokers, their Customers and the Transfer of Securities" (1988) 4 *TSAR* 477. See further case law mentioned in Malan *Collective Securities Depositories* 157 n 86 and 87. Also see above, n 362.

<sup>372</sup> See above, 8 2 4 Registration in South African law.

<sup>373</sup> See above, 8 2 Registration.

to limited authority granted by the principal.<sup>374</sup> The identity of the investor is irrelevant to the relationship between the mandatary and the issuer. In terms of the grant of authority, the mandatary has to pass on all benefits received by him from the issuer to the mandatary. The shareholder does not act as a conduit to bring about a legal relationship between an investor and an issuer. He is authorised only to bring about a legal relationship between himself and the issuer through registration, but acts as a mere conduit for the principal in respect of the performance that flows from the relationship.

The fact that an agent (acting as a nominee) acts in his own name and, at least traditionally, is neither obliged to reveal the identity of the principal, nor that he is acting as an agent, distinguishes nominees as agents from ordinary agency constructs. Ordinarily, an agent must either act in the name of the principal or indicate that he is acting for an unnamed principal.<sup>375</sup> An exception to this rule can be found in the doctrine of the undisclosed principal, which is considered to be anomalous, but justified by commercial convenience.<sup>376</sup> In this sense, a nominee is analogous to an agent of an undisclosed principal.<sup>377</sup> On the other hand, it is important to recognise that a shareholder as an agent is simultaneously a legislative construct and a nominee must be viewed in the context of specific legislative provisions. The Companies Act has traditionally not obliged shareholders that act as nominees to reveal their agency status to the company. To only view nominees as common law agents therefore falls short of their true characterisation. In addition, one of the most controversial aspects of the undisclosed principal is the fear that the principal can suddenly emerge from obscurity and enforce contractual rights.<sup>378</sup> This possibility is, however, expressly excluded in the context of shareholders acting as nominees.<sup>379</sup> In the context of mandatory beneficial interest disclosures for listed

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<sup>374</sup> FR Malan “Depositories, Nominees and the Uncertificated Security” (1987) *Moderne Besigheidsreg* 73 78, writes: “A nominee is an agent with limited authority who holds securities in his own name but on behalf of the owner. The precise nature of the relationship between the owner and the nominee is determined by contract which in the case of a managed securities portfolio, usually contains elements of a mandate”. Also see *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 1 SA 441 (A) 453: “A nominee is an *agent with limited authority*: he holds shares in name only” (own emphasis).

<sup>375</sup> Dendy & De Wet “Agency and Representation” in *LAWSA 1* para 136.

<sup>376</sup> Para 173; also see the cases cited in n 4.

<sup>377</sup> In effect an undisclosed agent see Para 173.

<sup>378</sup> Para 171.

<sup>379</sup> See s 37(9) of the Companies Act of 71 of 2008. Also see above, n 46.

shares, any analogy of nominees acting in their own name, but on behalf of other, unidentified persons to the doctrine of the undisclosed principal has become moot.

## 8 4 Certainty of transfer

### 8 4 1 Certainty of transfer and trust

“Trust is fundamental to commercial transactions”.<sup>380</sup> Yet, trust always poses a risk to the transacting parties. There are several factors that contribute to this risk when transacting with shares. One of them is that the parties rarely ever transact face-to-face. These elements of anonymity and multi-party involvement, while greatly enhancing the liquidity of shares, have the downside of increasing the risk of trust and reliance. This risk can be mitigated by conducting research into the reputation and reliability of a counterparty to a transaction.<sup>381</sup> Comprehensive research may attract significant transactions costs.<sup>382</sup>

The law has therefore devised several mechanisms to help ameliorate the trust conundrum.<sup>383</sup> The existence of the share certificate, and somewhat less so the register, in conjunction with the statements it makes about ownership presumptions is one such mechanism.<sup>384</sup>

When concluding a contract for the purchase of shares, the purchaser has the legitimate expectation that he will become the owner of the shares in due course. An existing owner similarly places his confidence in a legal system to protect his ownership interests. Balancing these expectations may be one of the most difficult tasks undertaken by the law. Although both expectations are founded in trust, trust is a legally empty concept<sup>385</sup> that must be given content by distinct legal mechanisms, the construction of which is dependent on discrete policy choices. These policy choices run like a golden thread through the development of the law on shares and securities.

<sup>380</sup> FB Cross & RA Prentice *Law and Corporate Finance* (2007) 28.

<sup>381</sup> 28-29.

<sup>382</sup> 29.

<sup>383</sup> Legal regulation and enforcement attracts transactions costs as well. This is at the root of the debate, conducted particularly among economists, on whether legal regulation is useful and desirable.

<sup>384</sup> See above, 8 1 The functions of the share certificate and 8 2 1 The functions of registration.

<sup>385</sup> See G Teubner “Expertise as Social Institution: Internalising Third Parties into the Contract” in D Campbell, H Collins & J Wightman (eds) *Implicit Dimensions of Contract: Discrete, Relational, and Network Contracts* (2003) 333 344.

## 8 4 2 “Verkehrsschutz” and the protection of bona fide purchasers in German law

The principal advantage of classifying shares as tangibles is the protection afforded to *bona fide* purchasers. This also appears to be the main motivation behind Savigny’s rejection of a transfer mechanism based on cession and his advocacy for treating shares as tangibles.<sup>386</sup> It has had a significant impact on the course of development of German securities law.

The German law of things recognises that two conflicting interests have to be balanced: On the one hand the interests of ownership have to be protected (“Eigentümerschutz”), on the other hand the expectations and interests of the acquirer are worthy of protection (“Erwerberschutz”), the recognition of which enhances the marketability and circulation of goods in the market (“Verkehrsschutz”).<sup>387</sup> One guarantor of the efficient circulation of movable property is the principle of abstraction. The separation of the real agreement from the underlying *causa* ensures that goods can circulate quickly and efficiently.<sup>388</sup> The ability to circulate is further strengthened by the good faith acquisition of movable tangibles.<sup>389</sup> If a disposal takes place,<sup>390</sup> the acquirer becomes owner even if the transferor is not the owner, provided that the acquirer is in good faith.<sup>391</sup> The acquirer is not in good faith if he knows that the transferor is not the owner of the thing or if he (the acquirer) is grossly negligent in not ascertaining this fact.<sup>392</sup> Possession of a movable thing ordinarily creates an impression of ownership (“Rechtsschein”).<sup>393</sup> The Federal Court of Justice has therefore clarified that the prerequisite for the good faith acquisition of ownership of a movable thing is the *bona fides* of the acquirer as well as the impression of ownership created by the possession of the movable thing.<sup>394</sup> Simple delivery in terms of § 929(1) sentence 1 is sufficient to create such an impression.<sup>395</sup>

<sup>386</sup> See above, 8 3 4 2 “Wertpapiere” and the materialisation of intangible rights.

<sup>387</sup> For justifications of the *bona fide* acquisition rule, see Baur et al *Sachenrecht* § 52 [8]-[10].

<sup>388</sup> Stadler *Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion* 728. Also see B Häcker *Consequences of Impaired Consent Transfers: A Structural Comparison of English and German Law* (2009).

<sup>389</sup> Although Häcker *Impaired Consent Transfers* 252 notes that “it is indeed hard to deny that the combination of abstraction and *bona fide* purchase within the BGB leads to a measure of overkill”.

<sup>390</sup> This is a disposal in accordance with §§ 329-331 BGB.

<sup>391</sup> BGB § 932(1) sent. 1.

<sup>392</sup> BGB § 932(2); Also see Handelsgesetzbuch § 367, which applies to merchants only.

<sup>393</sup> This impression is the basis for the presumption of ownership in BGB § 1006; see text to n 5 above. The good faith of the acquirer need not be causally connected to the impression so created; Wieling *Sachenrecht* 121.

<sup>394</sup> BGHZ 10, 81 (BGH, 11.06.1953 – IV ZR 181/52) Amtlicher Leitsatz.

<sup>395</sup> Baur et al *Sachenrecht* § 52 [3], [13].

To succeed with a defence based on good faith acquisition, the acquirer must therefore obtain some form of possession, particularly such possession that excludes the possession of the transferor.<sup>396</sup> This includes cases where a third party is in possession of the thing and the transferor merely assigns to the transferee, the right to claim the delivery of the thing from the third party (§ 931 as read with § 934 BGB),<sup>397</sup> but excludes those cases where possession remains with the transferor in terms of § 930 and 933 BGB.<sup>398</sup> In the latter case, it is argued, no impression of ownership is created for the acquirer to act upon.<sup>399</sup>

If the requirements of good faith and possession are met, the acquirer obtains full ownership unburdened by the rights of third parties.<sup>400</sup> Ownership of a movable thing is not acquired if the thing was stolen from the owner, was lost by him or went missing in any other way.<sup>401</sup> The principle behind this exception to the general rule is that the owner only loses ownership where he, through voluntarily providing another with possession of the object, creates the impression that the other is the owner. Where the loss of possession is involuntary, therefore, the rule does not apply.<sup>402</sup> Because the objective of circulation is prioritised in the case of shares, the exception does not apply to shares and other “Inhaberpapiere”.

#### 8 4 3 Negotiability and the protection of bona fide purchasers in US law

According to the general rules applicable to transfers of property at common law, a transferor cannot transfer more rights than he himself has. This is known as the *nemo plus iuris* or *nemo dat* rule. Classifying shares as tangibles to place them under the purview of property rules would therefore not be as attractive a solution as in German law. On the other hand, the commercial need for certainty and finality of transfers lead to the development of the negotiable instrument. Negotiability allows intangibles to be transferred like tangibles. Negotiability is not only aimed at

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<sup>396</sup> § 52 [3].

<sup>397</sup> These are cases where securities certificates are held by a third party. The seller (and owner) has the right to claim the certificates from the third party and assigns this right to the purchaser. No delivery takes place between the seller and purchaser.

<sup>398</sup> Micheler *Property in Securities* 171-172. This provision covers cases where the parties agree that the seller will remain in possession of the securities certificates, but ownership transfers to the purchaser without delivery. One example is where the seller is a financial institution that sells own securities to a purchaser who decides to keep them in deposit at the same bank. Also included are cases of a pledge of securities.

<sup>399</sup> 172.

<sup>400</sup> BGB § 936(1) sent 1.

<sup>401</sup> BGB § 935(1) sent 1.

<sup>402</sup> Baur et al *Sachenrecht* § 52 [7].

enhancing the ease with which shares can be transferred; it also ensures that the transferor takes the transferred instrument without any defects in title, provided that he acted in good faith. Negotiability therefore achieves the same result as the classification of shares as tangibles in German law.

The *nemo plus iuris* rule was long regarded unsuitable for the transfer of shares and other securities.<sup>403</sup> The rule, it was widely believed, would lead to a lack of certainty and significantly increase the transaction costs for potential purchasers, who have to investigate the title of their seller before entering into an agreement to purchase. This, so the thrust of the familiar argument, would significantly decrease the marketability and mobility of shares.<sup>404</sup> A finality principle was therefore applied to such transfers. Provided that the correct formal mechanism was followed, the transfer was final.<sup>405</sup> To the transfer of shares and other securities, the finality principle was applied as follows: A purchaser “who takes delivery of a security certificate in proper form for value and without notice qualifies as a bona fide purchaser who takes the certificate free from any adverse claim”.<sup>406</sup>

Inherent in the thrust of the argument in favour of negotiability is therefore the prioritisation of the acquirers’ interests over the interests of ownership. This balancing of interests is based not only on the interests of the acquirer. His concerns are rather representative of the interest that the entire legal (and commercial) community has in an efficient circulation of goods and the ease with which commercial operations take place.<sup>407</sup> This idea, aptly summed up in the German term “Verkehrsschutz”,<sup>408</sup> is of equal relevance in negotiable instruments law.

#### 8 4 4 Estoppel and the protection of bona fide purchasers in English law

Häcker writes: “Broadly speaking, the proprietary protection thus afforded to third party purchasers could be said to be too broad in German law and, by comparison,

<sup>403</sup> See the development of shares as negotiable instruments above, 8 3 3 2 Negotiation, assignment and the transfer of shares. Also see Rogers (1996) *UCLA LR* 1462.

<sup>404</sup> Rogers posits that there is little evidence to support this argument; See Rogers (1991) *Cardozo LR* 478-484. Also see AJ Rosenthal “Negotiability – Who Needs It?” (1971) 71 *Columbia LR* 375 376.

<sup>405</sup> Rogers (1996) *UCLA LR* 1462.

<sup>406</sup> 1462.

<sup>407</sup> L Rademacher *Verkehrsschutz im englischen Privatrecht: Zur Beständigkeit von Erwerbsvorgängen nach Englischem Sachen-, Stellvertretungs-, Abtretungs- und Bereicherungsrecht* (2016) 1.

<sup>408</sup> Häcker *Impaired Consent Transfers*, translates “Verkehrsschutz” as “transactional security”.

too narrow in English law.”<sup>409</sup> Protection of the purchaser is, however, far from absent in English law; it is just achieved in different, more roundabout ways.

Under English law, the risk of transfer of a defective title is generally placed on the buyer of the shares. In principle, a transferee cannot obtain a better title to the shares than the transferor had. This hardship is alleviated by shifting responsibility under some circumstances to the issuer. The share certificate, even if not fully mobile, nonetheless provides *prima facie* evidence of title to the shares.<sup>410</sup> It thus provides information on which a purchaser of shares can rely. If a company issues a share certificate, it makes certain representations, namely that the shares are paid up and that the person named on the certificate holds title to the shares. A transferee who relies on these representations can henceforth estop the company from denying the title of the transferor or from proving that the shares have not been paid up.<sup>411</sup> The purchaser cannot, however, compel the company to make an entry on the register in his favour or to rectify the register. The claim is solely one for damages.<sup>412</sup> If a company issues a share certificate pursuant to receiving a request for registration based on a forged certificate or transfer document, that certificate is therefore *prima facie* proof of title and any third party relying on it can claim an indemnity from the issuer.<sup>413</sup> The issuer can in turn claim the costs of this indemnity from the buyer of the forged certificate or his agent who initially presented the forged certificate for registration.<sup>414</sup> If a third party reaches his decision based on a forged certificate, the issuer has made no representation and cannot be estopped.<sup>415</sup>

As a general rule, the legal owner therefore retains the title to the shares, unless she has authorised a transfer or has created the impression that an agent had authority to transfer shares when he in fact did not. In the latter case, the buyer may

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<sup>409</sup> Häcker *Impaired Consent Transfers* 250. cf Micheler *Property in Securities* 101-102, who finds that the rules in English law provide a level of protection similar to that in German law. More generally also see Rademacher *Verkehrsschutz*.

<sup>410</sup> See above, 8 1 The functions of the share certificate.

<sup>411</sup> *Burkinshaw v Nicolls* (1878) 3 App Cas 1004; *Frederick Bloomenthal v James Ford* [1897] AC 156; Also see Pennington *Company Law* 350-354; D French, SW Mayson & CL Ryan *Mayson, French & Ryan on Company Law* 31 ed (2014-2015) 219; Micheler *Property in Securities* 97-98, 101-104.

<sup>412</sup> *Re Bahia and San Francisco Railway Co Ltd* (1868) LR 3 QB 584.

<sup>413</sup> Micheler *Property in Securities* 103-104.

<sup>414</sup> *Sheffield Coporation v Barclay* [1905] AC 392 (HL) also see the more recent case of *Cadbury Schweppes Plc v Halifax Share Dealing Ltd* [2006] EWHC 1184 (Ch). Micheler *Property in Securities* 105-106.

<sup>415</sup> Micheler *Property in Securities* 104.

exercise an estoppel against the owner preventing him from denying that the agent lacked authority to sell the shares.<sup>416</sup>

Micheler concludes that “[t]he rules on estoppel achieve a result comparable to the result achieved by the rules governing negotiable instruments. They transform shares into an asset that exists largely independently of the rules by which it was created.”<sup>417</sup>

#### 8 4 5 Estoppel and the protection of bona fide purchasers in South African law

A cession is a true transfer - the cessionary “steps into the shoes of the cedent”.<sup>418</sup> The rights of the cessionary are the same as those the cedent had. It therefore follows that the cessionary cannot obtain a better title to the shares than that which the cedent had.<sup>419</sup> A cession does not protect *bona fide* purchasers of shares.

The protection of *bona fide* purchasers of certificated shares was analysed extensively in Project 62 of the South African Law Commission.<sup>420</sup> The position in South African law is similar to that in English law. Both English and South African law assign the task of protecting *bona fide* purchasers of shares to the doctrine of estoppel.

That the concept of estoppel functions to temper the rights of the owner in favour of the rights of other parties appears from the judgement of Holmes JA in *Oakland Nominees v Gelria Mining*:

“Our law jealously protects the right of ownership and the correlative right of the owner in regard to his property, unless, of course, the possessor has some enforceable right against the owner. Consistent with this, it has been authoritatively laid down by this Court that an owner is estopped from asserting his rights to his property...”.<sup>421</sup>

The law of estoppel promotes the free flow of goods and services by providing a level of transactional security. In the words of Rumpff JA: “the demands of

<sup>416</sup> *Colonial Bank v Cady* (1890) 15 App Cas 267; *Fuller v Glynn, Mills, Currie & Co* [1914] 2 KB 168.

<sup>417</sup> *Micheler Property in Securities* 98.

<sup>418</sup> For the full implications of this “rule”, see Lubbe & Nienaber “Cession” in *LAWSA* 3 para 171; Van Huyssteen et al *Contract* 468-469 [12.58]-[12.59]. Compare this to a novation by way of a delegation where a debt is extinguished and a new one is created in its place – see Lubbe & Nienaber “Cession” in *LAWSA* 3 para 143.

<sup>419</sup> Van Huyssteen et al *Contract* 468 [12.59].

<sup>420</sup> See South African Law Commission *The Protection of a Purchaser of Shares: Report* (1993).

<sup>421</sup> *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 1 SA 441 (A) 452A.

commerce, as such, can have a restrictive influence on the application of the *rei vindicatio*...”<sup>422</sup>

Share certificates, even if not negotiable, do contain certain statements about ownership and entitlement.<sup>423</sup> They circulate in the market and are readily accepted as proof of ownership. The doctrine of estoppel latches onto these representations contained on the face of the certificate and conveyed by the fact of possession thereof. In terms of this doctrine, a purchaser can preclude the transferor “from denying the truth of a representation previously made by him [the transferor] to another person [the transferee] if the latter, believing in the truth of the representation, acted thereupon to his or her prejudice”.<sup>424</sup>

Traditionally, many cases of wrongful transfer in South Africa have arisen where a third party, such as a broker or a nominee, was in possession of the share certificates and transferred these without proper authority. In *United South African Association Ltd v Cohn*,<sup>425</sup> the court held that by endorsing a share certificate in blank and by entrusting that certificate to a third party for safe custody, the owner of the shares conveys to outside parties that the share is intended to circulate and that the third party has the authority to deal with it as owner.<sup>426</sup> In actual fact the owner of shares, by such conduct or other verbal or written representation, has given his “agent” ostensible authority. This is authority which never existed, but the purchaser can estop the true owner from denying that he gave the third party authority to sell the shares.<sup>427</sup> In *Oakland Nominees*, however, the court made it clear that where the owner does not put the shares in transferable form and does not create the impression that the third party has the authority to transfer them, the purchaser cannot rely on an estoppel.<sup>428</sup> Whether a purchaser must prove negligence on the part of the owner, in addition to the normal requirements for estoppel, to succeed with a claim based on estoppel has proven to be a contentious point.<sup>429</sup> Malan is of the opinion that “[d]eprivation of the shareholder of his rights, ... is not based on fault, or

<sup>422</sup> *Johaadien v Stanley Porter (Paarl) Pty Ltd* 1970 1 SA 394 (A) 411B (own translation). Also see 411C. The case raised the question of an estoppel in relation to movable goods.

<sup>423</sup> See above, 8 1 The functions of the share certificate.

<sup>424</sup> LTC Harms & PJ Rabie “Estoppel” in WA Joubert & JA Faris *LAWSA* 18 3 ed (2015) para 652.

<sup>425</sup> 1904 TS 733.

<sup>426</sup> *United South African Association Ltd v Cohn* 1904 TS 733 739-740.

<sup>427</sup> Also see *Van Blommenstein v Holliday* 1904 21 SC 11; *West v Pollak & Freemantle* 1937 TPD 64; *West v De Villiers* 1938 CPD 96.

<sup>428</sup> *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 1 SA 441 (A) 456-457.

<sup>429</sup> For an overview of the case law, see South African Law Commission *The Protection of a Purchaser of Shares: Report* Chapter 4.

on some fiction that the shareholder is negligent. It is rather a question of finding suitable and equitable criteria for attributing responsibility for the loss...".<sup>430</sup>

Instances of an estoppel raised against the company for representations made on the share certificate, common in England,<sup>431</sup> are rare in South Africa. Nonetheless, the principles enunciated by English courts in this regard were upheld by a South African court in *Albatross Fishing Corporation (Pty) Ltd v Ramsay*.<sup>432</sup>

## 8 5 Taking stock

The legal systems surveyed provide for nominees that hold securities for and on behalf of others. Functionally, a distinction can therefore be drawn between the ability to enforce and receive performance from the company and the entitlement to the benefits of performance. In the context of traditional paper-based systems, company laws facilitate such intermediation with the aid of a certificate, a register entry or a combination of both. Conceptually and from the perspective of private law, this distinction is mapped in different ways. The English legal system conceives of this distinction as a division of ownership into legal and beneficial ownership subject to the rules on trust law. The legal owner appears from the register and is in a position to receive performance from the issuer. The beneficial owner is entitled to the benefits of such performance. US law and German law traditionally understand the distinction on the basis of a relationship of deposit, US law through its classification of shares as negotiable instruments and German law by categorising shares as tangibles. The possessor of the physical token – the share certificate – has the ability to demand performance from the issuer. Such performance must be delivered to the depositor – the owner. South African law, on the other hand, considers the split to be the result of an agency relationship. References to concepts such as legal and beneficial ownership are misplaced in South African law. Registration places a shareholder in a position to demand and receive performance from the issuer. This must not detract from the fact that the shareholder does not become the owner of shares and must pass on the benefits to the owner. Functionally, all of these methods achieve the same result.

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<sup>430</sup> Malan (1977) *SALJ* 254.

<sup>431</sup> See above, 8 4 4 Estoppel and the protection of bona fide purchasers in English law.

<sup>432</sup> 1968 2 SA 217 (C).

To accommodate this functional distinction legal systems have devised mechanisms which enable the company to render performance, namely either registration or possession. These mechanisms must not be viewed in isolation. Possession of a share certificate may for example be an important indicator of the right to be on the register.

A distinction must therefore be drawn between the holding and “ownership” of shares. While the former is associated with the ability to enforce performance, the latter, where these functions are split, relates to the right to receive benefits. The establishment of a structure of holding, be it by trust, deposit or agency, creates lasting, vertical relationships. The value of a share lies in the relationship with an issuer; holding, on the other hand “is concerned with attributing the issuer-holder relationship” to a particular person.<sup>433</sup>

What differs between the conceptual design of these holding systems, is the direction of disbursement of powers or rights. Picture holding structures as pyramids with an issuing company located at the apex and investors and ultimate beneficiaries at the base. Trusts are top-down structures. Enforcement rights vest in the legal owner and any equitable rights are conceptually construed to flow from the legal ones.<sup>434</sup> Deposit is bottom-up in that it is the entitlement-holder that is thought to confer certain rights of enforcement on another person through a transfer of possession. In South Africa, agency relationships also confer the power to hold, and therefore the ability to effect registration, from the bottom up.

In all legal systems, a change in holding must be distinguished from a transfer of ownership of the shares.<sup>435</sup> The change in holding can stand independently from a transfer of ownership and is subject to its own transfer mechanisms. A change in holding may for example be brought about by a change in registration or the delivery

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<sup>433</sup> JH Sommer “International Securities Holding and Transfer Law” (2001) 18 *Ariz J Int & Com L* 685 688-689. But note that according to the provisions of the South African Companies Act 71 of 2008, the definition of “holder” for purposes of transactions which are subject to the Takeover Regulations (as contained in ss 117-127) includes a person who holds a beneficial interest in securities; see s 117(1)(e). There is thus an overlap between “holding” and “ownership”. Also see, 8 2 4 Registration in South African law n 47 above, on the concept of “beneficial interest” holders and its difficulties.

<sup>434</sup> This can be explained with reference to the dictum of Lord Browne-Wilkinson in *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669 (HL) 706: “A person solely entitled to the full beneficial ownership of money or property, both at law and in equity, does not enjoy an equitable interest in that property. The legal title carries with it all rights. Unless and until there is a separation of the legal and equitable estates, there is no separate equitable title.”

<sup>435</sup> In England, however, this translates to a transfer of legal and equitable title.

of possession. A transfer of ownership on the other hand is brought about by mechanisms which have in common that they require the intention to transfer rights (and obligations). Both a change in holding and a transfer of ownership differ from the creation of holding structures in that these are essentially once-off transactions, not lasting relationships.

## Chapter 9: The progression towards systemic intermediation

### 9 1 General remarks

When an increase in trading speed and volume ushered in an electronically-based system of holding and transferring shares, the need to accommodate the functions previously performed by share certificates, share registers and legal institutions such as possession, ownership, trusts, deposit and agency shaped the legal design of holding systems and transfer mechanisms in substantial, but different ways.

The use of physical certificates, initially aimed at enhancing transferability,<sup>1</sup> has the opposite effect in high-volume, high-speed and globalised modern trading environments. It has become impossible to move large volumes of certificates around the world and to do so timeously.<sup>2</sup> The importance of the certificate as “the proper (and, indeed, the only) documentary evidence of title in the possession of a shareholder”<sup>3</sup> continuously diminished with the rise of uncertificated securities.

The historic development of each legal system sketched above, illustrates that, despite the functional similarities, each system developed at its own pace. Thus, systems built on the possession of share certificates, notably the US and German legal systems, progressed towards more sophisticated nets of intermediaries considerably earlier. These systems, developing in a path-dependent manner, did not get rid of certificates completely. They rather accommodated them within their existing conceptual framework. The decisive progression present across all legal systems was therefore neither from certificated to uncertificated securities nor from systems of direct holding to indirect holding systems. Early networks of intermediaries exhibit few of the characteristics present today. The key progression was facilitated by the introduction of pervasive electronic technologies that enabled the creation of complex structures of intermediaries.

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<sup>1</sup> See above, 8 1 The functions of the share certificate.

<sup>2</sup> M Vermaas “The Reform of the Law of Uncertificated Securities in South African Companies Law” (2010) *Acta Juridica* 87 93.

<sup>3</sup> *Société Générale de Paris v Walker* (1885) App Cas 20 (HL) 29 as quoted in JT Pretorius, PA Delpont, M Havenga & M Vermaas (eds) *Hahlo’s South African Company Law through the Cases* 6 ed (1999) 169; Delpont *Henochsberg* 209.

## 9 2 Immobilisation and Dematerialisation

Following the crises caused by paper-based systems, electronic settlement systems were introduced. Electronic settlement necessitated the abandonment of paper certificates. The form that shares were issued in as paper-based instruments, determined the approach to electronic settlement. In 1989 the Group of 30 published an influential report on “Clearance and Settlement in the World’s Securities Markets”,<sup>4</sup> which identified two models to facilitate electronic settlement – immobilisation and dematerialisation.<sup>5</sup>

Systems which traditionally issued shares in bearer form or as negotiable instruments have frequently opted for the immobilisation of securities. Immobilisation is the “storage of securities certificates in a vault in order to eliminate physical movement of certificates/documents on transfer of ownership”.<sup>6</sup> Due to the risk of theft and fraud associated with bearer shares, “Wertpapiere” and negotiable instruments, systems for the deposit and safekeeping of certificates developed. Although physical certificates continue to exist, often in the form of global or jumbo certificates,<sup>7</sup> they are stored in a depository,<sup>7</sup> and no longer circulate. Deposit, however, did not only eliminate the movement of paper. Initially only aimed at safekeeping, depositories also turned into settlement agents so that shares are also transferred by book entries made by depositories.

An alternative approach is dematerialisation. Dematerialisation is the “elimination of physical certificates or documents of title which represent ownership of securities so that securities exist only as computer records”.<sup>8</sup> Certificates are no longer issued, resulting in the complete elimination of paper. Title to shares is recorded and transferred by electronic book entries.

Both, dematerialisation and immobilisation convert paper certificates into electronic account entries. In immobilised systems the certificate is retained as a

<sup>4</sup> Group of Thirty *Clearance and Settlement Systems in the World’s Securities Markets* (1989).

<sup>5</sup> 55-56; also see Recommendation 3 at 7-8.

<sup>6</sup> Group of Thirty *Clearance and Settlement Systems in the World’s Securities Markets* (1989) 83; See also S Schwarz “Intermediated Securities” in J Basedow, KJ Hopt, R Zimmermann & A Stier (eds) *The Max Planck Encyclopaedia of European Private Law* (2012) 950 950; R Goode “The Nature and Transfer of Rights in Dematerialised and Immobilised Securities” (1996) *JIBFL* 167 168.

<sup>7</sup> Both, global and jumbo certificates, are a single certificate representing an entire issue. Whereas a jumbo certificate can however be divided into individual certificates, the division of a global certificate is impossible.

<sup>8</sup> Group of Thirty *Clearance and Settlement Systems in the World’s Securities Markets* (1989) 82; See also Schwarz “Intermediated Securities” in *Max Planck Encyclopaedia* 951; Goode (1996) *JIBFL* 168.

conceptual token. Whereas an account entry *replaces* the paper certificate when dematerialised, it merely *represents* the paper certificate when immobilised.<sup>9</sup>

As a result of the concept of storing share certificates centrally, immobilisation automatically severs the direct relationship between the issuer and the investor. A depository or custodian typically acts as a holder of the shares. At least one intermediary is positioned between the investor and the issuer and the investor must exercise her rights through the intermediary. The same is not true for dematerialised shares. Dematerialisation by itself has no impact on the relationship between the issuer and investor.<sup>10</sup> Yet, even where the system permits investors to hold shares directly, in practice many investors will make use of custodians who hold investor's shares in pooled accounts maintained in their own (the custodian's) name. Such intermediation had already developed prior to the introduction of electronic systems.<sup>11</sup> The reality is therefore that a great number of dematerialised shares are today held by intermediaries. It therefore appears that the *modus operandi* of classifying holding systems as direct or indirect is unhelpful and probably redundant.<sup>12</sup>

Although both immobilisation and dematerialisation are aimed at eliminating the circulation of paper and replacing it with electronic entries, this aim is achieved in different ways. These differences can mostly be traced back to legal rules and structures that were prevalent before electronic processes changed the landscape of securities holding and trading.

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<sup>9</sup> L Thévenoz "Intermediated Securities, Legal Risk, and the International Harmonization of Commercial Law" (2008) 13 *Stan JL Bus & Fin* 384 386.

<sup>10</sup> Goode (1996) *JIBFL* 168. M Dubovec *The Law of Securities, Commodities and Bank Accounts: The Rights of Account Holders* (2014) 34.

<sup>11</sup> See above, 8 3 2 6 Equity and trusts and 8 3 5 4 Agency.

<sup>12</sup> Much of the early research into securities systems focused on the distinction between direct and indirect systems. Yet, as Phillip Paech points out, it is unclear what is meant by a direct system – it is the complete absence of intermediaries or the fact that investors have "property" rights in the securities? P Paech "Market Needs as Paradigm – Breaking up the Thinking on EU Securities Law" in P-H Conac, U Segna & L Thévenoz (eds) *Intermediated Securities: The Impact of the Geneva Securities Convention and the Future European Legislation* (2013) 22 50-51.

## 9 3 Intermediation and the creation of new assets

### 9 3 1 The economic theory of intermediation

Intermediation is a central feature of modern economic systems.<sup>13</sup> One of the primary functions of financial markets is to allocate capital by collecting funds from those market participants who have a surplus of funds and directing them to those participants that are in need of funds to finance operations and growth. To match the supply and demand of capital may sound easy in theory, but is difficult to achieve in practice. Two factors serve to ameliorate the discrepancy between the supply and the demand of capital: financial instruments and financial intermediaries.

It is trite to state that financial instruments play a key role in financial transactions.<sup>14</sup> Moore describes the effect of financial instruments as two-fold: they have an intermediation effect and a transmutation effect. Financial instruments facilitate an exchange between market participants because they are a generally accepted means of payment (comparable to money).<sup>15</sup> As a result, the exchange is not dependent on a simultaneous concomitance of needs and wants as would be the case in transactions of barter. The (mostly) free circulation of financial instruments adds the possibility of a time-discrepancy to the supply and demand of capital. In this way, financial instruments intermediate between market participants to such an extent that Moore terms the exchange an indirect one.<sup>16</sup>

In addition, financial instruments, according to Moore, have a transmutation effect. They have the effect of transforming real wealth (in the form of tangible assets) into financial wealth from the perspective of the supplier of capital and *vice versa* from the perspective of the user of capital.<sup>17</sup> The transformation aims to transform the

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<sup>13</sup> G Gorton & R Winton “Financial Intermediation” in GM Constantinides, M Harris & R Stulz (eds) *Handbook of the Economics of Finance IA* (2003) 431 433: “Financial intermediation is a pervasive feature of all the world’s economies”; TCW Lin “Infinite Financial Intermediation” (2015) 50 *Wake Forest LR* 643 643: “Intermediation is a fundamental fact of finance” and “form[s] the fabric of modern finance”.

<sup>14</sup> For a description of the term, see previous chapter.

<sup>15</sup> BJ Moore *An Introduction to the Theory of Finance: Assetholder Behaviour under Uncertainty* (1968) 16.

<sup>16</sup> Indirect exchange in this instance does not imply that an intermediary institution is positioned between the market participants, but merely that the financial instrument itself is the “intermediary”.

<sup>17</sup> Moore *Theory of Finance* 17. Linking the financial capital supplied to the tangible assets they are ultimately used to purchase does not give the holders of the financial instruments any direct claim to these assets. This would be in conflict with the principle of separate juristic personality (see above, 4 2 1 The development of the doctrine of juristic personality and 4 2 2 The consequences of juristic personality). It is suggested that the proposition by Moore has more descriptive value. It is for example

characteristics of the financial assets to better meet the needs and demands of the potential borrowers of capital, such as building the characteristic of limited liability into equity securities.

The “intermediation” function of financial instruments alone is insufficient to solve the demand and supply conundrum of capital. In addition, institutions that act as “financial intermediaries” position themselves between the suppliers and users of capital. A comprehensive economic model of financial intermediation was first formulated by Gurley and Shaw.<sup>18</sup> Traditionally, financial intermediaries are defined as financial institutions that “purchase primary securities from ultimate borrowers and [to] issue indirect debt for the portfolios of ultimate lenders”.<sup>19</sup> The archetype of financial intermediaries according to this definition, are banks. Banks accept short-term deposits (indirect securities) and convert these to long-term loans advanced to companies (primary securities). In this process, they channel capital from their deposit customers to their loan customers. In addition, they transform the characteristics of the financial assets, effecting a change of maturity (from short-term to long-term loans), liquidity (from demand deposits to mortgages) and risk profile (investing insured deposits in risky assets). In the traditional model, all intermediaries therefore create financial assets,<sup>20</sup> in particular financial assets with characteristics that differ from those exhibited by the primary securities. From an examination of the reasons for the existence of intermediaries as well as a description of the functions they perform, it will emerge that this definition of financial intermediaries is too narrow in a modern context.

Following Gurley and Shaw, most of the economic literature on financial intermediaries was an examination of why market participants transact indirectly

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impossible to link the value of the financial instrument to the value of the underlying assets. It may, at most be one of numerous factors that determine the value of a financial instrument.

<sup>18</sup> JC Gurley & ES Shaw *Money in a Theory of Finance* (1960).

<sup>19</sup> Gurley & Shaw *Money in a Theory of Finance* 192. Similar Moore *Theory of Finance* 95-96: Financial intermediaries are financial institutions “whose principal economic activity is the purchase and sale of financial assets”; HE Leland & DH Pyle “Informational Asymmetries, Financial Structure, and Financial Intermediation” (1977) 32 *Jnl of Finance* 371 382: Financial intermediaries are “firms which hold one class of securities and sell securities of other types”. In the definition, Gurley and Shaw distinguish between primary securities and indirect securities. Whereas primary securities are claims against market participants (typically companies) “whose principal economic activity is to buy and sell productive factors and current output”, indirect securities are “claims against financial institutions whose principal economic activity is the purchase and sale of financial assets”. – see Moore *Theory of Finance* 95-96.

<sup>20</sup> Gurley & Shaw *Money in a Theory of Finance* 198.

through intermediaries rather than directly.<sup>21</sup> The early answers involve transaction costs and information asymmetries. Specialised intermediaries reduce the costs of exchanging capital. It takes time and effort for a borrower to find a suitable lender and vice versa. Intermediaries reduce search and information costs by facilitating contact between lenders and borrowers.<sup>22</sup> Transactions costs are reduced further by aggregating the interests of a large group of investors and thereby avoiding the wasteful duplication of costs.<sup>23</sup> Intermediaries reduce transaction costs by obtaining information about the company and the quality of the investment, by negotiating the exchange and concluding contracts favourable to investors and by monitoring the fulfilment of contractual duties on behalf of investors.<sup>24</sup>

Markets are not perfect. Situations frequently arise in which one market participant has information that is superior to that of another in an exchange transaction. The informational asymmetry can be of an *ex ante* or an *ex post* nature.<sup>25</sup> Typically, the lender or user of capital possesses information about the investment not available to the investors or suppliers of capital. This information may not be publicly available and costs have to be incurred by the investor to obtain it. Alternatively, the credibility of the information available to the investor may be difficult to evaluate. The problem can be overcome by financial intermediaries who serve to close information gaps between the transacting parties by specialising in obtaining information on behalf of their clients.

More recently the continued exclusivity and even relevance of these reasons as explanations for the existence of intermediaries has been questioned.<sup>26</sup> Despite a

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<sup>21</sup> This is similar to the question as to why market participants transact through firms instead of through the market (see, 4.3 The nexus theory) and in fact the reasons provided in answer to this question are very similar to the reasons advanced here.

<sup>22</sup> N Galpin & H Park "The Roles of Financial Intermediaries in Raising Capital" in BH Kent & GS Martin (eds) *Capital Structure and Corporate Financing Decisions: Theory, Evidence, and Practice* (2011) 263 265.

<sup>23</sup> RTS Ramakrishnan & AV Thakor "Information Reliability and a Theory of Intermediation" (1984) 51 *RESTUD* 415 416.

<sup>24</sup> See for example GJ Benston & CW Smith "A Transactions Cost Approach to the Theory of Financial Intermediation" (1976) 31 *Jnl of Finance* 215; DW Diamond "Financial Intermediation and Delegated Monitoring" (1984) 51 *RESTUD* 393; K Judge "Fee Effects" (2013) 98 *Iowa LR* 1517 1538-1541.

<sup>25</sup> For *ex ante* informational asymmetries, see Leland & Pyle (1977) *Jnl of Finance*. In general see B Scholtens & D van Wensveen "The Theory of Financial Intermediation: An Essay on What it (Does) Not Explain" (2003) *Discussion Paper: SUERF – The European Money and Finance forum Vienna 2003*.

<sup>26</sup> See for example F Allen & AM Santomero "The Theory of Financial Intermediation" (1998) 21 *JBF* 1461; B Scholtens & B van Wensveen "A Critique on the Theory of Financial Intermediation" (2000) 24 *JBF* 1243; F Allen & AM Santomero "What do Financial Intermediaries Do?" (2001) 25 *JBF* 271.

marked decrease in transaction costs and informational asymmetries, intermediaries continue to flourish.<sup>27</sup> Many authors therefore highlight the ability of intermediaries to manage and redistribute risk at minimal cost as an additional factor.<sup>28</sup> Furthermore, intermediaries are said to reduce the costs of participating in financial markets.<sup>29</sup> Scholtens and Van Wensveen conclude that the primary focus of intermediary theory should be the value-addition undertaken by intermediaries in financial markets.<sup>30</sup>

Frankly, it is difficult to separate the question of why intermediaries exist from an analysis of their functions. In fact, the newer additions to financial theory set out above explicitly advocate a functional- instead of the traditional institutional perspective.<sup>31</sup> A core function of financial intermediaries remains that of capital aggregation i.e. collecting capital from market participants with a surplus and redistributing it to those with capital demands.<sup>32</sup> Some intermediaries are market-makers, matching suppliers and users of capital.<sup>33</sup> Stock exchanges are classic facilitators of exchanges. Other more traditional functions of intermediaries are those already mentioned above, namely risk management and the provision and clearing of information.<sup>34</sup> To achieve the overarching goal of efficient capital flows, an increasingly large and sophisticated brigade of intermediaries has emerged offering either a range of innovative, highly specialised intermediary services or a new take on the traditional functions described above. Advances in technology have had a particularly large impact on the growth and transformation of intermediaries.<sup>35</sup> Many of these intermediaries neither purchase nor create financial assets as analysed by

<sup>27</sup> Allen & Santomero (1998) *JBF* 1464-1466; Scholtens & Van Wensveen (2000) *JBF* 1245; Allen & Santomero (2001) *JBF* 272.

<sup>28</sup> See Allen & Santomero (1998) *JBF* 1465, Allen & Santomero (2001) *JBF* 288-289. Scholtens & Van Wensveen (2000) *JBF* 1247, 1247-1248 agree with Allen & Santomero but point out that risk-management is not a new phenomenon in intermediation. Also see Lin (2015) *Wake Forest LR* 648-649.

<sup>29</sup> Allen & Santomero (1998) *JBF* 1480-1482, but see the critical analysis of Scholtens & Van Wensveen (2000) *JBF* 1248-1249.

<sup>30</sup> Scholtens & Van Wensveen (2000) *JBF* 1250-1251. Also see PC Leyens "Financial Intermediaries" in J Basedow, KJ Hopt, R Zimmermann & A Stier (eds) *The Max Planck Encyclopaedia of European Private Law I* (2012) 701 701, who writes that financial intermediaries are "all institutions supporting the congruence of supply and demand in financial markets".

<sup>31</sup> See the references in n 26 above.

<sup>32</sup> Lin (2015) *Wake Forest LR* 646; Judge (2013) *Iowa LR* 1539; Allen & Santomero (2001) *JBF* 273; Diamond (1984) *RESTUD* 398-399.

<sup>33</sup> Lin (2015) *Wake Forest LR* 648; Judge (2013) *Iowa LR* 1539; Allen & Santomero (2001) *JBF* 273.

<sup>34</sup> See Lin (2015) *Wake Forest LR* 648-650 and the references in n 28 above.

<sup>35</sup> H Genberg "The Changing Nature of Financial Intermediation and its Implications for Monetary Policy" in Bank for International Settlements (BIS) *Financial Market Developments and Their Implications for Monetary Policy* (2008) 100 101; Lin (2015) *Wake Forest LR* 652.

Gurley and Shaw and others.<sup>36</sup> While some intermediaries provide the technology, for example the electronic settlement and clearing system, others, such as depositories and designated participants of the settlement and clearing system provide access to the system. Indeed, the function of providing access to structures or systems is becoming increasingly important, bolstered by legal regulation. Kathryn Judge writes: “There are also many settings where market structures are so firmly entrenched, by law or otherwise, that a party seeking to consummate a particular type of transaction has little choice but to work with the intermediary controlling the relevant structure.”<sup>37</sup> Financial markets further exhibit an increase in complexity, whether brought about by technology or otherwise. Intermediaries play an important role in simplifying complexities on behalf of their clients.<sup>38</sup> Scholtens & Van Wensveen conclude that the role of intermediaries is that of active participants in financial markets.<sup>39</sup> They do not merely passively intermediate between two market participants; they add value to the exchange.<sup>40</sup> Intermediaries must be recognised as independent players in the financial markets.<sup>41</sup> The principal mechanism through which they add value remains the transformation of financial assets. The transformation may not be from one type of financial asset to another with vastly different characteristics, such as short- and long-term maturity (from a deposit to a long-term loan, for example). It is in fact frequently a more subtle transformation of, for example, liquidity, maturity, risk, location or complexity.<sup>42</sup> In addition, it is

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<sup>36</sup> Some, however, still do – see the example of securitisation to create new financial instruments such as asset-backed securities or mortgage-backed securities.

<sup>37</sup> Judge (2013) *Iowa LR* 1540. While stock exchanges have long become gatekeepers to markets in traditional debt and equity trading, the new breed of intermediaries specifically controls access to electronic structures. On the original “gatekeeper” literature see the references in Judge (2013) *Iowa LR* 1519 n 6.

<sup>38</sup> Allen & Santomero (2001) *JBF* 289. J Sommer posits that complexities are simplified by the compartmentalisation of functions so that complex nets of relationships are reduced to pairwise relations; JH Sommer “International Securities Holding and Transfer Law” (2001) 18 *Ariz J Int & Com L* 685 700. Also see below, 16 2 2 Joseph Sommer.

<sup>39</sup> Scholtens & Van Wensveen (2000) *JBF* 1250.

<sup>40</sup> Scholtens & Van Wensveen (2000) *JBF* 1250; Genberg “Changing Nature of Financial Intermediation” in BIS *Financial Market Developments* 101.

<sup>41</sup> Scholtens & Van Wensveen (2000) *JBF* 1250-1251: “His [the intermediaries’] business is selling financial services to customers and making a profit on it. Reducing costs and informational asymmetries may be part of this process, but it occurs as a by-effect.”

<sup>42</sup> Scholtens & Van Wensveen (2000) *JBF* 1250; Genberg “Changing Nature of Financial Intermediation” in BIS *Financial Market Developments* 101.

necessary to recognise that intermediaries increasingly also serve the purpose of transaction handling, information intermediation and access.<sup>43</sup>

The proliferation, increased specialisation and the transformative function of intermediaries become apparent when considering a few examples from the financial securities markets. Typically, the more sophisticated a settlement and clearing system becomes and the larger the volume of transactions processed by such system, the more specialisation takes place, increasing the number of intermediaries. A central securities depository (CSD) may for example provide the infrastructure for the settlement of securities transactions. The registered participants provide access to this settlement system, whereas settlement banks provide access to the payment system. A range of custodians further down the line in turn provide access to the system to end-investors, they can offer cost reductions by pooling securities and they simplify the complexity of the settlement process by concluding the exchange on behalf of clients. Intermediaries may undertake the netting of transactions for the settlement of funds, thereby expediting the exchange. They may provide clearing functions such as the matching of trade data (regularly undertaken by stock exchanges) or the reduction of counter-party risk through becoming guarantors of a trade (this is a function performed in sophisticated systems by intermediaries known as central counterparties); or they may facilitate the “transfer of ownership” by maintaining a system of ledgers and accounts. Custodians manage securities on behalf of clients, providing a service of simplification and convenience. The credit ratings supplied by rating agencies have an effect on the liquidity of securities and the services offered by international depositories promote trading on a global scale.

### 9 3 2 Relationship-based and systemic intermediation

In theory, a definition or description of intermediaries is therefore so wide that it includes any entity or institution that provides value-adding services in financial markets. For purposes of this analysis, the descriptor “intermediary” can be significantly narrowed by focusing exclusively on those intermediaries that are positioned between an issuer and an investor in relation to holding, “ownership”, and the flow of benefits. Of interest are therefore the relationship-based intermediaries, not those that provide a once-off service in the process of transacting with shares

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<sup>43</sup> The first two are named by Leyens “Financial Intermediaries” in *Max Planck Encyclopaedia of European Private Law I* 701 as functions in addition to transformation.

and other securities. Relationship-based intermediaries create vertical structures. Transaction-based intermediaries facilitate horizontal movement. The former type of intermediation creates a relationship between an investor and an intermediary. This relationship does not eliminate the issuer-investor relationship, but it may transform it. A vertical layering of relationships takes place.

The business of intermediation has evolved dramatically, particularly in the sphere of financial markets, from the custody and safekeeping of physical things to the custody of intangible investments.<sup>44</sup> Modern custody of investments is concerned with monetary value, not the physical integrity of the deposited thing. It is accompanied by a number of accessory services, such as settlement and clearing, which may indeed be the primary reason for appointing an intermediary.<sup>45</sup> This is true for all systems, regardless of whether they ever made use of the concept of deposit in relation to shares. Changes are primarily driven by the emergence of more, and particularly more specialised and sophisticated intermediaries. When referring to “intermediation”, two situations therefore need to be distinguished; for convenience, I will label them “simple intermediation” and “systemic intermediation”.

Nominee holdings of shares surfaced quite early in all of the legal systems surveyed. Although nominees do intermediate the relationship between the issuer and the investor, this intermediation is optional and the structure of the relationship between the investor and the use of a nominee is subject to their own determination. This is not what one usually has in mind when considering “intermediation” in a modern context. “Systemic intermediation” rather describes a form of intermediation that is frequently neither optional, particularly in the context of listed shares, nor can the framework, rules and structures of intermediation be negotiated by the parties. Essential system structures, such as settlement and clearing can regularly not be accessed without the assistance of certain intermediaries.<sup>46</sup> The same is true of the payment side of securities transactions – most investors are neither permitted nor do

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<sup>44</sup> AO Austen-Peters *Custody of Investments: Law and Practice* (2000) 2.

<sup>45</sup> 3.

<sup>46</sup> These intermediaries act as “gatekeepers” in that they provide access to markets and systems, see above, 9 3 1 The economic theory of intermediation. Also see CW Mooney “Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries” (1990) 12 *Cardozo LR* 305 316: “However, this intermediary control phenomenon reflects more than mere convenience for active investors; it is an essential element of their participation in the market.”

they desire to maintain accounts directly with a central bank.<sup>47</sup> Legal regulation is an enabler of systemic intermediation; in fact, for truly systemic structures of intermediation to exist, legislation is a prerequisite.

Systemic intermediation is shaped significantly by the electronic environment. Long past is the time when investors would receive aesthetically appealing certificates to evidence their shareholding and would have their name entered onto the company's share register or present the company with coupons to claim dividends or other performance by the company. In modern, indirect holding systems, one or more persons are typically positioned between the issuer and the investor. These persons perform an assortment of tasks, ranging from settlement and clearing, exercising voting rights, receiving income and capital distributions, maintaining customer accounts and making book entries, amongst others. A great preponderance of these tasks have an exclusive existence in the virtual world. This is the phenomenon of systemic intermediation.

Structures of intermediation now consist of various "tiers of intermediaries". At the top tier is the direct holder, registered as such on, either the records of an issuer or those maintained by a central securities depository. This is typically a depository or a similar central agency or system participant. At the bottom is the final investor. Sandwiched between them are one or more tiers of intermediaries. They maintain accounts on behalf of investors or lower-tier intermediaries and some of them access the central register. It is intermediaries that facilitate trading and settlement as well as the transfer of shares.<sup>48</sup> Intermediation therefore inevitably has an effect on how we hold shares, how we transfer shares, how we pay for the transfer and how we generally transact with shares. More specifically, the central feature is intermediation in an electronic setting. It is account structures and book entries that populate the spaces and define the relationships between the various intermediaries and parties in the pyramid. When selling a share, a seller's account with his intermediary is debited to reflect the decrease in shares and a buyer's account with her intermediary is credited to reflect an increase. The same is true of the accounts cascading up. The pyramid is an accounts-based construct.

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<sup>47</sup> RD Guynn *Modernizing Securities Ownership, Transfer and Pledging Laws: A Discussion Paper on the Need for International Harmonization* (1996) 17. On the use of central bank money, see below, 9 4 3 Payment.

<sup>48</sup> For a more comprehensive list of the functions performed by intermediaries, see Dubovec *Securities, Commodities and Bank Accounts* 10.

How does systemic intermediation influence the primary relationship between the issuer and the investor? A company is traditionally entitled, in fact mandated, to perform only towards persons registered as shareholders on the register maintained by the company for that purpose, or alternatively, depending on the design of the system, towards those persons in possession of a valid share certificate. Intermediaries are positioned between an issuer and an investor with the implication that some of them will become shareholders directly entitled to receive performance from the company. A relationship will come into existence between an issuer and an intermediary. In addition, an intermediary will enter into a relationship with its client, which may be another intermediary or an investor. An investor is ultimately entitled to the benefits by virtue of being the “owner” of the shares, even if he is not registered as such in the records of a company. The comparative analysis will show that there are various ways in which structures of intermediation, through which benefits will flow from the company to the investor, can be conceptualised. The “object” of the relationship between the investor and his intermediary and therefore the basis for his claim of the benefits may be a “share”, or it may be a different asset altogether, although one that is derived from a “share”. Succinctly stated, the question is how and in which form the benefits that flow from shares are passed down a chain of intermediaries from one tier to another. The question is also one of the quality and scope of the transformation undertaken by the intermediaries. The transformation will determine whether a new asset is created. It will furthermore determine the relationship between the intermediary and the share and the newly created asset. Lastly, it will define the relationship between the intermediary and its client.

The intermediation between a company and an investor in relation to the flow of benefits must be carefully distinguished from the relationship between a seller and purchaser of shares. The former is a vertical movement along structures of intermediation, the latter a horizontal movement from one investor to another that may simultaneously result in a rearrangement of the vertical structure of intermediaries.

Systemic intermediation, for all the value it adds to transactions on financial markets is also inherently risky. The accounts-based structure connects numerous participants, intermediaries, custodians and central agencies. While enabling faster and more efficient settlement and clearing, it creates a dangerous interdependence.

If one participant fails there is a very real possibility that the failure will cascade along the chain of intermediaries to other participants, compromising the stability of the entire system – a threat known as systemic risk.<sup>49</sup> What makes this risk particularly potent are the additional links between the securities settlement system, markets and securities exchanges and other accounts based systems, most importantly the banking system.<sup>50</sup>

Every investor of shares is exposed to issuer risk – that is the risk of the failure or poor performance of the issuer of securities.<sup>51</sup> Over and above the issuer risk, investors holding through intermediaries carry intermediary risk. This is the risk that the intermediary will fail, experience financial distress or may experience a shortfall.<sup>52</sup>

In addition, structures of systemic intermediation generally exhibit great complexity. The credit risks associated with complexity become particularly pronounced during exchange transactions. Credit risk is “the risk that a counterparty will not settle an obligation in full, either when due or at any time thereafter”.<sup>53</sup> Credit risk can be subdivided into principal risk, replacement cost risk and liquidity risk. While principal risk is the risk of loss of the full value of funds or securities, liquidity risk is the risk that a counterparty does not perform in full on the agreed date of settlement but on an unspecified future date.<sup>54</sup> Parties are further exposed to replacement cost risk, which describes the unrealised gain from a failed transaction,

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<sup>49</sup> This is also known as the domino effect. See J Benjamin *Interests in Securities: A Proprietary Analysis of the International Securities Markets* (2000) 197; S Rambure & A Nacamuli *Payment Systems: From the Salt Mines to the Board Room* (2008) 151. In the report, Bank for International Settlement *Delivery Versus Payment in Securities Settlement Systems* (1992) 14, systemic risk is defined as “the risk that the inability of one institution to meet its obligations when due will cause other institutions to fail to meet their obligations when due”.

<sup>50</sup> Dubovec *Securities, Commodities and Bank Accounts* 7-8.

<sup>51</sup> CW Mooney “Law and Systems for Intermediated Securities and the Relationship of Private Property Law to Securities Clearance and Settlement: United States, Japan, and the UNIDROIT Draft Convention” in *Institute for Monetary and Economic Studies, Bank of Japan Discussion Paper Series 2008-E-7* (2008) 2-3.

<sup>52</sup> 2-3.

<sup>53</sup> The Giovannini Group *Second Report on EU Clearing and Settlement Arrangements* (April 2003) 53.

<sup>54</sup> The Giovannini Group *Cross-Border Clearing and Settlement Arrangements in the European Union* (2001) 18; The Giovannini Group *Second Report on EU Clearing and Settlement Arrangements* (April 2003) 54, 55; Bank for International Settlement *Delivery Versus Payment in Securities Settlement Systems* (1992) 13; Rambure & Nacamuli *Payment Systems* 150-151.

leaving the party to replace the transaction at a current market price that is lower than the contract price initially agreed to.<sup>55</sup>

### 9 3 3 A brief overview of important intermediaries

#### 9 3 3 1 Custodians

Custody is a commercial, not a legal term.<sup>56</sup> On the one hand a custodian is the equivalent of a traditional depositary, but for intangibles – a custodian takes responsibility for the safekeeping of securities. To this end, custodians maintain securities or cash accounts or both for their clients. The safekeeping of securities has mutated to a function of record-keeping. Transfers must be meticulously recorded, balances must be reconciled with central registers and client assets must be properly segregated from own assets.<sup>57</sup> All these actions are exclusive to electronic records and have no equivalent in the physical world. Custodians facilitate access to a securities settlement system, a payment system and to other non-custody intermediaries, such as central counterparties.<sup>58</sup> In addition, custodians in modern financial systems perform a variety of tasks, most notably the administration of assets.<sup>59</sup> This includes servicing corporate actions such as the payment of dividends and voting.<sup>60</sup> Custodians may also offer a range of value-adding services to generate additional revenue, including cash management, collateral management, foreign exchange, tax support, reporting and securities lending.<sup>61</sup> Global custodians perform these tasks across national borders.<sup>62</sup> While local custodians may also offer brokerage services, the brokerage and custodial functions should be viewed separately. The same is true for the additional services offered by custodians.

<sup>55</sup> The Giovannini Group *Cross-Border Clearing and Settlement Arrangements in the European Union* (2001) 18; Bank for International Settlement *Delivery Versus Payment in Securities Settlement Systems* (1992) 13.

<sup>56</sup> Benjamin *Interests in Securities* 226.

<sup>57</sup> The Clearing House *The Custody Services of Banks* (2016) 5.

<sup>58</sup> 11-12, iii.

<sup>59</sup> Benjamin *Interests in Securities* 223-224.

<sup>60</sup> 224.

<sup>61</sup> M Yates & G Montagu *The Law of Global Custody: Legal Risk Management in Securities Investment and Collateral* 4 ed (2013) 4 [1.10]. Also see The Clearing House *Custody Services of Banks* 7-9.

<sup>62</sup> See AW Beaves “Global Custody – A Tentative Analysis of Property and Contract” in N Palmer & E McKendrick (eds) *Interests in Goods* 2 ed (1998) 117.

### 9 3 3 2 Brokers

Brokers conclude transactions in securities (typically buying and selling transactions) for others.<sup>63</sup> In addition, they may provide investment advice.<sup>64</sup> Whether a broker has a discretion in the buying and selling of securities on behalf of a client depends on the terms of the agreement concluded between a broker and its client.<sup>65</sup> The term brokerage, Rogers notes, is frequently used to denote three functions, namely the investment-advice function, the trading (buying and selling) function as well as the custodial function.<sup>66</sup> He cautions that the custodial function must be distinguished from the other functions.<sup>67</sup> It is at issue only where intermediaries are used to “maintain *continued* control” over securities belonging to another.<sup>68</sup>

### 9 3 3 3 Depository Institutions

Depository institutions initially emerged in Germany and the US for the safekeeping of certificated shares and securities.<sup>69</sup> Deposit is a concept traditionally used in relation to physical objects.

In the US, physical custody continues to play an important role. At the apex of a pyramid of depositories is a central securities depository (“CSD”). Applying the principles of bailment to intermediary relationships would, however, fall short of the far-reaching changes brought about by the introduction of concepts such as securities accounts and security entitlement.

In German law the physical share certificate remains the basis of the relationships formed in a securities holding chain structured in line with the traditional concept of deposit. Its principles and rules have, however, been adapted to meet the specific demands of the securities industry.<sup>70</sup>

The descriptor “CSD” is now used widely across many legal systems. Except in systems where physical custody of certificates continues to have conceptual force, it

<sup>63</sup> See for example the definition in the US Securities Exchange Act of 1934 s 3(4). A “dealer”, on the other hand, is defined as a person who buys and sells securities for his own account – s 3(5)(A).

<sup>64</sup> *Reviewing the Regulation of Financial Markets in South Africa: Policy Document Explaining the Financial Markets Bill, 2011* (2011) 16.

<sup>65</sup> 16-17.

<sup>66</sup> JS Rogers “Policy Perspectives on Revised U.C.C Article 8” (1996) 48 *UCLA LR* 1431 1494.

<sup>67</sup> 1495.

<sup>68</sup> Mooney (1990) *Cardozo LR* 316.

<sup>69</sup> Financial Markets Act 19 of 2012, definition of “deposit” in s 1(1). For a more detailed discussion see below, 13 1 Overview of the commercial structures.

<sup>70</sup> The framework of a deposit of securities is set out in the Depotgesetz.

is, however, largely unrelated to the physical custody traditionally associated with a deposit. In England, legislation refers to “depositories” only in relation to foreign associations.<sup>71</sup> The documentation of CREST uses the terms “CSD” and “deposit”, but without defining them. It becomes clear that a deposit only relates to the initial dematerialisation of shares held in certificated form.<sup>72</sup> As such, deposit denotes not a lasting relationship, but a once-off event. Mechanisms of deposit do not apply to shares already issued in dematerialised form.<sup>73</sup> The mechanism of deposit does not make CREST (“Certificateless Registry for Electronic Share Transfer”) a holder of securities. CREST is merely an operator.<sup>74</sup> It does not stand in the chain of holding between the issuer and the investor.<sup>75</sup>

In South Africa, the definition of a “central securities depository” follows the English model of the CSD as an operator rather than a holder. A CSD is defined as “a person who constitutes, maintains and provides an infrastructure for holding uncertificated securities which enables the making of entries in respect of uncertificated securities, and which infrastructure includes a securities settlement system”.<sup>76</sup>

Whether a CSD therefore physically holds securities certificates or underlying assets or only regulates and provides access to a system designed to facilitate the settlement of securities differs across legal systems.

## 9 4 Trade, settlement and clearing

### 9 4 1 Trade

Whereas the issuing of shares takes place on the primary market, should the initial holder of the shares decide to realise his investment, he will do so on the secondary market. The sale of shares, through contractual agreement, is known as trading. In other words, the trade encompasses the process of contract formation. In the context

<sup>71</sup> See for example the Uncertificated Securities Regulations 2001 Schedule 5(7).

<sup>72</sup> See Euroclear *CREST Reference Manual Chapter* (October 2018) ch 3.

<sup>73</sup> Ch 3.

<sup>74</sup> See below, 10 1 Overview of the commercial structures. See Benjamin *Interests in Securities* 205 [9.53]. Also see the definition of a CSD in art 2(1)(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories (“Central Securities Depositories Regulation”), being “a legal person that operates a securities settlement system”.

<sup>75</sup> See Department for Business Innovation and Skills *BIS Research Paper 261: Exploring the Intermediated Shareholding Model* (2016) 25.

<sup>76</sup> Financial Markets Act 19 of 2012 s 1(1). Also see s 30(2)(a)-(b).

of listed shares, trading takes place through the stock exchange and is facilitated by electronic trading systems. Trading is also known as a front-end function.<sup>77</sup> Trading today is synonymous with remote exchanges between market participants.

#### 9 4 2 Clearing and settlement

Trades concluded in the front-end segment of the market must be settled in the back-end. Once shares have been sold, the seller must deliver the title to shares in exchange for the payment contractually agreed upon. This performance of the contract is known as settlement, facilitated by electronic settlement systems.<sup>78</sup> More specifically, settlement concerns itself with the technical performance of the contract within the bounds of a given legal framework. The settlement infrastructure,<sup>79</sup> largely hidden from sight, is essential for the proper functioning of financial systems.<sup>79</sup>

Settlement involves two legs – a transfer of the shares and the corresponding transfer of the funds – and therefore necessitates the interaction between a securities settlement system and a payment system. The aim is that these two legs should occur simultaneously or as close as possible to each other to achieve what is known as delivery-versus-payment (“DVP”). This minimises credit risk, particularly principal risk. In 1989 the Group of Thirty recommended that Delivery versus Payment should be the method for settling all securities.<sup>80</sup> Various Delivery versus Payment models have been identified.<sup>81</sup> DVP Model 1 refers to the settlement of both securities (delivery) and funds (payment) on a gross basis as every transaction occurs. Both the final transfer of securities and funds takes place intra-day and simultaneously.<sup>82</sup> DVP model 2 is the settlement of securities (delivery) on a gross basis as the transaction takes place and the corresponding settlement of funds (payment) on a net basis at the end of the settlement cycle or settlement day. The final transfer of securities takes place intra-day, whereas the final transfer of funds takes place at the

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<sup>77</sup> Dubovec *Securities, Commodities and Bank Accounts* 3.

<sup>78</sup> Yates & Montagu *The Law of Global Custody* 9 [1.27].

<sup>79</sup> The settlement infrastructure has been compared to the plumbing of a building – see Rogers (1996) *UCLA LR* 1448; Benjamin *Interests in Securities* 19-22, [1.65]-[1.74]; in general see M Haentjens “The Law Applicable to Indirectly Held Securities: the Plumbing of International Securities Transactions” in S van Erp, A Salomons & B Akkermans (eds) *The Future of European Property Law* (2006) 165.

<sup>80</sup> Group of Thirty *Clearance and Settlement Systems in the World's Securities Markets* (1989) 11 (Recommendation 5).

<sup>81</sup> See Bank for International Settlement *Delivery Versus Payment in Securities Settlement Systems* (1992).

<sup>82</sup> 16, 17-19.

end of the day.<sup>83</sup> DVP Model 3 describes a settlement system that settles both securities (delivery) and funds (payment) on a net basis at the end of a settlement cycle. Both the final transfer of securities and funds takes place at the end of the settlement day.<sup>84</sup>

Traditionally, settlement involved the movement of paper.<sup>85</sup> Electronic settlement takes place by a book transfer of shares. Book entry transfers are implemented through the debiting and corresponding crediting of securities accounts held by participants upon the receipt of an electronic instruction to that effect.

Although the electronic settlement system significantly reduces the delay between trade and settlement, known as the settlement interval, a few days usually elapse before the trade is finally settled.<sup>86</sup> This delay creates risks for the parties, most notably the risk that the buyer or seller may become insolvent before settlement takes place.<sup>87</sup> The management of these post-trade, pre-settlement credit risks is known as clearing.<sup>88</sup> The clearing function, together with settlement, custody and account management comprise the back-end system. Clearing is largely an administrative process.<sup>89</sup> Stated very briefly, during clearing the contractual rights and obligations agreed to during trade are modified to enable settlement.<sup>90</sup> An important clearing function is the matching or confirmation of trade data. If A, for example, sends an instruction to buy 100 shares in company X for 20 per share, this instruction is matched with the instruction of B to sell 100 shares in company X for 20 per share. Matching takes place before a transaction can proceed to be settled. On settlement day, clearing includes calculating the positions of the counterparties, which may be facilitated by central counterparties. To reduce the risk that the counterparty to a transaction may default, a central counterparty (CCP) may be interposed, provided such a facility is made available by the clearing organisation. A

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<sup>83</sup> 16, 20-21.

<sup>84</sup> 16, 21-24.

<sup>85</sup> With regard to bearer shares, only the delivery of paper certificates is required, whereas registered shares usually involve the delivery of an instrument of transfer (a transfer form in English law), the share certificate and registration (in English law).

<sup>86</sup> The Group of Thirty *Clearance and Settlement Systems in the World's Securities Markets* (1989) has recommended a settlement interval of T+3 (see Recommendation 7). In South Africa the settlement interval has been reduced to T+3 during 2016.

<sup>87</sup> Yates & Montagu *The Law of Global Custody* 208 [8.22]. For a brief exposition of risks, see 208-211.

<sup>88</sup> 9 [1.26].

<sup>89</sup> Dubovec *Securities, Commodities and Bank Accounts* 9.

<sup>90</sup> Benjamin *Interests in Securities* (2000) 22-23; also see Group of Thirty *Global Clearing and Settlement: A Plan of Action* (1990) 13.

CCP can be defined as “[a]n entity that is the buyer to every seller and the seller to every buyer of a specified set of contracts”.<sup>91</sup> In this construction the CCP becomes the legal counterparty to every trade. Typically this can be achieved in two ways: By replacing the existing contract between, for example A and B, with a set of contracts between A and the CCP and B and the CCP.<sup>92</sup> This model amounts to a novation. In legal terms, the original bilateral contract marks the point of contract formation. Another approach is an “open offer” by the CCP to act as a counterparty; the CCP is interposed between the market participants when the trade is executed, thus there is no obligation between the market participants that must be extinguished.<sup>93</sup> As soon as matching takes place, the CCP is interposed and makes an “open offer” to the relevant parties, whereby two contracts are concluded – one between each party and the CCP. In legal terms, these contracts mark the point of contract formation and no obligations ever arise between the parties. While CCP’s act as guarantors of the trade and therefore mitigate the risk that one of the parties fails to perform, they are themselves exposed to significant risk<sup>94</sup> and in turn expose the entire system to risk should one or more CCP fail.<sup>95</sup> To manage the credit risk that the CCP is exposed to, membership, and particularly capital requirements of clearing members must be carefully set.<sup>96</sup> In addition, clearing members are usually required to provide collateral, and a CCP maintains sufficient financial resources of its own, in the form of a default fund, to cover uncollateralised losses and to provide sufficient liquidity.<sup>97</sup>

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<sup>91</sup> Group of Thirty *Global Clearing and Settlement: A Plan of Action* (1990) 22; Bank for International Settlement *Recommendations for Central Counterparties: Consultative Report* (2004) 1 para 1.1; Bank for International Settlements, Committee on Payment and Settlement Systems (CPSS) & Technical Committee of the International Organization of Securities Commissions (IOSCO) *Recommendations for Securities Settlement Systems: Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems* (January 2001) 44.

<sup>92</sup> For more detail on central counterparties see European Central Bank & Federal Reserve Bank of Chicago *The Role of Central Counterparties* (2007).

<sup>93</sup> Bank for International Settlement *Recommendations for Central Counterparties: Consultative Report* (2004) 5 para 2.1.

<sup>94</sup> Bank for International Settlement *Recommendations for Central Counterparties: Consultative Report* (2004).

<sup>95</sup> This is known as systemic risk.

<sup>96</sup> Bank for International Settlement *Recommendations for Central Counterparties: Consultative Report* (2004) 7-8; European Central Bank & Federal Reserve Bank of Chicago *The Role of Central Counterparties* (2007) 6.

<sup>97</sup> Bank for International Settlement *Recommendations for Central Counterparties: Consultative Report* (2004) 8-9; European Central Bank & Federal Reserve Bank of Chicago *The Role of Central Counterparties* (2007) 6.

Netting has become an important clearing function. Netting is the offsetting of the positions of multiples parties in order to reach a single value.<sup>98</sup> Whereas bilateral netting is the netting of all transactions between two parties, multilateral netting achieves the netting of all transactions of one party as against all other parties.<sup>99</sup> Netting greatly enhances the speed and efficiency of securities settlement. Yet, it has as a consequence that particular deliveries can no longer be linked to particular trades or contractual arrangements from which they emanate.<sup>100</sup>

### 9 4 3 Payment

The interaction between securities settlement systems and payment systems has the potential to be particularly marred by risk. Central banks play a vital role in mitigating these risks. Central bank money refers to money that can only be created by a central bank, usually in the form of cash (coins and banknotes) or central bank deposits, which include mandatory deposits and deposits used to settle transactions.<sup>101</sup> Each system participant must nominate a settlement bank with central bank access to ensure payment of its securities transactions.

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<sup>98</sup> Group of Thirty *Clearance and Settlement Systems in the World's Securities Markets* (1989) 37

<sup>99</sup> Rogers (1996) *UCLA LR* 1442.

<sup>100</sup> JS Rogers "An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision" (1995) 31 *Idaho LR* 694.

<sup>101</sup> In general, see Bank for International Settlements *The Role of Central Bank Money in Payment Systems* (August 2003); European Central Bank *The Use of Central Bank Money for Settling Securities Transactions* (May 2004).

## Chapter 10: The effect of systemic intermediation in England

### 10 1 Overview of the commercial structures

The key provisions enabling the issue of shares without a written instrument are found in Chapter 2, Part 21 of the Companies Act 2006. These do not include any substantive rules on the regulation of uncertificated securities, but merely enable regulations to be made to that effect. Section 785(1) provides that “[p]rovision may be made by regulations for enabling title to securities to be evidenced and transferred without a written instrument”. The Uncertificated Securities Regulations 2001 completely eliminate physical securities certificates, enabling securities to be issued in dematerialised form.<sup>1</sup>

The electronic settlement of securities takes place through CREST, an electronic settlement system operated by Euroclear UK & Ireland. In addition to providing settlement services through CREST, Euroclear offers custody services and issuer services, amongst others. In the context of UK shares and securities, CREST does not act as a depository in the traditional, relationship-based sense.<sup>2</sup> Nonetheless, it is often referred to as a central securities depository.<sup>3</sup> The Uncertificated Securities Regulations 2001 rather label CREST as a “relevant system”, being “a computer-based system, and procedures, which enable title to the units of a security to be evidenced and transferred without a written instrument, and which facilitate supplementary and incidental matters”.<sup>4</sup> Deposit or bailment, as historically conceived, may have ownership implications.<sup>5</sup> The fact that CREST is not a depository is significant, because it means that CREST does not hold title to the securities and therefore does not stand between the issuers and the investors.<sup>6</sup>

<sup>1</sup> See for example s 2 of the Uncertificated Securities Regulations 2001.

<sup>2</sup> See above, 9 3 3 A brief overview of important intermediaries.

<sup>3</sup> See for example D French, SW Mayson & CL Ryan *Mayson, French & Ryan on Company Law* 31 ed (2014-2015) 221. The website of Euroclear UK & Ireland also refers to a CSD, but rather determines Euroclear UK & Ireland, as the operator of CREST, to be the CSD.

<sup>4</sup> Uncertificated Securities Regulations s 2(1).

<sup>5</sup> See above, 8 3 3 4 Deposit and bailment.

<sup>6</sup> J Benjamin *Interests in Securities: A Proprietary Analysis of the International Securities Markets* (2000) 205 [9.53] and [9.54]. Compare this to the position in US law set out below at 11 2 Overview of the commercial structures.

All publicly traded shares and securities must be held electronically,<sup>7</sup> which requires that the operator admit these shares to the electronic system and that the company provide for electronic shares in its articles of association.<sup>8</sup> A share or security admitted by the operator to be transferred by means of the electronic system is known as a “participating security” and an issuer of such a security is known as a “participating issuer”.<sup>9</sup>

To sell or otherwise transfer securities via this system, to put up securities as collateral or to undertake other acts in relation to the securities, the parties involved (the buyer and the seller in case of a sale) must have member accounts<sup>10</sup> and therefore be members of CREST.<sup>11</sup> While some members are “system-participants” and as such have the requisite hardware and software to send dematerialised instructions concerning shares and securities held by themselves, other members are “sponsored members” and must use the services of a “sponsored system-participant” to send a properly authenticated dematerialised instruction on their behalf.<sup>12</sup> CREST segregates the function of transferring shares and being a party to a transaction from the function of inputting instructions. While all system members are parties to a transaction, not all of them will be able to generate properly authenticated dematerialised instructions themselves.<sup>13</sup> Only certain parties are approved to connect to the CREST system.

CREST members can also act as custodians (or nominees) for their clients.<sup>14</sup> Generally, custodians which are CREST participants hold client shares and securities in pooled accounts, the custodian therefore opening only one CREST member account. Both the CREST and issuer’s register will reflect the custodian as the shareholder. Alternatively, custodians can hold the securities of clients in designated accounts, being separate member accounts, which are nonetheless opened in the

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<sup>7</sup> See London Stock Exchange *Rules of the London Stock Exchange: Rule Book* (18 June 2018) Section 5: Settlement, Clearing and Benefit Rules, Rule 5025; also see the definition of “electronic form”.

<sup>8</sup> Uncertificated Securities Regulations 2001 ss 14 and 15.

<sup>9</sup> For the definitions see Uncertificated Securities Regulations 2001 s 3(1).

<sup>10</sup> See Euroclear *CREST Glossary* (October 2018) “member account”.

<sup>11</sup> Also see the definition of “system member” in Uncertificated Securities Regulations 2001 s 3(1).

<sup>12</sup> See the definition of “sponsored member” in Euroclear *CREST Glossary*. Also see the definition of “sponsoring system-participant” in s 3(1) of the Uncertificated Securities Regulations 2001.

<sup>13</sup> Note that the terminology employed by CREST in their own documentation deviates from that in the Uncertificated Securities Regulations. CREST describes a “user” as a person that communicates directly with the CREST system; see Euroclear *CREST Glossary*.

<sup>14</sup> Generally on the different types of custody arrangements see M Yates & G Montagu *The Law of Global Custody: Legal Risk Management in Securities Investment and Collateral* 4 ed (2013) 253-256.

name of the custodian.<sup>15</sup> As a final option, custodians can act as sponsors for their clients, who open their own CREST member accounts, but rely on the custodian to communicate with the system on their behalf.<sup>16</sup> In this model the custodian does not act as an intermediary. In theory at least, CREST therefore makes provision for a direct holding of shares and other securities; yet, in practice, most securities are held indirectly in pooled accounts.

In addition to the member accounts in which shares (and other securities) are held, each member also has a cash memorandum account in which the cash balance of a member is recorded.<sup>17</sup> To implement the payment leg of a transaction, each member must nominate a “settlement bank”.<sup>18</sup> An agreement between a member and his settlement bank makes credit available to the client for purchases of shares and other securities. The settlement bank’s exposure to risk can be limited by imposing a cap on the amount of credit granted, known as a debit cap.<sup>19</sup> Additionally, the credit may be secured by a charge over the securities held in the member account.<sup>20</sup>

## 10 2 Intermediation – a legal perspective

The moment an entry is made in the investor’s account with his intermediary, the investor has certain rights he can exercise against his intermediary. Widely discussed in recent years has been the question whether these rights comprise an asset that is separate from the shares themselves.

The notion of a separate asset being created through intermediation originated in US law, but has found its proponents in English law. Benjamin terms the asset “interests in securities”, defined as “the assets of a client for whom an intermediary holds securities (or interests in securities) on an unallocated basis, commingled with the interests in securities of other clients”.<sup>21</sup> The implication is that “interests in securities” are conceptually separate from the underlying securities. She does

<sup>15</sup> Yates & Montagu *The Law of Global Custody* 208 254 [9.34]; Benjamin *Interests in Securities* 207 [9.60].

<sup>16</sup> Yates & Montagu *The Law of Global Custody* 208 175 [9.36]; Benjamin *Interests in Securities* 207-208 [9.61].

<sup>17</sup> See definitions of “member account” and “cash memorandum account” in Euroclear *CREST Glossary*; See also Euroclear *CREST Reference Manual Chapter* (October 2018) ch 2, s 5. A member may have more than one member account.

<sup>18</sup> See definition in Uncertificated Securities Regulations 2001 s 3(1).

<sup>19</sup> Euroclear *CREST Reference Manual* ch 6 s 3.

<sup>20</sup> Ch 6 s 7.

<sup>21</sup> Benjamin *Interests in Securities* 5 [1.04].

recognise, however, that “interests in securities” derive from “securities”, particularly their economic value and the economic risks and rewards usually associated with ownership of the underlying securities.<sup>22</sup> The same terminology is used in the Uncertificated Securities Regulations 2001<sup>23</sup> as well as the Financial Markets Law Committee.<sup>24</sup>

Austen-Peters similarly recognises that the interests of the parties must be separated. Analogous to a structure of trusts and sub-trusts, the depository or first-tier custodian has the legal title to shares, a sub-custodian has the right to benefit from shares held by the first-tier custodian for the sub-custodian, and an investor, in turn, has the right to benefit from the equitable interest held by the sub-custodian.<sup>25</sup> His terminology neatly elucidates the different tiers of holding securities, but is somewhat cumbersome.

Pretto-Sakmann dedicates a portion of her enquiry to finding the most suitable terminology for these newly created assets.<sup>26</sup> She prefers the term of sub-securities, more specifically sub-shares, which is easy to augment in the case of multi-tiered holdings to illustrate the various levels of intermediation. A sub-share can therefore become a sub-sub-share and so forth.<sup>27</sup>

In fact, the terminology employed is often reminiscent of the vocabulary of trusts and sub-trusts. Leaving aside the question of nomenclature for the time being, the principles of the law of trusts are frequently brought to bear on intermediated structures of holding shares. Trust law, as depicted above,<sup>28</sup> is traditionally used to explain intermediated holdings of shares, either where such a holding is expressly desired or where fairness demands it. Through intermediation, there is at once a distinction between a registered holder and an investor. The question is how the benefit derived from shares can be passed down multiple tiers of intermediaries to a

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<sup>22</sup> 29, 30.

<sup>23</sup> See the definition of “interest in a security” in s 3(1) of the Uncertificated Securities Regulations 2001. Interestingly, the definition includes, not only interests or rights created when a security is held by a custodian or trustee, but also “an absolute or contingent right to acquire a security created, allotted or issued or to be created, allotted or issued”.

<sup>24</sup> Financial Markets Law Committee *Property Interests in Investment Securities: Analysis of the Need for and Nature of Legislation Relating to Property Interests in Indirectly Held Investment Securities, with a Statement of Principles for an Investment Securities Statute* (July 2004) Principle 2 (Part 8).

<sup>25</sup> AO Austen-Peters *Custody of Investments: Law and Practice* (2000) 70 [4.40].

<sup>26</sup> See A Pretto-Sakmann *Boundaries of Personal Property: Shares and Sub-Shares* (2005) 49-59.

<sup>27</sup> 57.

<sup>28</sup> See above, 8 3 2 6 Equity and trusts.

final investor. Trust law, by enabling a distinction between legal and beneficial ownership, lends itself to facilitating such structures of intermediation. Furthermore, trust law provides the beneficial owner with some kind of proprietary interest.<sup>29</sup> Trust law therefore allays the fears that a client's rights in relation to shares held by an intermediary are merely contractual claims.<sup>30</sup>

The intricacies of trust law cannot be applied seamlessly to multi-tiered constructs of intermediaries.<sup>31</sup> Intermediation today is systemic; it permeates the entire structure of securities holdings. What would be required is a pyramid of trusts. Traditional principles of trust law do make provision for multi-tiered trusts, commonly known as sub-trusts. Maitland has written of “the use” (which is the beneficial interest) being turned into an incorporeal thing.<sup>32</sup> This appears even more clearly from the writings of Langdell. He distinguishes between the trust property, which is the subject (*res*) of the equitable obligation and the equitable obligation, which can be a *res* itself.<sup>33</sup> Therefore, “the equitable obligation itself is as much the subject of ownership as is a legal obligation”,<sup>34</sup> and further, “it follows that such a right [the equitable obligation] may be the subject of a purchase and sale, or of a new equitable obligation”.<sup>35</sup> These statements at once illustrate the creation of separate assets and the possibility of creating sub-trusts over such assets. The beneficial obligation, although being an asset in itself, is derived from the trust asset, as well as dependent on it.<sup>36</sup>

Yet, sub-trusts are not without their problems. If we assume that a trustee holds property on trust for X and X subsequently declares that he holds his equitable interest on trust for Y absolutely, it is not entirely clear whether the sub-trust will effectively collapse, thus removing X from the construction. The courts in some cases contemplate that the sub-trustee “disappears from the picture”,<sup>37</sup> the rationale being

<sup>29</sup> See the debate above on the nature of such an interest, above 8 3 2 6 Equity and trusts.

<sup>30</sup> Some authors argue that bailment may be an alternative or complementary solution; AW Beaves “Global Custody – A Tentative Analysis of Property and Contract” in N Palmer & E McKendrick (eds) *Interests in Goods* 2 ed (1998) 117.

<sup>31</sup> See R Goode “Security Entitlements as Collateral and the Conflict of Laws” (1998) 7 *JIBFL* 22 23-24, who cautions that the reference to trusts should be avoided.

<sup>32</sup> FW Maitland *Selected Essays* (1936) (edited by HD Hazeltine, G Lapsley & PH Winfield) 164-165.

<sup>33</sup> CC Langdell *A Brief Survey of Equity Jurisdiction* 2 ed (1908) 6 n 1.

<sup>34</sup> 5 n 1.

<sup>35</sup> 6 n 1.

<sup>36</sup> 5.

<sup>37</sup> See for example *Grey v Inland Revenue Commissioners* [1958] Ch 375 (ChD) at 382, which was set aside on appeal; also see the dissenting judgement of Lord Evershed in the appeal case of *Grey v Inland Revenue Commissioners* [1958] Ch 690 (HL) at 715. The dispute in this case concerned the question whether a declaration of sub-trust is a disposition in the form of an assignment, which

that the sub-trustee divests himself of his entire interest and no longer holds any property; he becomes but a superfluous bare trustee. Elsewhere, the courts have stated that, even though “the practical effect would seem to amount to or be capable of amounting to the ‘getting rid’ of the trust of the equitable interest then subsisting, it is not the same as saying that as a matter of law it does get rid of the intermediate trust”.<sup>38</sup> Austen-Peters similarly refutes the “bare trustee” argument by finding that the sub-trustee does precisely what he is intended to do, namely fulfilling the functions of a repository of a benefit received from an upper-tier trustee.<sup>39</sup> Despite remaining uncertainties, the creation of multi-tiered sub-trusts without collapse therefore must be taken to be possible. The structure envisaged for shares and other securities would be one of a series or hierarchy of sub-shares or sub-securities that is stable and not susceptible to collapse, each sub-share being a separate and different asset, though being derivative.<sup>40</sup>

Nonetheless, Goode cautions that the sub-trust construction is not completely analogous of the intermediation of securities.<sup>41</sup> Combined with the distinctive characteristics of securities intermediation, Goode argues, that the focus should be on the formation of an entirely different asset and therefore on the creation of an original trust rather than a derivative sub-trust.<sup>42</sup> In the same vein, Austen-Peters, in his analysis of sub-trusts, highlights the fact that a sub-trust leads to the creation of an entirely new equitable interest that must be understood to be different from the original equitable interest.<sup>43</sup>

Most commonly, an investor acquires a proportionate interest in a pool of like securities administered by an intermediary. The investor has no rights in specific shares or securities, but rather an interest in the pool of securities. If there are multiple tiers of intermediaries, the intermediary in the top tier will be registered and therefore be the legal owner, but will (mostly) pool like shares together. The next

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requires writing in terms of s 53 (1)(c) of the Law of Property Act 1925, or a transfer of equitable title by declaration of trust. Of interest for the time being is merely the question whether a multi-tiered trust is possible at all or whether it inevitably collapses.

<sup>38</sup> *David Nelson v Greening & Sykes (Builders) Ltd* [2007] EWCA Civ 1358 (CA) at para 57, per Lord Collins.

<sup>39</sup> Austen-Peters *Custody of Investments* 66-67 [4.29].

<sup>40</sup> Pretto-Sakmann *Boundaries of Personal Property* 58.

<sup>41</sup> See the warning expressed by Goode (1998) *JIBFL*, as quoted in Pretto-Sakmann *Boundaries of Personal Property* 58.

<sup>42</sup> Goode (1998) *JIBFL* 25.

<sup>43</sup> Austen-Peters *Custody of Investments* 66-67 [4.29].

level intermediary will have an interest in the pool of shares and will most likely pool like interests together. The investor will therefore have an interest in the pool of security interests maintained by his immediate intermediate. The interest derives from the securities account maintained by the intermediary and the account becomes the source of the investor's entitlement.<sup>44</sup> This total disconnect between the investor and any higher-tier intermediaries, or in fact the issuer, the pooling of assets held on trust, as well as the absolute inability to "leap frog" tiers, all serve as distinguishing factors from the ordinary principles of sub-trusts.<sup>45</sup>

The same requirements as described in relation to trusts above apply; most notably certainty as to intention, subject matter and beneficiaries.<sup>46</sup> Considering that an intermediary will typically conclude an agreement with a client to demarcate the boundaries of their relationship, intention is not problematic.<sup>47</sup> Neither are the beneficiaries, who will be clearly identified as part of such an agreement. Concerning the requirement of writing, an issue discussed with some frequency is whether the creation of a trust over a beneficial interest (such as a sub-trust) is a disposition and therefore required to be in writing.<sup>48</sup> It is clear that the intermediary, as the client's trustee, would not merely be a bare trustee, whose role can be filled out by his own trustee, as illustrated in relation to the collapsing of sub-trusts above.<sup>49</sup> Indeed collapsing is neither envisaged nor desired. Again the changed nature of the asset merits emphasis. The intermediary is not only a conduit for the shareholder's rights, but plays a vital role in ensuring that the benefits of shareholding reach the investor. Furthermore, the intermediary, as a nominee, acts as a repository of title – a role that may not demand active intervention, but that nonetheless realises exactly what was intended by the parties.<sup>50</sup> As set out in the economic analysis of intermediation above, intermediation has changed to such an extent that factors such as convenience, risk reduction and the facilitation of system access can be subsumed

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<sup>44</sup> Goode (1998) *JIBFL* 23.

<sup>45</sup> 25.

<sup>46</sup> See above, 8 3 2 Transfer and holding in English law, n 129.

<sup>47</sup> Note that the use of the word "trust" is not mandatory to establish a trust relationship. Rather the consequences of a trust must be intended. This applies even in cases of express trusts. See *In Re Kayford Ltd (in liquidation)* [1975] 1 WLR 279 at 281.

<sup>48</sup> If it is a disposition s 53(1)(c) of the Law of Property Act would apply. For more detail on the section see below at 10 3 Electronic settlement and transfer.

<sup>49</sup> See the cases cited above in nn 37 and 38.

<sup>50</sup> Austen-Peters *Custody of Investments* 67 [4.29].

under the intermediary function.<sup>51</sup> Against this background writing is not required.. Nonetheless, agreements between intermediaries and their clients will customarily be put into writing.

Lengthy and important discussions have been dedicated to determining whether the subject matter in a pool of securities is certain. For the purposes of this discussion, it suffices to summarise the major findings of the debate. To give effect to the requirement of certainty of subject matter, the trust property must be identifiable.<sup>52</sup> In a pool of intangible, dematerialised securities, the interests in securities of a client are commingled with the interests in securities of other clients. Interests in securities are unallocated as they do not attach to specific assets,<sup>53</sup> they are fungible and have no distinguishing designations. The identifiability of trust property becomes problematic when mixing takes place. Roman law distinguished *commixtio* from *confusio*.<sup>54</sup> In the former case, the individual units retain their physical identity after mixing.<sup>55</sup> Subsequent to a *confusio*, on the other hand, the units lose their physical integrity and it becomes impossible to separate the mixture.<sup>56</sup> The commingling of both registered shares as well as interests in shares are examples of *confusio*.<sup>57</sup> Interests in shares have no unique designation and are by their nature undivided.<sup>58</sup> Following a *confusio*, the prior owners become the owners in common of the unallocated whole in proportion to the value of their contribution to the whole.<sup>59</sup> English law has developed to recognise that an undivided share of a whole is sufficiently identifiable without there being segregation or appropriation of specific property.<sup>60</sup> The subject matter is certain if the interest is expressed as a proportion of the pool and not as a definite number of units in a pool. Applied to commingled interests in securities, it has been suggested that a single trust is established over the entire pool of interests with the clients as beneficiaries.<sup>61</sup> Clients will own an undivided fraction of the entire pool and therefore will be co-owners of the pool, the

<sup>51</sup> See above, 9 3 1 The economic theory of intermediation.

<sup>52</sup> *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669 at 705E.

<sup>53</sup> Benjamin *Interests in Securities* 53 [2.72].

<sup>54</sup> Justinian *Institutes* 2.1.27-28; P Birks "Mixtures" in N Palmer & E McKendrick (eds) *Interests in Goods* 2 ed (1998) 227 233.

<sup>55</sup> Birks "Mixtures" in *Interests in Goods* 233.

<sup>56</sup> 233-234.

<sup>57</sup> Benjamin *Interests in Securities* 55 [2.78].

<sup>58</sup> 34-35.

<sup>59</sup> P Stein "Roman Law in the Commercial Court" (1987) 46 *Cambridge LJ* 369 369.

<sup>60</sup> See *Re London Wine Co (Shippers)* [1986] PCC 121 at 135-137; Pretto-Sakmann *Boundaries of Personal Property* 150-151.

<sup>61</sup> Benjamin *Interests in Securities* 56 [2.82]-[2.84].

subject matter of the trust being certain.<sup>62</sup> It is commonly suggested, that co-ownership in relation to an unallocated pool of assets is in effect co-ownership of every single unit in the pool.<sup>63</sup> This type of co-ownership may cause problems in relation to the disposal and burdening of an interest from the pool, possibly requiring the consent of every beneficiary, who each owns a fraction of every unit. Additionally, a shortfall may result in claims against units previously disposed of.<sup>64</sup>

In a widely debated and controversial decision, the court in *Hunter v Moss*<sup>65</sup> has embarked on a different route. In the case, the defendant declared himself a trustee for 5% of the share capital of the company consisting of 1000 identical shares. The defendant was the registered holder of 950 of these shares. Had a valid trust been established over the 50 shares without the separation of these shares from the 950 shares? The court finds, that the determination of the certainty of intangibles cannot be based on the same principles as that of tangible assets.<sup>66</sup> Specifically, the subject matter of the trust is certain, so the court finds, “if immediately after the declaration of trust ... there would not have been any difficulty in ordering the trust to be carried into execution”.<sup>67</sup> In these cases identification or segregation would be “unnecessary and irrelevant”.<sup>68</sup> The decision was followed as binding in *Re Harvard Securities Ltd (in liquidation)*.<sup>69</sup> Criticised for being without basis in the law of trusts,<sup>70</sup> the decision of the court was aimed at pragmatism and the recognition of commercial realities.<sup>71</sup>

The two approaches yield different results in terms of the design of the trust structure: whereas the first approach results in a single trust over an entire pool of interests in shares, the second approach creates separate trusts for the interests in shares of each client and therefore sanctions the creation of a trust consisting of a definite number of unallocated units from a pool.

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<sup>62</sup> 56.

<sup>63</sup> *Jackson v Anderson* (1811) 128 ER 235 at 238; Birks “Mixtures” in *Interests in Goods* 248. But see the suggestion by Austen-Peters *Custody of Investments* 49-50, that the contributors to a pool of unallocated assets are rather co-owners of a number of whole units of the pool in proportion to the size or value of their contribution.

<sup>64</sup> Austen-Peters *Custody of Investments* 48 [3.45].

<sup>65</sup> [1993] 1 WLR 934; [1994] 1 WLR 452.

<sup>66</sup> *Hunter v Moss* [1993] 1 WLR 934 at 940.

<sup>67</sup> 946.

<sup>68</sup> 946.

<sup>69</sup> [1998] BCC 567.

<sup>70</sup> Benjamin *Interests in Securities* 58 [2.88].

<sup>71</sup> Petto-Sakmann *Boundaries of Personal Property* 152. Also see E McKendrick (ed) *Goode on Commercial Law* 4 ed (2010) 64.

Assuming that a valid trust can be created over a pool of interests in shares, the last remaining issue to be addressed is whether interests in shares confer proprietary rights and whether these rights relate to the underlying shares held in the top-tier. Despite some ambiguity, we have seen above, that trusts vest in their beneficiaries a combination of proprietary rights in the trust property itself and personal rights against the trustees. The principles of multi-tiered trusts dictate, that an investor enjoys personal rights against his intermediary as well as proprietary rights in his intermediary's interest, which constitutes the trust property of the sub-trust, which is in turn made up of the personal and proprietary rights enjoyed that intermediary against and in the interests of his own intermediary.<sup>72</sup> The investor will neither have rights against the issuer, nor direct proprietary rights in the underlying shares. His proprietary rights therefore attach to the beneficial interest of his intermediary over which the sub-trust is created and not the underlying shares.<sup>73</sup>

A number of uncertainties remain in the English legal landscape of intermediation. Widely accepted, however, is the view that intermediation creates new assets and that trust law is the primary vehicle facilitating intermediated holdings of shares. The interests conferred under such pyramids of trusts are said to take the form of a combination of personal and proprietary rights, but only in relation to the immediate intermediary, with no look-through permitted to higher-tiers or the issuer.

### 10 3 Electronic settlement and transfer

The transfer of uncertificated shares follows the same steps as the transfer of certificated shares, namely an agreement to sell, the completion of the agreement and registration.<sup>74</sup> These legal steps are taken within an electronic environment of trading, clearing and settlement. The electronic transfer of shares has a dual existence in commerce and law.

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<sup>72</sup> Austen-Peters *Custody of Investments* 77-78 [5.18]-[5.19].

<sup>73</sup> Austen-Peters *Custody of Investments* 78 [5.21]; also see Financial Markets Law Committee *Property Interests in Investment Securities: Analysis of the Need for and Nature of Legislation Relating to Property Interests in Indirectly Held Investment Securities* 12-13, Part 6.5, which discusses the “no-look through principle” and 14, Part 7, which refers to “co-proprietary interests in the pool”.

<sup>74</sup> See PL Davies *Gower and Davies' Principles of Modern Company Law* 7 ed (2003) 699. In PL Davies & S Worthington *Gower & Davies' Principles of Modern Company Law* 9 ed (2012), these steps are no longer mentioned in relation to transfers of uncertificated shares. The focus is placed on instructions and account entries. This does not mean that the parties do not have to agree, but it does reflect that the importance of the agreement and the intentions of the parties has decreased relative to the procedural aspects of instructions and account entries. This is also the conclusion reached on the basis of South African law; see below, 13 2 5 2 Legal framework. Also see, 17 2 A law of accounts.

After reaching an agreement to sell, respectively to buy, through the process of trading, the transaction proceeds to settlement. Both parties to the agreement must send “dematerialised instructions” through the electronic settlement system.<sup>75</sup> The seller will send the instruction to deliver the shares to the buyer and the buyer will instruct payment to be made to the seller.

As described above, a sales transaction will only be possible if both parties have member accounts as well as cash accounts. After instructions are sent, CREST matches the instructions and verifies that they correspond. If they match and there are sufficient shares in the seller’s member account and sufficient credit (or headroom)<sup>76</sup> in the buyer’s cash memorandum account, the transfer is processed or settled on a pre-determined settlement day. The seller’s member account is debited and the buyer’s member account is credited. Likewise, the buyer’s cash memorandum account is debited and the seller’s cash memorandum account is credited. Through the debiting and crediting of the relevant accounts, CREST amends its register. Simultaneously, CREST sends instructions to issuers to amend their registers and to the settlement banks to pay the purchase price. This delivery-versus-payment constitutes settlement.<sup>77</sup>

The payment leg of the settlement transaction takes place in central bank money on a real-time gross settlement basis (RTGS).<sup>78</sup> Each settlement bank opens a settlement account at the Bank of England in which it deposits funds for CREST settlement. At the beginning of a settlement cycle, funds in the settlement account are earmarked or frozen to ensure the availability of funds during the settlement process.<sup>79</sup> CREST then proceeds to make the relevant entries, after which the Bank of England is notified of the use of earmarked funds and the remainder of the funds are released for use during the next settlement cycle.<sup>80</sup> The Bank of England “gives an unconditional and irrevocable undertaking to each CREST settlement bank to

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<sup>75</sup> See the definition in Uncertificated Securities Regulations 2001 s 3(1).

<sup>76</sup> Headroom is the unused credit still available to the member; see Benjamin *Interests in Securities* 206 [9.57].

<sup>77</sup> See above, 9 4 2 Clearing and settlement.

<sup>78</sup> This is true for transactions in pound sterling and Euro. Transactions in US dollars are settled according to the “assured payments mechanism”; see Euroclear *CREST Reference Manual* Chapter 6 Section 6.

<sup>79</sup> Euroclear *CREST Reference Manual* ch 6 s 6; Committee on Payment and Settlement Systems (CPSS) “CPSS Red Book - Payment, Clearing and Settlement Systems in the United Kingdom” in Bank for International Settlements (BIS) *Payment Clearing and Settlement Systems in the CPSS Countries* (2012) 467.

<sup>80</sup> Euroclear *CREST Reference Manual* ch 6 s 6; CPSS “CPSS Red Book – United Kingdom” in *Payment, Clearing and Settlement Systems* 467.

complete payment”,<sup>81</sup> and therefore provides the necessary liquidity to finalise settlement. This enables the simultaneous transfer of securities and funds and, importantly, the transfer of direct, irrevocable title. Upon being notified, the Bank of England debits and credits the relevant settlement accounts at the end of each settlement cycle.<sup>82</sup> Settlement therefore takes place as each transaction occurs in accordance with DVP model 1.

To facilitate the clearing function, central counterparty (CCP) facilities can be utilised in conjunction with CREST.<sup>83</sup> Central counterparty clearing of equities traded on the London Stock Exchange typically takes place by “open offer” and therefore through the conclusion of single contracts between the CCP and the parties and without any obligation between the parties themselves.<sup>84</sup> This is followed by optional netting.<sup>85</sup> Central counterparty clearing moreover ensures the anonymity of the trading parties so that the trader will not be aware of the buyer and vice versa.<sup>86</sup>

In theory, the CREST system allows investors to hold shares directly and is therefore classified as a direct holding system. From a practical perspective, shares are held by CREST members as custodians (nominees) on behalf of investors in pooled accounts. As a result of this intermediation, investors will not have a direct relationship with the issuers of shares. Investors and lower-tier intermediaries will not hold a share, but rather a different asset – an interest in a share. A transfer of shares from a seller to a buyer will therefore simultaneously need to achieve a transfer of shares as well as interests in shares.

#### 10 4 Registration and the passing of legal title

The system that developed to accommodate the dematerialisation of shares was modelled on existing structures and concepts, most notably the mechanism of registration. In addition to the issuer’s register, records are maintained by CREST and by intermediaries administering securities accounts on behalf of clients. This is the essence of a book-entry system. It is crucial to distinguish the issuer’s- and

<sup>81</sup> Euroclear *CREST Reference Manual* ch 6 s 1; ch 6 s 6.

<sup>82</sup> Euroclear *CREST Reference Manual* ch 6 s 6; CPSS “CPSS Red Book – United Kingdom” in *Payment, Clearing and Settlement Systems* 467.

<sup>83</sup> Euroclear UK & Ireland (CREST) provides central counterparty services, such as netting, but does not act as central counterparty. The central counterparties for exchanges on the London Stock Exchange are LCH.Clearnet, SIX x-clear or EuroCCP.

<sup>84</sup> See above, 9 4 2 Clearing and settlement. Benjamin et al *Law of Global Custody* 190 [9.38].

<sup>85</sup> See Euroclear *CREST Reference Manual* 87-91.

<sup>86</sup> French et al *Company Law* 224.

operator's registers, on the one hand, from the records maintained by intermediaries on the other.

Initially, the records maintained by CREST were intended for internal use only and did not constitute the share register or register of members.<sup>87</sup> Every transaction was recorded by CREST in its internal records and thereafter instructions were sent to the issuer to amend the register and to the settlement bank to pay the purchase price. The only change from the paper-based system was therefore that instructions were sent and processed electronically and the transferee was identified electronically.<sup>88</sup> Legal title to the shares transferred when the name of a transferee was entered on the register maintained by an issuer. With the elimination of certificates, the issuer's register also became the sole source of evidence of title to the shares.

This system was reformed by the Uncertificated Securities Regulations 2001. The regulations introduced a dual register. One register, termed the "issuer register of members" must be maintained by the participating issuer and another register, the "operator register of members", must be maintained by the operator.<sup>89</sup> In addition to the issuer register of members, each participating issuer must also compile a record of the entries made in the operator register of members.<sup>90</sup> This record is known as the "record of uncertificated shares".<sup>91</sup> The record of uncertificated shares must be regularly reconciled with the operator register of members.<sup>92</sup> The information that each of these registers must contain is set out in Schedule 4 to the regulations. As determined by the Companies Act, any trusts are not entered on operator registers.<sup>93</sup>

A register of members is defined as either the issuer or operator register of members or both.<sup>94</sup> In terms of Regulation 24(1) the register of members is *prima facie* evidence of any matters inserted in it as directed or authorised by the regulations. Since the register of members, per definition, includes both issuer and operator registers, both are *prima facie* evidence of membership and of legal title to shares. Where there are inconsistencies between the two registers, the operator register takes preference. Thus, the issuer register of members is not regarded as

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<sup>87</sup> See Uncertificated Securities Regulations 1995 No. 3272 s 20.

<sup>88</sup> E Micheler *Property in Securities: A Comparative Study* (2007) 70.

<sup>89</sup> Uncertificated Securities Regulations 2001 s 20(1).

<sup>90</sup> S 20(6)(a).

<sup>91</sup> S 20(6)(a).

<sup>92</sup> S 20(6)(b) and Schedule 4 Item 5(2).

<sup>93</sup> S 23(3).

<sup>94</sup> S 3.

*prima facie* evidence of the matters recorded therein if it is inconsistent with the operator register of members.<sup>95</sup> Micheler points out that the legislator did not determine the point in time at which legal title vests, but rather changed the legal significance of the operator register, which had the desired effect on the time of vesting of legal title.<sup>96</sup> The dual register only applies to uncertificated shares.<sup>97</sup>

## 10 5 Equity and trusts

In principle, the position on uncertificated shares does not differ from the one on certificated shares. Only through registration is legal title to the shares transferred and functionally, such legal title determines who the company must render performance to.<sup>98</sup> The main difference is that the operator register takes preference. As a result, registration takes place at an earlier stage than was the case when CREST was first launched.

Beneficial interests in shares are created by way of trust. It will be recalled from the discussion above that constructive trusts can arise in three situations.<sup>99</sup> Due to the limited application of specific performance in English law, the second and third grounds are of particular relevance, namely where the seller has done everything in his power to divest himself of the shares and secondly, where the shares have been identified and paid for. Traditionally, a beneficial interest under a trust was created either with the execution and delivery of the documents of transfer to the buyer or with the identification of the number and quantity of shares in conjunction with payment of the purchase price. These rules were intended for paper-based systems. In electronic systems it is no longer possible to determine this point in time without the assistance of third parties beyond the seller and the buyer. The mechanisms of trading, clearing and settlement are required to identify the quantity and type of shares and to assist the seller in fully divesting himself of the shares. Electronic systems therefore have a significant impact on the vesting of equitable title. This illustrates the full extent of systemic intermediation.

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<sup>95</sup> S 24(2).

<sup>96</sup> Micheler *Property in Securities* 74-76. For an overview of the considerations behind the change, see 80-83.

<sup>97</sup> See also schedule 4(5) of the Uncertificated Securities Regulations 2001, in terms of which the operator register is the record of uncertificated securities.

<sup>98</sup> An operator is, like the issuer, not bound to recognise any trusts in relation to interests in uncertificated securities – see s 40(3).

<sup>99</sup> See above, 8 3 2 6 Equity and trusts. Also see Micheler *Property in Securities* 71.

As a result, legislative intervention was required to provide certainty on the time of vesting of equitable title. The Regulations of 1995 provided that equitable title is acquired when the operator sends an instruction to the issuer to register a transfer.<sup>100</sup> A constructive trust would therefore arise between the point in time at which the instruction was sent and the time of registration by the issuer. Constructive trusts could no longer arise after trade but before the issuance of the operator instruction. The significant decrease in time between trade and settlement brought about by electronic settlement and payment systems served to limit the exposure of the buyer to the risk of insolvency of the seller.<sup>101</sup>

Under the 2001 Regulations, the point in time at which legal ownership vests was brought forward by making the operator register the legally significant record. Legal ownership now passes when the electronic accounts held with CREST are amended. Thus, there is no longer a lapse of time between the point at which one of the grounds for equitable title arise and the point at which the change in title is registered.<sup>102</sup> The 2001 Regulations now expressly provide for equitable title only in the case where shares are converted from uncertificated form in the hands of the transferor to certificated form in the hands of the transferee.<sup>103</sup> In this case the entry of the uncertificated securities is deleted and the certificated securities must be recorded on the issuer register. This will result in a time lag during which the transferor will retain legal title and the transferee will be regarded as the equitable owner of the shares.<sup>104</sup>

This conclusion does not imply that the concept of trusts becomes irrelevant; quite to the contrary. The scope for the creation of constructive trusts between transferor and transferee may have diminished, yet the law of trusts provides the legal and explanatory basis for the many intermediary relationships that define the electronic landscape. Making an entry on an intermediary's records, in modern securities' holding systems, is the declaration of a sub-trust. The aim of the act of recording is to formalise the relationship – to the intermediary it makes known who must receive performance, to the client it reveals from whom he may claim. No look-through is

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<sup>100</sup> Uncertificated Securities Regulations 1995 s 25.

<sup>101</sup> Micheler *Property in Securities* 72.

<sup>102</sup> Micheler *Property in Securities* 80-85; See also Davies *Modern Company Law* 701, who writes that "analysis of the rights of the transferee in equity after contract but before entry on the register becomes unnecessary".

<sup>103</sup> See Uncertificated Securities Regulations 2001 s 31 as read with s 27(7).

<sup>104</sup> S 31(2).

permitted beyond the confines of this relationship. By making an entry, an intermediary declares that he is holding for the benefit of another.

On the basis that the records kept by the intermediaries are analogous to a securities register, Benjamin puts forward the argument that interests in securities can likewise be said to pass by novation.<sup>105</sup> On the basis of account debits and credits in the books of intermediaries, a transfer of interests in securities amounts to an extinction (on the seller's side) and creation (on the buyer's side) of an equitable interest. Micheler, on the other hand, argues that an application of the rules of novation of contractual rights in the context of intermediated, dematerialised securities amounts to nothing more than a fiction.<sup>106</sup> She suggests that securities today have a "special transfer regime" that is determined by their nature as highly mobile, circulating assets.<sup>107</sup>

The pertinent question is whether the benefits that flow from interests in shares can be said to pass before the formal declaration of the sub-trust effected by entry in the intermediary's records? To conceive of benefits to pass only by an update of the relevant intermediary's records could result in a lack of protection of the ultimate beneficiary where an intermediary further up the chain takes its time to make an entry or fails to make an entry at all. In US law, by comparison, the UCC provides two alternative methods to acquire a security entitlement other than by entry in an account.<sup>108</sup>

## 10 6 Protection of bona fide purchasers of shares

The protection of *bona fide* purchasers of shares traditionally hinged on the share certificate. It was the misrepresentation originating from a share certificate in conjunction with transfer forms that provided a basis for estoppel.<sup>109</sup> The electronic system no longer requires share certificates and transfer forms for the transfer of shares. Although the common law rules are not abolished, they are supplemented by the Uncertificated Securities Regulations 2001 and seem to have become partly

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<sup>105</sup> Benjamin *Interests in Securities* 70 [3.27].

<sup>106</sup> Micheler *Property in Securities* 96-97; also see 93-96.

<sup>107</sup> E Micheler "The Legal Nature of Securities: Inspirations from Comparative Law" in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 131-147. On Micheler's views, also see 16-13 Eva Micheler.

<sup>108</sup> See the text to 11-5-2 Legal framework, nn 114-121.

<sup>109</sup> See above, 8-4-4 Estoppel and the protection of bona fide purchasers in English law.

redundant due to the significant changes in the mechanisms of transfer.<sup>110</sup> English law traditionally solved the conflict between an owner of securities and a purchaser thereof by shifting some of the risk to the issuer through estoppel. The issuer is, however, no longer involved in the registration and transfer procedure. Some of the risk of unauthorised transfers is therefore imposed on the system operator (Crest), but most of it inevitably settles on the legal owner.

Section 35 of the Regulations determines that 1. Where a properly authenticated dematerialised instruction was sent by a sponsor or an operator on behalf of a member, such member cannot deny that the instruction was sent with his authority and cannot deny its correctness;<sup>111</sup> 2. Likewise, the sponsoring-participant or the operator cannot deny authority to send the instruction and that the instruction was sent;<sup>112</sup> and 3. A person sending the instruction himself can neither deny that he sent the instruction nor dispute its correctness.<sup>113</sup> The flipside is, that the addressee of such an instruction may accept that the information contained therein is correct, the instruction was actually sent and it was sent with the requisite authority (where relevant),<sup>114</sup> unless she had actual notice of the incorrectness of any of these assertions.<sup>115</sup>

The effect of the regulation is therefore similar to that of estoppel. If the person who has sent such an instruction or has caused it to be sent, demands rectification of the register to have his name reinstated, he cannot deny that the instruction was in fact sent and that the information contained therein is correct. A claim for rectification will therefore fail.

In a system of certificated shares, the risk was primarily on the buyer. Estoppel provided an exception to the rule. Where a transfer was effected by an agent without the requisite authority, the true owner could only be successfully estopped where it could be shown that he had made some representation on which the buyer acted to his detriment.<sup>116</sup> The new regulations shift the focus, and in fact the risk, to the legal

<sup>110</sup> See Micheler *Property in Securities* 108-109.

<sup>111</sup> Uncertificated Securities Regulations 2001 s 35(2)(a).

<sup>112</sup> S 35(2)(b).

<sup>113</sup> S 35(3).

<sup>114</sup> S 35(4).

<sup>115</sup> S 35(5)(a)-(b). Also see the exceptions in s 35(5)(c)-d). In addition, see s 35(6), which stipulates that the assertion may be accepted "if at the time that he received the actual notice it was not practicable for him to halt the processing of the instruction".

<sup>116</sup> See above, 8 4 4 Estoppel and the protection of bona fide purchasers in English law.

owner, who is now bound by any instruction sent from his computer<sup>117</sup> or the computer of his broker.<sup>118</sup> Nonetheless, the requirement that the buyer must be in good faith does not fall away. Overall, the shift in focus can be considered a strengthening of the certainty of transfer and transactional security. Micheler welcomes this change as it places the risk on that party best suited to control it i.e. the legal owner, who is in the best position to restrict access to his network connection point from which instructions are sent.<sup>119</sup>

The regulations also place liability for forged instructions on the operator of the system (CREST).<sup>120</sup> An instruction is forged if it was not sent from a participant's computer or a computer of the operator system<sup>121</sup> or if it was sent from a network computer, but was manipulated.<sup>122</sup> CREST will be liable for any loss suffered as a result of the forged instruction,<sup>123</sup> unless it can prove that another person was responsible.<sup>124</sup>

Lastly, the liability of the issuer based on the share certificate is no longer applicable in an electronic system as the company no longer issues share certificates.<sup>125</sup> In addition, issuers have no control over clearing and settlement.

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<sup>117</sup> Uncertificated Securities Regulations 2001 s 35(3).

<sup>118</sup> S 35(2). In the context of brokers also see schedule 1, para 15.

<sup>119</sup> Micheler *Property in Securities* 116.

<sup>120</sup> Uncertificated Securities Regulations 2001 s 36.

<sup>121</sup> S 36(1)(a)(i).

<sup>122</sup> S 36(1)(a)(ii).

<sup>123</sup> S 36(2). Crest only bears the loss up to a certain statutory limit.

<sup>124</sup> S 36(4).

<sup>125</sup> See Micheler *Property in Securities* 111-114 on the question whether there could be liability of the issuer based on the register. This is unlikely, however.

## Chapter 11: The effect of systemic intermediation in the United States

### 11 1 Opening remarks

Historically, shares may have originated in Europe. Shares and other securities have, however, played a lead role in the tale of the American industrialisation, the advent of the big corporation and the rise and fall of financial giants. America is also the stage for one of the most important innovations in the re-conceptualisation of shares and securities, namely the Uniform Commercial Code.

The main distinction established by the UCC is not between certificated and uncertificated shares, but rather between a direct holding system and an indirect holding system.<sup>1</sup> Although the UCC does make provision for dematerialised shares,<sup>2</sup> the main trend in the US has been to immobilise shares. This means that the share certificate, adapted to the electronic environment, continues to play an important part in the construction of electronic share transactions.

In the following passage Aronstein captures the essence of shares and securities before the advent of the electronic age:

“In an environment in which the rights represented by a security were embodied in a unique piece of paper and that piece of paper was typically in the possession of the owner, the concept of transfer by delivery was a blissfully simple and totally effective approach. In the case of an outright transfer, the transferor was instantly deprived of all indicia of ownership and the transferee received something he could keep, sell, or pledge to another, and, if the security was in registered form, present to the issuer in exchange for a like security in his name.”<sup>3</sup>

Aronstein calls the share certificate a “truly marvellous invention which responded to the needs of the market”.<sup>4</sup> The share certificate “embod[ied] the rights of a corporate shareholder in a piece of paper” and “ultimately acquired almost all the

<sup>1</sup> JS Rogers “An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision” (1995) 31 *Idaho LR* 691.

<sup>2</sup> Both a “certificated security” and an “uncertificated security” are defined by the UCC – see UCC § 8-102 (4) and (18). Furthermore, an issuer of certificated securities is distinguished from an issuer of uncertificated securities – see UCC § 8-201 (a)(1) and (a)(2). Also, part 3 of the UCC is titled the “Transfer of Certificated and Uncertificated Securities” – see UCC § 8-301(a) and (b). The same distinction can be seen in Part 4 on Registration – see for example § 8-401(a).

<sup>3</sup> MJ Aronstein “The New/Old Law of Securities Transfer: Calling a ‘Spade’ a ‘Heart, Diamond, Club or the Like” (1990) 12 *Cardozo LR* 429 429.

<sup>4</sup> MJ Aronstein “The Decline and Fall of the Stock Certificate in America” (1978) 1 *J Comp Corp L & Sec Reg* 273 273.

other attributes of negotiable instruments”.<sup>5</sup> Shares were not considered to be movable property, but were rather clothed as negotiable instruments. In fact, US shares have been regarded as negotiable instruments at least since the promulgation of the Uniform Stock Transfer Act in 1910.<sup>6</sup> Share certificates were therefore considerably more prominent than merely aiding the visualisation of rights. This markedly altered the position in relation to English law. Registration in the books of the issuer remained a shared feature.

At the same time, the market environment underwent radical changes. The increasing rift between market needs and market infrastructure culminated in the “paper crunch”. Settlement by physical delivery of share certificates could no longer keep up with exponentially increasing trading volumes. The share certificate, once heralded as “the paradigm of simplicity”<sup>7</sup> forced the entire system to a halt.

The aftermath of the crisis was marked by a scurry for sustainable solutions. One envisaged solution was to completely abandon physical share certificates:

“We had a commercial system based on paper and a law written in terms of paper. The paper was being replaced by modern media, so the law had to be revised to reflect that change. How do you do that? Simple; you just take the paper part out.”<sup>8</sup>

The 1978 amendment of Article 8 of the UCC therefore simply added parallel provisions for “uncertificated securities”.<sup>9</sup> Likewise, a basis allowing companies to issue shares in uncertificated form can still be found in state company laws. Both the Delaware Code and the Model Business Corporation Act authorise a company to issue “some or all of the shares of any or all of its classes or series without certificates”.<sup>10</sup> Both the immobilisation and dematerialisation of shares and other securities follow from section 17A of the Securities Exchange Act, which stipulates that “[t]he Commission shall use its authority to end the physical movement of

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<sup>5</sup> 273.

<sup>6</sup> For a brief overview of the development of negotiability in the context of shares see JS Rogers “Negotiability, Property, and Identity” (1991) 12 *Cardozo LR* 471.

<sup>7</sup> Aronstein (1978) *J Comp Corp L & Sec Reg* 273.

<sup>8</sup> Rogers (1995) *Idaho LR* 690. Also see the call for the elimination of the share certificate by the Commissioner of the Securities and exchange Commission at the time of the paper crunch; RB Smith “A Piece of Paper” (April 1970) 25 *Bus L* 923; RB Smith “A Piece of Paper Revisited” (July 1971) 26 *Bus L* 1769.

<sup>9</sup> For a brief overview of the development, see Rogers (1995) *Idaho LR* 690-691.

<sup>10</sup> Model Business Corporation Act § 6.26; Delaware Code § 158. UCC Article 8 is also neutral and provides for both immobilisation and dematerialisation.

securities certificates in connection with the settlement among brokers and dealers”.<sup>11</sup> The issue of uncertificated shares is, however, not compulsory.

Today, shares in the United States are usually immobilised.<sup>12</sup> Developing in a path-dependent fashion, share certificates have not lost their relevance in modern, electronic settlement systems. Americans went on to immobilise rather than dematerialise shares. Share certificates had seemingly become essential, not only to the day-to-day functioning of the system, but also as the conceptual underpinning of an entire legal construct.

## 11 2 Overview of the commercial structures

The central body in immobilised systems is a depository. In the United States, the central securities depository is the Depository Trust Company (DTC), which is a subsidiary of the Depository Trust and Clearing Company (DTCC) and the world’s largest securities depository. Shares are deposited with the DTC. The definition of a “deposit” in the DTC Rules includes: 1. the delivery of the share certificate to the DTC and the crediting of the account of a participant for certificated shares; and 2. registration of the DTC or its nominee company in the books of an issuer and the crediting of the account of a participant for uncertificated shares.<sup>13</sup> The effect of the deposit is therefore that the DTC, or more accurately its nominee company,<sup>14</sup> will physically hold the share certificates and will become the holder of the shares through registration. Thus, a direct relationship exists only between the issuer and the DTC.

The DTC only allows the deposit of “eligible securities”.<sup>15</sup> Amongst other requirements, eligible securities need to be freely tradeable.<sup>16</sup> Although issuers may therefore want to ensure that shares are eligible, they do not need to issue them in a

<sup>11</sup> Securities Exchange Act of 1934 § 17A(e).

<sup>12</sup> PR Woods *Set-off and Netting, Derivatives, Clearing Systems* 2 ed (2007) 325. Chun uses the description of a “de facto system of immobilisation” because the system provides for both immobilisation and dematerialisation, whereas the German system, for example, does not cater for dematerialisation at all; see C Chun *Cross-border Transactions of Intermediated Securities: A Comparative Analysis in Substantive Law and Private International Law* (2012) 212.

<sup>13</sup> See the definition of “deposit” in Depository Trust Company (DTC) *Rules, By-Laws and Organization Certificate of the Depository Trust Company* (August 2018) rule 1.

<sup>14</sup> The nominee company is Cede&Co; see the Depository Trust Company (DTC) *Deposits Service Guide*.

<sup>15</sup> See DTC *Rules* rule 1 s 1 (definition), read in conjunction with rule 5 s 1.

<sup>16</sup> See Depository Trust Company (DTC) *Operational Arrangements (Necessary for Securities to Become and Remain Eligible for DTC Services)* (June 2018) 2-3.

form different from the usual physical form – shares deposited with the DTC are not dematerialised. A request to make a security eligible does not come from an issuer, but must instead be made by a participant.<sup>17</sup>

Once they have been identified as “eligible”, shares can be deposited with the DTC by participants.<sup>18</sup> This means that only participants can open accounts with the DTC. The rank of “participant” is only open to certain entities, typically clearing and settlement organisations, banks and trust companies, insurance and investment companies as well as pension funds, amongst others.<sup>19</sup> A participant opens both a “securities account” and a “settlement account” with the DTC.<sup>20</sup> The securities side of the transaction is booked to the securities account, whereas the money side of the transaction is booked to the settlement account. Essentially, there are three ways of holding shares through a securities account maintained by the DTC. Most commonly, it is the DTC or their nominee that is recorded on the issuer’s books, not the investor. This is referred to as street-name registration. Through the Direct Registration System (DRS), an investor can also hold shares directly. The investor will be the registered holder, but will receive an electronic statement in lieu of a stock certificate. Should an investor wish to hold physical share certificates, the share will be withdrawn from its broker’s DTC account and re-registered directly in the name of the investor. In addition, participants have the option of using the DTC for custody services only. Even though this may include the deposit of securities for safekeeping, the securities are not registered in the name of the DTC’s nominee.<sup>21</sup> As a result, the participant retains control of the securities, but does not have to handle and secure the physical certificates.<sup>22</sup>

The clearing of share transfers, which will be discussed in more detail below, is outsourced to the National Securities Clearing Corporation (NSCC), which is also a subsidiary of the DTCC. The NSCC also acts as a central counterparty (CCP) for share trades settled.

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<sup>17</sup> 1-2.

<sup>18</sup> See DTC *Rules* rule 6.

<sup>19</sup> See DTC *Rules* rule 3 for participants’ qualifications; also see rule 2.

<sup>20</sup> See the definitions in DTC *Rules* rule 1 section 1.

<sup>21</sup> Depository Trust Company (DTC) *Custody Service Guide* 4.

<sup>22</sup> DTC *Custody Service Guide* 4.

### 11 3 Intermediation – a legal perspective

After the “paper crunch”, the securities solved the problems associated with certificated shares not by getting rid of the certificates, but by immobilising them in a central securities depository.<sup>23</sup> While the certificates therefore migrated to a CSD, the CSD maintained accounts for its participants, which in turn opened accounts for their own clients and so forth. Recorded on those accounts were electronic entries called “book entries”, more specifically account credits. This solution predated the legislative changes that followed and legitimated it.<sup>24</sup> The problem: “No one could know, what, exactly, was created by a credit to a securities account. By any conventional definition of ‘security’, a credit entry in a securities account was certainly not a security.”<sup>25</sup>

The terminology of “bailment” was initially taken up by the code, but Aronstein states that held in bulk and in account structures, “the analogy to a ‘bailment’ becomes, at best, strained”.<sup>26</sup> Roughly two decades later, the old “bailment” cloak had not been shrugged off completely; not recognising the profound changes brought about by systematic intermediation, relationships between investors and intermediaries, as well as relationships amongst intermediaries, continued to be analysed in terms of bailment.<sup>27</sup> The traditional bailment idea was finally cast-off in the 1994 revision of Article 8 of the UCC. The current system makes provision for a depository at the top of the pyramid which continues to take the physical certificates, whether as individual or global certificates, into deposit. Yet, the relationships between intermediaries positioned below a central depository are no longer subject to the rules on deposit or bailment.

The idea that multi-tiered structures of intermediation change not only the way in which shares are held, but also the type of asset being held, the relationships with intermediaries and the way in which we assert rights and perform duties that flow from this relationship, was pioneered by American legal scholars, most notably

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<sup>23</sup> See above, 11 1 Opening remarks.

<sup>24</sup> For a brief overview of the chronological development of the intermediated system in the US, see CR Reitz “Reflections on the Drafting of the 1994 Revision of Article 8 of the US Uniform Commercial Code” (2005) 10 *Uniform LR* 357.

<sup>25</sup> 359.

<sup>26</sup> Aronstein (1990) *Cardozo LR* 431.

<sup>27</sup> JL Schroeder “Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street” (1994) *Columbia Bus LR* 291 328-329.

Charles Mooney in a seminal article published in 1990,<sup>28</sup> and found its way into Article 8 of the Uniform Commercial Code.

Mooney argued that the continued reliance on traditional negotiable instruments and property law constructs is unworkable in the context of intermediated holdings of securities.<sup>29</sup> He proposed a new model, based not on a property construct, but rather on the relationships between clients and their intermediaries.<sup>30</sup> His difficulty with a property law construct lies with principles such as tracing, *bona fide* purchasers and the *nemo dat* principle.<sup>31</sup> In terms of his proposition of upper-tier priority, a client can only look towards his own intermediary in claiming the benefits that flow from shares.<sup>32</sup> The no-look-through approach is not novel. The abstract from Roman law cited above, features not only tiered deposits, but also determines that, in case of fraud or loss in the second tier, only the first-tier depository had a claim and had to assign this claim to the depositor.<sup>33</sup>

This approach prohibits any look-through from lower tiers to higher tiers. At the top of a pyramid of intermediaries is the central securities depository. Only the CSD has rights against the issuer resulting from the entry on the register. Lower-tier intermediaries or investors have a package of rights against their own intermediaries flowing from an account credit. This package consists of the right to demand that payments or distributions originating from the underlying shares will be passed on to them and that other rights, such as voting rights, will be exercised by their intermediary according to their instructions. Included in the package are rights that protect the assets held by the intermediary for its clients from the intermediary's own creditors.<sup>34</sup> This package is named a "security entitlement" by Article 8 of the UCC. It is the security entitlement that is recorded by book-entry in the securities accounts maintained for that purpose by intermediaries.

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<sup>28</sup> CW Mooney, Jr "Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries" (1990) 12 *Cardozo LR* 305. Also see the contributions by JS Rogers "Policy Perspectives on Revised U.C.C Article 8" (1996) 48 *UCLA LR* 1431 and RD Guynn *Modernizing Securities Ownership, Transfer and Pledging Laws: A Discussion Paper on the Need for International Harmonization* (1996).

<sup>29</sup> Mooney (1990) *Cardozo LR*, see especially the Introduction, 307-316.

<sup>30</sup> 312.

<sup>31</sup> 379.

<sup>32</sup> 379-380.

<sup>33</sup> See above, 8 3 3 4 Deposit and bailment, particularly the text to n 231.

<sup>34</sup> For a list of rights, see Rogers (1996) *UCLA LR* 1450-1451 and below at 11 5 Electronic settlement and transfer.

The model envisages the security entitlement as a separate asset that is derived from the underlying asset, but also distinct from it.<sup>35</sup> The underlying asset (the security) remains unchanged – it constitutes the obligation of the issuer and presupposes a direct link with the issuer. Any interests in the underlying asset are, while also defined as financial assets, assets in their own right. The security entitlement has a market value identical to that of the underlying security because the intermediaries are required to maintain financial assets “corresponding to the aggregate of all security entitlements it has established”.<sup>36</sup>

The US approach is a functional one.<sup>37</sup> It focuses on finding pragmatic solutions rather than enquiring into the general nature and classification of rights as proprietary or contractual.<sup>38</sup> The details of the functional approach will be further disseminated in Part 3. Mooney therefore concluded that “its details [of the upper-tier priority model proposed by him] are less important than moving the legal regime toward a more precise vision of the sui generis characteristics of the relationship that results when interests in fungible bulks of securities are transferred on the books of intermediaries”.<sup>39</sup>

#### 11 4 Registration

The rules for registration of transfers are in principle the same as outlined above.<sup>40</sup> The legally relevant register remains the record prepared by the issuer. In a system constructed around immobilised shares deposited with a central securities depository and entered on the register in the name of the depository or that of its nominee, the relevance of the register dissipates. The system is designed to function in such a way that a change of registration will rarely be necessary.

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<sup>35</sup> For a critical view on the statement that security entitlements are separate assets, see M Khimji “The Role of Legal Concepts in Commercial Law: Comments on Spink, Rogers and Scavone” (2007) 45 *Can Bus LJ* 94 97; MF Khimji “The Securities Transfer Act – The Radical Reconceptualization of Property Rights in Investment Securities” (2007) 45 *Alberta LR* 137 151.

<sup>36</sup> UCC § 8-504(a); Reitz (2005) *Uniform LR* 362.

<sup>37</sup> Rogers (1996) *UCLA LR* 1450.

<sup>38</sup> Rogers (1996) *UCLA LR* 1452. English law, as was illustrated above at 10 2 Intermediation – a legal perspective, also recognises that intermediation results in the creation of interests in shares that are different from the underlying shares, but derives any rules of transfer from the law of trusts.

<sup>39</sup> Mooney (1990) *Cardozo LR* 413; also see Guynn *Modernizing Securities Ownership* 9-10, 34-35.

<sup>40</sup> See above, 8 3 3 3 The change in registration.

## 11 5 Electronic settlement and transfer

### 11 5 1 Commercial mechanisms

Once the trade has been completed, most likely through an exchange, the details of the trade are transmitted via the electronic system of the exchange to the NSCC. The NSCC performs clearing and risk-management functions for the DTC. The transaction will be settled by the NSCC three days after trade i.e. on T+3.<sup>41</sup> Clearing commences on the day after trade (T+1) and is aimed at ensuring that sufficient securities are held by the seller and includes multilateral netting of the positions of all participants in the system. The processing of the transaction for settlement starts on the afternoon of the day before settlement (T+2). Settlement consists of a securities leg and a money settlement leg.

The settlement of securities, in our example shares, takes place through the Continuous Net Settlement System (“CNS”) of the NSCC. The NSCC nets each participant’s position to a net receive (known as a long position) or a net deliver (a short position) per type of security and per settlement day.<sup>42</sup> Thereafter, the short positions are compared to the relevant participant’s DTC account<sup>43</sup> to determine whether sufficient shares are available for settlement. Thereafter, the NSCC will instruct the DTC to “deliver” the number of shares, as calculated, from the account of the participant with a short position to the NSCC’s DTC account.<sup>44</sup> This step is known as short cover. It is followed by the allocation of shares from the NSCC’s DTC account to the account of the participant with a long position, known as long allocation.<sup>45</sup> In this process, the NSCC acts as a central counterparty. At the point of short cover, the NSCC assumes the obligations of the selling participant to “deliver” the shares and simultaneously assigns the related rights to receive the shares to the receiving participant.<sup>46</sup> It is specifically provided that ownership rights pass to the

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<sup>41</sup> Committee on Payment and Settlement Systems (CPSS) “CPSS Red Book - Payment, Clearing and Settlement Systems in the United States” in Bank for International Settlements (BIS) *Payment, Clearing and Settlement Systems in the CPSS Countries* (2012) 495.

<sup>42</sup> National Securities Clearing Corporation (NSCC) *Rules & Procedures* (September 2018) rule 11 s 1(a).

<sup>43</sup> The DTC is used here, as the majority of shares are deposited with the DTC. A participant may however make use of another depository, known as a “Designated Depository” within the CNS system.

<sup>44</sup> NSCC *Rules* rule 11 s 3.

<sup>45</sup> Rule 11 s 3.

<sup>46</sup> Rule 11 s 1(b).

NSCC.<sup>47</sup> This construct is aimed at guaranteeing each trade and thereby reducing the risk of non-settlement.<sup>48</sup> This leg of the transaction is processed free of payment. Therefore, it is provisional intra-day until payment has been made.<sup>49</sup> After the long allocation, which takes place in the books of the DTC, the participants and other lower tier intermediaries must make corresponding changes in their own books.

The payment side of the settlement process only takes place at the end of the settlement day. The DTC-NSCC therefore operates a DVP2 settlement model. Each participant must nominate a settlement bank. The settlement bank is also a participant of the DTC and may settle its own transactions or transactions for other participants, including other bank participants.<sup>50</sup> The settlement bank must have access to the National Settlement System (“NSS”) operated by the Federal Reserve Banks as well as the Fedwire system.<sup>51</sup> Money settlement therefore takes place in central bank money. Each settlement bank’s debits and credits at both the DTC and the NSCC are netted. Thereafter, cross-endorsement takes place between the DTC and the NSCC positions resulting in a single net-net debit or credit per settlement bank.<sup>52</sup> This is known as multilateral netting. Netting arrangements significantly enhance the speed, efficiency and volume of processing. The DTC may also establish a net debit cap, which is the maximum debit that a participant may incur at any point during the day.<sup>53</sup> Towards the end of the settlement day, the DTC will post final figures, which must be acknowledged by the settlement bank.<sup>54</sup> The settlement bank must further ensure that sufficient funds are available for settlement in its

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<sup>47</sup> Rule 11 s 1(e).

<sup>48</sup> See Rule 11 s 1(c).

<sup>49</sup> CPSS “CPSS Red Book – United States” in *Payment, Clearing and Settlement Systems* 495; See also NSCC *Rules* Rule 12 s 2(a) and (c). These rules provide that any book-entries made on the accounts of the depository are not appropriate entries until the effective time. The effective time is the earlier of i) the time it is determined that the participant’s gross credit balance exceeds his gross debit balance; ii) if this is not the case and the participant settles through a settlement bank, the time it is determined that the settlement bank has a net-net credit balance or iii) if i) and ii) are not applicable, at the time when the participant pays his debit balance or if the settlement bank pays its net-net debit balance. See below for the completion of the money settlement side.

<sup>50</sup> Depository Trust Company (DTC) *Settlement Service Guide* 18.

<sup>51</sup> DTC *Settlement Service Guide* 18; The Fedwire system is operated by the Federal Reserve Banks and allows for the electronic transfer of funds on a real-time gross settlement basis. This is equivalent to a DVP1 settlement system.

<sup>52</sup> DTC *Settlement Service Guide* 18, 29-31; NSCC *Rules* Procedure VIII, D3.

<sup>53</sup> DTC *Settlement Service Guide* 5. This is aimed at managing risk. In addition, all net debits are collateralised. See CPSS “CPSS Red Book – United States” in *Payment, Clearing and Settlement Systems* 508; The settlement bank may limit the debit cap of a participant to an amount less than the debit cap calculated by the DTC; see DTC *Settlement Service Guide* 19.

<sup>54</sup> DTC *Settlement Service Guide* 19; NSCC *Rules* Procedure VIII, D1.

account at the Federal Reserve Bank.<sup>55</sup> The DTC then processes a single NSS file with the Federal Reserve Bank to debit or credit each settlement bank's NSS account.<sup>56</sup>

### 11 5 2 Legal framework

Recent years have seen an increasing disenchantment with the principles underlying negotiability. The substantial revision of Article 8 was aimed at, amongst others, moving away from the concept of negotiability and its limitations. Nonetheless, the idea of negotiability is the still discernible basis from which the current law developed.

The US securities holding system is characterised by a clear distinction between a direct and an indirect holding system, which is equivalent to holding shares versus holding a security entitlement. Even in complex structures of intermediaries, both direct and indirect holding continue to exist alongside each other. In the top tier, the holding is direct and most commonly in the name of a depository (or its nominee). All lower tiers hold indirectly. While the former relates to a physical certificate, the latter is purely conceptual.

Certificated shares are transferred by delivery of the share certificate as well as indorsement.<sup>57</sup> Delivery is the first leg on which the transfer of shares rests. Before the certificate can be delivered, it must be indorsed. Indorsement is the second leg of an effective transfer of shares. Usually there is an assignment form printed on the back of the certificate that allows for indorsement. The indorsement can also be made on a separate stock assignment form. Indorsement is "a signature that alone or accompanied by other words is made on a security certificate in registered form or on a separate document for the purpose of assigning, transferring, or redeeming the security or granting a power to assign, transfer, or redeem it".<sup>58</sup> If a seller of shares merely signs his name at the back of the certificate, he makes a blank indorsement. Alternatively, he can specify who has the power to transfer the share.<sup>59</sup> This is known as a special indorsement. It is important that the indorsement made by the seller is

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<sup>55</sup> DTC *Settlement Service Guide* 19; NSCC *Rules* Procedure VIII, D1.

<sup>56</sup> DTC *Settlement Service Guide* 20, NSCC *Rules* Procedure VII D3.

<sup>57</sup> UCC § 8-304(c).

<sup>58</sup> UCC § 8-102(11); See also UCC § 8-304(a).

<sup>59</sup> UCC § 8-304(a).

effective. This will be the case if the seller is an appropriate person,<sup>60</sup> being “the person specified by a security certificate or by an effective special indorsement to be entitled to the security”.<sup>61</sup> The signature of the indorser can further be verified.<sup>62</sup> In practice, this is done by a so-called medallion signature guarantee, which can be obtained from a host of financial institutions.

A transfer cannot stand on one leg – only when both, an indorsement has been made, and the indorsed share certificate has been delivered to the purchaser, is the transfer complete.<sup>63</sup> In its simplest construction, delivery of a certificated share simply means that the purchaser acquires physical possession of the share certificate.<sup>64</sup> Alternatively, the purchaser can determine that a third person, who is not a securities intermediary, acquires possession of the certificate on his behalf.<sup>65</sup> The third party would act as the purchaser’s nominee. If the third party is at the same time also the nominee of the seller, she has previously acquired possession of the certificate and may therefore merely acknowledge that she now holds for the purchaser.<sup>66</sup> Delivery therefore does not have to be physical, but can instead be constructive i.e. without a change in possession. Delivery can also occur if “a securities intermediary, acting on behalf of the purchaser acquires possession of the certificate” and the share is in registered form and is (i) registered in the name of the purchaser, (ii) payable to the order of the purchaser, or (iii) specially endorsed to the purchaser by an effective indorsement and has not been indorsed to the securities intermediary or in blank”.<sup>67</sup> Upon indorsement and delivery, the transfer of the shares will be complete. This is followed by registration. Registration is, however, not required to transfer the rights.

If the seller delivers the shares to the purchaser without the necessary indorsement, the UCC determines that the transaction will be complete as between the parties, provided that the transferor had the intention to transfer title to the shares.<sup>68</sup> The purchaser may also compel the seller to supply the indorsement.<sup>69</sup>

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<sup>60</sup> UCC § 8-107(b)(1); Alternatively an indorsement is also effective if it is made by an agent, who has the power to transfer or if the appropriate person ratifies the indorsement “or is otherwise precluded from asserting its effectiveness” UCC § 8-107(b)(2)-(3).

<sup>61</sup> UCC § 8-107(a)(1).

<sup>62</sup> See UCC § 8-306.

<sup>63</sup> UCC § 8-304(c).

<sup>64</sup> UCC § 8-301(a)(1).

<sup>65</sup> UCC § 8-301(a)(2).

<sup>66</sup> UCC § 8-301(a)(20).

<sup>67</sup> UCC § 8-301(a)(3). Also see UCC § 8-501(d) – the purchaser of a certificate registered or indorsed in the manner described is said to hold the securities directly.

<sup>68</sup> UCC 8-304(d).

Without the indorsement, the purchaser will not be a “protected purchaser” and will therefore not purchase the shares free of any adverse claims.<sup>70</sup> Furthermore, an issuer is only obliged to register the transfer if an indorsement has been made by an appropriate person.<sup>71</sup> The company will therefore continue to render performance to the seller of the shares.

If, on the other hand, the indorsement has been made, but there has been no delivery (either of the indorsed certificate or of the certificate and document of indorsement, if separate), the transfer is not complete<sup>72</sup> and there is no equivalent right to compel the purchaser to deliver.<sup>73</sup> Decisive for an effective transfer is therefore that the seller relinquishes control through actual or constructive delivery, with the intention to transfer.<sup>74</sup>

In modern holding structures, a change in direct holding will be infrequent. The holding of shares typically remains with the DTC and actual delivery of the physical share certificates will only take place if there is a change in the direct holding i.e. a change of depositories or a withdrawal of certificates from deposit. It is far more important therefore to map a change in indirect holding.

If a seller's shares are held directly by the DTC through its nominee Cede & Co, the register of the issuer will reflect Cede & Co as the holder of the shares. As the shares are immobilised, the seller cannot physically deliver the share certificate to the purchaser. The mechanism of delivery must therefore be amended to cater for immobilised shares and securities. This overhaul of existing concepts and mechanisms was undertaken by the drafters of Article 8 of the UCC of 1994. Article 8 introduced novel rules, reconceptualised the law of securities transfers and combined empirical market practice with legal theory – described by Schroeder as a legal realist approach.<sup>75</sup> Its focus is no longer a physical object but rather the relationship with an intermediary. The central concepts of an immobilised and intermediated system are: 1. a securities account; 2. a securities intermediary; 3. a financial asset; and 4. a

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<sup>69</sup> UCC 8-304(d); *Coats v Guaranty Bank and Trust Co* 170 La 871 (1930) 875-876.

<sup>70</sup> On protected purchasers see below, 11 6 Protection of bona fide purchasers. The lack of protection from adverse claims results from the failure to exercise control.

<sup>71</sup> UCC § 8-401(a)(2).

<sup>72</sup> UCC § 8-304(c).

<sup>73</sup> UCC *Official Comments* – Article 8 § 8-304 para 3.

<sup>74</sup> Also see above, 8 3 3 2 Negotiation, assignment and the transfer of shares.

<sup>75</sup> Schroeder (1994) *Columbia Bus LR* 351-352.

security entitlement (held by an entitlement holder). These concepts will be considered in turn.

A securities account is an account “to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset”.<sup>76</sup> The definition features three important elements: 1. A securities account is established by consensual agreement. In line with the definition of an agreement in article 1-2-1(3) this requirement must be interpreted broadly and does not require writing or other formalities.<sup>77</sup> 2. A financial asset is credited to the account. 3. The account holder is entitled to the rights comprising the financial asset. The crux of the agreement is therefore that an intermediary undertakes to treat the account holder as entitled to exercise all the rights that comprise his interests in the shares.<sup>78</sup> Whether such an undertaking is agreed to, must be interpreted with regard to the underlying purpose of Article 8 and the expectations of the parties.<sup>79</sup> A securities account does not establish a trust relationship.<sup>80</sup> Whereas the DTC holds the securities, an investor holds a credit in the securities account maintained by his immediate intermediary.

A repetition of this construction takes place at every level or tier of intermediaries, creating a chain of cascading securities accounts. The act of creating and maintaining a securities account is central to the definition of a securities intermediary. A securities intermediary is either a clearing corporation or “a person including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity”.<sup>81</sup>

At the core of the securities account is the financial asset. Before directing the focus to security entitlements, it is useful to obtain a clear understanding of financial assets. A financial asset includes 1. securities; 2. obligations or a share, participation or interest in property or an enterprise which is dealt with on financial markets or as a medium for investment and 3. property held in a securities account if it was expressly

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<sup>76</sup> UCC § 8-501(a).

<sup>77</sup> UCC *Official Comments* – Article 8 § 8-501 para 1.

<sup>78</sup> UCC *Official Comments* – Article 8 § 8-501 para 1, para 3.

<sup>79</sup> UCC *Official Comments* – Article 8 § 8-501 para 1; Chun *Cross-border Transactions* 204.

<sup>80</sup> UCC *Official Comments* – Article 8 § 8-501 para 1. UCC *Prefatory Note* – 1994 *Revision Note III C* para 5.

<sup>81</sup> UCC § 8-102(14).

agreed that this property should be treated as a financial asset.<sup>82</sup> Under the second category, options and similar obligations qualify as financial assets.<sup>83</sup> The third category catches any property, provided it is held in a securities account. Thus, negotiable instruments held in a securities account are financial assets.<sup>84</sup> The term “financial asset” can be taken to refer either to the underlying asset or to the means by which ownership of the underlying asset is evidenced.<sup>85</sup> To illustrate this: at the top tier, a financial asset is either the obligation of an issuer i.e. the bundle of rights flowing from a security in the case of a directly held certificated security or the certificate itself that evidences ownership of those rights.<sup>86</sup> In the case of indirectly held securities, the term may refer to the underlying asset or to a security entitlement, which is the means by which ownership of the underlying asset is evidenced.<sup>87</sup>

In a securities account, assets are created that must be conceptualised separately from the assets underlying them. These are security entitlements. Nonetheless, security entitlements can never exist independently of their underlying financial assets. The concept “security entitlement” encompasses “the rights or property interest of an entitlement holder with respect to a financial asset”.<sup>88</sup> A person is an entitlement holder if he is “identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary”.<sup>89</sup> An entitlement holder holds a security entitlement, not a security. The security, such as a share, is held by the DTC (through Cede & Co). A direct relationship exists between the issuer and the DTC through registration and the issuer is entitled to perform towards the DTC only.<sup>90</sup> What rights does the entitlement holder have? The construct of securities intermediaries maintaining securities accounts encompassing security entitlements for entitlement holders is aimed at ensuring that each intermediary exercises the rights comprising the assets for its respective customer. An investor, as the ultimate entitlement holder receives and exercises the rights comprising his shares indirectly through his intermediary, who may again make use of an intermediary and so forth. In fact, a security entitlement only gives each party in the

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<sup>82</sup> UCC § 8-102(a)(9).

<sup>83</sup> This example is expressly mentioned in UCC § 8-103(e). Commodity contracts, on the other hand, are neither securities nor financial assets; see § 8-103(f).

<sup>84</sup> See UCC § 8-103(d).

<sup>85</sup> UCC 8-102(9).

<sup>86</sup> UCC *Official Comments – Article 8* § 8-102 para 9.

<sup>87</sup> UCC *Official Comments – Article 8* § 8-102 para 9.

<sup>88</sup> UCC § 8-102(17).

<sup>89</sup> UCC § 8-102(7).

<sup>90</sup> UCC § 8-207.

chain rights against its own intermediary, never against the issuer. It is made clear in § 8-503(c) that the interest of an entitlement holder may be enforced against the securities intermediary only and only in terms of the rules set out in the Uniform Commercial Code.

A security entitlement is frequently described as a package of rights against the intermediary.<sup>91</sup> Included in the package are the following rights: First, the intermediary must obtain payments and distributions made by the issuer and disburse these to its entitlement holder.<sup>92</sup> Second, an intermediary must exercise any rights that an entitlement holder has in respect of the financial asset if the entitlement holder directs it to do so.<sup>93</sup> This includes exercising voting rights as directed by the entitlement holder. Third, the intermediary must comply with an entitlement order.<sup>94</sup> An entitlement order is “a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement”.<sup>95</sup> Furthermore, the intermediary has a duty to change a security entitlement to another form of holding or to transfer the security entitlement to a securities account held with another intermediary.<sup>96</sup> Last, the intermediary must match the quantity of financial assets it maintains to the quantity of security entitlements it establishes<sup>97</sup> and may not grant security interests in financial assets maintained for such a purpose.<sup>98</sup> Additionally, an entitlement holder is protected against the creditors of the intermediary. Interests in financial assets held for entitlement holders do not become the property of the intermediary and are not subject to claims by creditors of the intermediary.<sup>99</sup> The entitlement holder will have a pro-rata property interest in the pool of all financial assets of that type held by the intermediary.<sup>100</sup>

Rather than changing the underlying nature of the financial asset (the share or security) the UCC creates a new asset, the security entitlement. This asset is not an

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<sup>91</sup> See for example Rogers (1995) *Idaho LR* 692; Rogers (1996) *UCLA LR* 1451.

<sup>92</sup> UCC § 8-505.

<sup>93</sup> UCC § 8-506.

<sup>94</sup> UCC § 8-507.

<sup>95</sup> UCC § 8-201(8).

<sup>96</sup> UCC § 8-508.

<sup>97</sup> UCC § 8-504(a).

<sup>98</sup> UCC § 8-504(b).

<sup>99</sup> UCC § 8-503(a).

<sup>100</sup> UCC § 8-503(b).

identifiable object, but rather a collection of rights.<sup>101</sup> These rights are designed to be exercised against the intermediary only. No provision is made for claims against upper-tier intermediaries or against the issuer. The legal status of the investor is that of an entitlement holder, not a securities holder.<sup>102</sup>

The personal nature of the intermediary-investor relationship leads to the conclusion that a security entitlement consists of rights *in personam*.<sup>103</sup> From the definition of a security entitlement it appears, however, that the package of rights includes property rights,<sup>104</sup> a position confirmed by commentators and authors.<sup>105</sup> The Prefatory Note states that “a security entitlement is itself a form of property interest not merely an *in personam* claim against the intermediary”.<sup>106</sup> Instead of only having rights *against* an intermediary, an entitlement holder also has rights *in the property* of an intermediary.<sup>107</sup> It is an interest in the property or financial assets held by the intermediary that is less than ownership of that property.<sup>108</sup> The property interest is pro rata without a claim to a specific item of property or financial asset.<sup>109</sup> Chun finds that “[a] security entitlement has the nature of a property right, but the property nature is reshaped in a restricted way into a proportional interest”.<sup>110</sup> The property rights are a creation of Article 8; they are not common law property rights.<sup>111</sup> Property rights can usually be exercised against the world. Despite their proprietary nature, these property rights can only be enforced against third parties in exceptional and strictly limited cases.<sup>112</sup> The relationship between an intermediary and an entitlement holder is hence frequently labelled *sui generis* rather than being categorised in accordance with the legal concepts from a bygone era.<sup>113</sup>

<sup>101</sup> Rogers (1996) *UCLA LR* 1456.

<sup>102</sup> Chun *Cross-border Transactions* 222.

<sup>103</sup> 203, 209.

<sup>104</sup> See definition above, text to n 88.

<sup>105</sup> See for example Rogers (1996) *UCLA LR*; Rogers (1995) *Idaho LR*; Guynn *Modernizing Securities Ownership*; RA Hakes “UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day?” (2002) 35 *Loyola of LA LR* 661; CW Mooney, Jr, SM Rocks & RS Schwartz “An Introduction to the Revised U.C.C. Article 8 and Review of Other Recent Developments with Investment Securities” (August 1994) 49 *Bus L* 1891.

<sup>106</sup> UCC *Prefatory Note – 1994 Revision* Note II C.

<sup>107</sup> UCC § 8-503(b).

<sup>108</sup> Hakes (2002) *Loyola of LA LR* 687.

<sup>109</sup> UCC § 8-503(b); also see Chun *Cross-border Transactions* 213.

<sup>110</sup> Chun *Cross-border Transactions* 213.

<sup>111</sup> UCC *Official Comments – Article 8* § 8-503 comment 2; Hakes (2002) *Loyola of LA LR* 686.

<sup>112</sup> See § 8-503(d) and (e) for the details. Also see Chun *Cross-border Transactions* 213-214. No claim lies against a purchaser who has given value, obtains control and has not colluded with the securities intermediary in obtaining the security entitlement; see § 8-503(e).

<sup>113</sup> UCC *Prefatory Note – 1994 Revision* III B, 45.

According to the UCC, a purchaser will acquire the shares or an interest in the shares if he acquires the security entitlement to those shares.<sup>114</sup> The code sets out three ways in which a security entitlement can arise. First, if a securities intermediary “indicates by book entry that a financial asset has been credited to the person’s securities account”.<sup>115</sup> In other words, the intermediary acknowledges, through a credit in a securities account, that he is holding an interest in a financial asset for its customer.<sup>116</sup> Second, a person acquires a security entitlement if a securities intermediary “receives a financial asset from the person or acquires a financial asset for the person and, in either case, accepts it for credit to the person’s security account”.<sup>117</sup> This typically takes place where a customer delivers a share certificate in physical form to his bank or broker to be held in his account.<sup>118</sup> The third option is a residual test and determines that a security entitlement arises if a securities intermediary “becomes obligated under other law, regulation, or rule to credit a financial asset to the person’s securities account”.<sup>119</sup> This test applies if the intermediary fails to make the required entries to the securities account of a customer. Ordinary cases should be covered by the first test.<sup>120</sup> What is clear is that the matter is not so much a transfer of rights, but rather, as the Official Commentary to the UCC emphasises “the significant fact is that the securities intermediary has undertaken to treat the customer as entitled to the financial asset”.<sup>121</sup>

What appears from both the legal rules as well as the commercial procedures is that, unlike shares, security entitlements are not transferred. This is highlighted by the Official Comment to the UCC:

“Securities, in the Article 8 sense, are fungible interests or obligations that are intended to be tradable. The concept of security entitlement under Part 5 is quite different. A security entitlement is the package of rights that a person has against the person’s own intermediary with respect to the positions carried in the person’s securities account. That package of rights is not, as such, something that is traded. When a customer sells a security that she had held through a securities account, her security entitlement is

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<sup>114</sup> UCC § 8-104(a)(2).

<sup>115</sup> UCC § 8-501(b)(1).

<sup>116</sup> See UCC *Official Comments* – Article 8 § 8-501 para 2.

<sup>117</sup> UCC § 8-501(b)(2).

<sup>118</sup> See UCC *Official Comments* – Article 8 § 8-501 para 2.

<sup>119</sup> UCC § 8-501(b)(3).

<sup>120</sup> UCC *Official Comments* – Article 8 § 8-501 para 2.

<sup>121</sup> UCC *Official Comments* – Article 8 § 8-501 para 3; also refer to definition of “securities account” above.

terminated; when she buys a security that she will hold through her securities account, she acquires a security entitlement. In most cases, settlement of a securities trade will involve termination of one person's security entitlement and acquisition of a security entitlement by another person. That transaction, however, is not a "transfer" of the same entitlement from one person to another."<sup>122</sup>

Share certificates, delivery and transfer in the traditional sense only play a role in the top tier, and even at this level, the paper exists only to provide a fit with a legal regime it has long outgrown. At lower tiers there is no object of transfer, only a credit entry and with it the termination and creation of a relationship with an intermediary.<sup>123</sup> Thus it has been said that it is no longer negotiability, but rather novation that forms the basis of share transfers.<sup>124</sup> This conclusion is dictated not only by the absence of paper in account-based structures, but also by mechanisms such as the use of central counterparties and netting facilities. Abstract rights that can only be enforced against a specific intermediary, "pass" from a seller to a buyer. Where one party sells these rights, they are extinguished and created anew in relation to the buyer and the buyer's intermediary. The buyer does not have the same package of rights that the seller had. Even if the newly created rights may be economically equivalent to those extinguished, it does not follow that they are the same.<sup>125</sup>

To conclude the discussion, dematerialised shares must be briefly considered. The UCC makes provision for dematerialised shares. The distinction between certificated and uncertificated shares is, however, only relevant at the level of direct holding. Uncertificated shares are transferred by an instruction (which replaces the indorsement) and delivery. The instruction is a "notification communicated to the issuer...which directs that the transfer of a security be registered".<sup>126</sup> Delivery will take place when the issuer registers the purchaser<sup>127</sup> or when another person, not being a securities intermediary, becomes the registered owner on behalf of the purchaser or acknowledges that he holds for the purchaser.<sup>128</sup> This constitutes the

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<sup>122</sup> UCC *Official Comments – Article 8* § 8-501 para 5; See also Rogers (1995) *Idaho LR* 689 693-695 on difficulties with the transfer concept.

<sup>123</sup> Chun *Cross-border Transactions* 230; Schroeder (1994) *Columbia Bus LR* 374.

<sup>124</sup> M Dubovec *The Law of Securities, Commodities and Bank Accounts: The Rights of Account Holders* (2014) 14-15.

<sup>125</sup> Rogers (1991) *Cardozo LR* 506; Hakes (2002) *Loyola of LA LR* 717; Chun *Cross-border Transactions* 230-231.

<sup>126</sup> UCC § 102(11).

<sup>127</sup> UCC § 8-301(b)(1).

<sup>128</sup> UCC § 8-301(b)(2).

transfer of a security. If uncertificated shares are held through securities intermediaries, the ultimate investor holds a security entitlement not a security and a sale will result in the extinction and acquisition of the security entitlement in the same manner as illustrated above. For this reason the distinction between certificated and uncertificated shares is not relevant at the indirect holding level. The real difference between certificated and uncertificated shares lies in the way in which ownership of the shares is evidenced.<sup>129</sup> Whereas the share certificate is central to evidencing ownership of certificated shares, the issuer's register takes over this evidentiary role for uncertificated shares.

## 11 6 Protection of bona fide purchasers

The concept of a protected purchaser in the Uniform Commercial Code gives a statutory basis to the negotiability principle. Due to confusion in case law about the precise meaning of good faith, the terminology of "good faith" and "bad faith" was abandoned in revised Article 8 of the UCC.<sup>130</sup> As a general point of departure, a purchaser acquires only those rights that the seller had.<sup>131</sup> The only exception is made for a "protected purchaser", referring to "a purchaser of a certificated or uncertificated security, or of an interest therein, who: (1) gives value;<sup>132</sup> (2) does not have notice of any adverse claim to the security; and (3) obtains control of the certificated or uncertificated security".<sup>133</sup> A protected purchaser acquires the security or interest in the security free from any adverse claims.<sup>134</sup> An adverse claim is "a claim that a claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset".<sup>135</sup> If a purchaser is not a protected purchaser, he "acquires all rights in the security that the transferor had or had power to transfer".<sup>136</sup> A person has knowledge of an adverse claim if he knows about it,<sup>137</sup> if he is aware of sufficient facts that establish a significant probability of an adverse claim and he avoids any

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<sup>129</sup> UCC *Official Comments* – Article 8 Section II B.

<sup>130</sup> Rogers (1996) *UCLA LR* 1471-1472; UCC *Official Comments* – Article 8 § 8-303 para 4.

<sup>131</sup> UCC § 8-302(a).

<sup>132</sup> For a definition of "value", see UCC § 1-204.

<sup>133</sup> UCC § 8-303.

<sup>134</sup> UCC § 8-303.

<sup>135</sup> UCC § 8-102(a).

<sup>136</sup> UCC § 8-302.

<sup>137</sup> UCC § 8-105(a)(1).

information regarding the claim,<sup>138</sup> or if he has a statutory duty to investigate the existence of an adverse claim.<sup>139</sup> The third requirement of a protected purchaser, namely “control” of a certificated share in registered form, is present if the certificate is delivered and indorsed to the purchaser<sup>140</sup> or if it is delivered to and registered in the name of the purchaser upon original issue thereof.<sup>141</sup> The control requirement speaks to the form of the transfer. To qualify as a protected purchaser all three requirements must be met at the same time.<sup>142</sup> If the purchaser, for example, receives notice of an adverse claim before he gives value or obtains control, he will not be a protected purchaser.<sup>143</sup>

The drafters of Article 8 have opted not to apply the concept of a “protected purchaser” to indirect holdings. They have rather provided for three unique circumstances which merit purchaser protection. First, the purchaser of a security entitlement is protected from adverse claims to a financial asset, provided that he has given value and has had no notice of the adverse claim.<sup>144</sup> Compared to the “protected purchaser” rules, control is not required. Hakes points out that the rule protects an adverse claim to an underlying financial asset, over which an entitlement holder can never exercise control.<sup>145</sup> Second, the purchaser of a security entitlement or an interest therein is protected from an adverse claim to a financial asset or a security entitlement, provided she has given value, has received no notice and exercises control.<sup>146</sup> This rule covers claims to both financial assets and security entitlements.<sup>147</sup> It covers cases in which the purchaser does exercise control, but does not become an entitlement holder, typically being a person taking a security interest.<sup>148</sup> The third rule protects the purchaser of a financial asset transferred by a

<sup>138</sup> UCC § 8-105(a)(2).

<sup>139</sup> UCC § 8-105(a)(3).

<sup>140</sup> UCC § 8-106(b)(1). This must be an effective indorsement – see UCC § 8-107. Thus, a forged indorsement will not be effective and will not give the purchaser the necessary control (unless the company registers the purchaser, in which case the second element of control is met). The purchaser will not be a protected purchaser, but he may take the shares free from the issuer’s defense (See UCC § 8-202), provided that he gave value and had no notice of an adverse claim.

<sup>141</sup> UCC § 8-106(b)(2). If an issuer registers the purchaser pursuant a forged indorsement, the purchaser will be protected, but the true owner can claim from the issuer for “wrongful registration”; see UCC § 8-404.

<sup>142</sup> UCC *Official Comments* – Article 8 § 8-303 para 2.

<sup>143</sup> UCC *Official Comments* – Article 8 § 8-303 para 2.

<sup>144</sup> UCC § 8-502.

<sup>145</sup> Hakes (2002) *Loyola of LA LR* 713. Also see FJ Facciolo “Father Knows Best: Revised Article 8 and the Individual Investor” (2000) 27 *Florida State Uni LR* 615 655.

<sup>146</sup> UCC § 8-510.

<sup>147</sup> Hakes (2002) *Loyola of LA LR* 716-717.

<sup>148</sup> UCC *Official Comments* – Article 8 § 8-510 para 2.

securities intermediary in violation of its duties, provided the purchaser has given value, exercises control and has not colluded with the securities intermediary.<sup>149</sup> These rules serve to strengthen transactional security. Dubovec, for example, recognises that the finality and irrevocability of transfers reign paramount.<sup>150</sup> Hakes argues, however, that the strongest protection against adverse claims is not laid down by any rules in Article 8, but is built into the structure of the indirect holding system. The netting of trades during the settlement process renders the tracing of a financial asset through the process almost impossible.<sup>151</sup> While the protection of *bona fide* purchasers from adverse claims is a distinctive property of negotiability, Mooney and Rogers argue that in modern, intermediated systems, certainty of transfer is not warranted by negotiability, but rather by the trust- and creditworthiness of intermediaries and systems.<sup>152</sup>

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<sup>149</sup> UCC § 8-503 (e).

<sup>150</sup> Dubovec *Securities, Commodities and Bank Accounts* 15. Some authors however posit that the move from protecting security of title to security of transfer means that property rights of owners are not adequately protected; see Facciolo (2000) *Florida State Uni LR* 653-660, 711.

<sup>151</sup> Hakes (2002) *Loyola of LA LR* 711-712.

<sup>152</sup> Rogers (1991) *Cardozo LR* 479; Mooney (1990) *Cardozo LR*.

## Chapter 12: The effect of systematic intermediation in Germany

### 12 1 Introduction

According to Micheler, the classification of shares and securities as tangibles also has normative force; “the existence of paper certificates is essential; if paper certificates cease to exist, securities transfers would be subject to the rules on assignment”.<sup>1</sup> German law has therefore developed to immobilise shares and other securities to retain the conceptual basis provided by the law of things. The concepts of property and deposit therefore remain acutely relevant.

### 12 2 Overview of the commercial structures

The origin of the current structures facilitating the deposit, custody and transfer of securities can be found in the Berliner Kassenverein, as briefly set out above.<sup>2</sup> The business of the safekeeping and custody (“Depotgeschäft”) of securities is regulated by the Depotgesetz of 1937. The “Depotgeschäft” is simply defined with reference to its function of deposit and custody of securities for others.<sup>3</sup> It further falls under the rubric of banking business (“Bankgeschäft”). A bank is in turn a financial institution (“Kreditinstitut”) and is therefore subject to banking and financial regulation. While the securities are deposited by a depositor known as a “Hinterleger”, the Depotgesetz further distinguishes between a depository or custodian (“Verwahrer”) and a collective securities depository (“Wertpapiersammelbank”/CSD). The latter is empowered by the provisions permitting third-party custody.<sup>4</sup> A collective securities depository is simultaneously a custodian as defined; the investor and holder of physical securities certificates deposits securities with a custodian, who becomes a so-called “Zwischenverwahrer”, and who in turn deposits securities centrally with a collective, third-party custodian.<sup>5</sup> Whereas a depository is an entity that accepts the deposit of unsealed securities (“offenes Depot”) in the course of its business,<sup>6</sup> a collective depository is simply defined as an entity recognised as such by legislation.<sup>7</sup>

<sup>1</sup> E Micheler *Property in Securities: A Comparative Study* (2007) 184.

<sup>2</sup> See above, 8 3 4 4 Deposit.

<sup>3</sup> See §1(1) 5 of the Kreditwesengesetz.

<sup>4</sup> See below, 12 3 Intermediation – a legal perspective.

<sup>5</sup> T Heinsius, A Horn & J Than *Depotgesetz* (1975) 22.

<sup>6</sup> Depotgesetz § 1(2). A depository (custodian) must be a merchant (“Kaufmann”) as defined by § 1 Handelsgesetzbuch.

<sup>7</sup> Depotgesetz § 1(3).

The Berliner Kassenverein was followed by the establishment of a number of collective depositories, frequently founded exclusively for the purpose of accepting deposits of securities in particular states and affiliated with state-based stock exchanges.<sup>8</sup> In 1989, the existing seven collective depositories merged to form the Deutscher Kassenverein AG, the only shareholder being the Deutsche Börse AG.<sup>9</sup> After several mergers and substantial restructuring, the only collective depository in Germany today is Clearstream Banking AG, whose holding company is a wholly owned subsidiary of the Deutsche Börse AG.<sup>10</sup> Participants of the CSD are known as customers or clearing members and are the only entities allowed to open accounts with Clearstream. In general, all customers are juristic persons, specifically regulated banks or other financial institutions.<sup>11</sup> Investors that are natural persons cannot become direct customers of the CSD. They rather make use of financial institutions that act as intermediaries and accept deposits and perform custodial functions on their behalf. There may be more than one such intermediary positioned between the investor and the CSD. Settlement and clearing of securities takes place through an electronic system known as CASCADE, operated by Clearstream Banking. Customers open securities accounts with Clearstream Banking. They do not maintain cash accounts, but instead merely open internal cash accounts which reflect the amount of the transactions settled. These accounts are in turn netted and conveyed to the central bank for payment. Cash settlement takes place in central bank money. Customers therefore need to open a cash account in TARGET2, the RTGS payment platform operated by, amongst other European central banks, the Deutsche Bundesbank, or contract with a settlement bank which maintains such an account with the central bank.

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<sup>8</sup> For a list, see for example Heinsius et al *Depotgesetz* 28; H Delorme *Die Wertpapiersammelbanken* (1970) 13.

<sup>9</sup> For a history of the Deutsche Börse AG see <<http://deutsche-boerse.com/dbg-de/ueber-uns/gruppe-deutsche-boerse/unternehmensgeschichte/text-collection/2552990?frag=2552994>> (accessed 29-09-2018); Clearstream *Kundenhandbuch* (August 2018) 1.1, 1-1.

<sup>10</sup> In 1997, Deutscher Kassenverein AG merged with Auslandskassenverein and was restructured as the Deutsche Börse Clearing AG, which in turn merged with Cedel International in 2000 and was later renamed. See L Böttcher *Depotgesetz* (2012) § 1 [5]; Clearstream *Kundenhandbuch* 1.1, 1-1.

<sup>11</sup> See Clearstream *Allgemeine Geschäftsbedingungen der Clearstream Banking AG* (25 September 2017) II(1). A financial institution is one as defined in § 1 Kreditwesengesetz and permitted to operate as such in terms of § 32.

### 12 3 Intermediation – a legal perspective

Despite commonly taking securities into deposit and at times even holding them collectively,<sup>12</sup> the common practice of the banks lacked a legal basis. The turning point for the development of modern and pervasive collective securities custody was an opinion written by Hans Schultz and Georg Opitz outlining the legal and practical requirements of collective custody and forming the basis of the Depotgesetz.<sup>13</sup> The Act, which is still in force today, provides a statutory basis for collective custody (“Sammelverwahrung”) by determining in § 5 that a depository may transfer fungible securities to collective custody, unless the depositor specifically requests a separate custody (“Sonderverwahrung”) provided for in § 2. While the Act initially determined that a separate deposit should be the default position, this is no longer the case.<sup>14</sup>

Furthermore, the Act makes provision in § 3 for third-party custody (“Drittverwahrung”), enabling a depository to deposit client certificates with a third party under its own name either in the form of separate or collective custody. The consent of the depositor is not required for third-party custody.

The relationship between the owner and the intermediaries (and between intermediaries *inter se*) continues to be one of deposit, regulated in first instance by the contract of deposit and subjected, secondly, to special rules as set out in the Depotgesetz. A deposit of securities is a regular deposit,<sup>15</sup> even if securities are fungible and held collectively. It follows, that ownership does not pass to the depository.<sup>16</sup> Instead, a depository becomes a co-possessor of the securities.<sup>17</sup> A depositor of securities held in collective deposit can, in principle, demand re-delivery of certificates of equal value or number.<sup>18</sup> This entitlement falls away if securities are held as a permanent global certificate.<sup>19</sup> Depositors can claim only from their own,

<sup>12</sup> See above, 8 3 4 4 Deposit.

<sup>13</sup> H Schultz & G Opitz “Sammeldepots beim Kassenverein: Gutachten, erstattet namens der Rechtsabteilung der Deutschen Bank, Berlin” in G Opitz *Fünfzig depotrechtliche Abhandlungen* (1954) 1 (original publication in 1926, 16 Sonderbeilage *Bank-Archiv*).

<sup>14</sup> The change was only introduced in 1994 by the Zweites Finanzmarktförderungsgesetz vom 26.7.1994, art 7 (1), (3) and (4). On the old position see Heinsius et al *Depotgesetz* 31, 46, 94. On the change see J Than “Wertpapierrecht ohne Wertpapiere?” in N Horn, H-J Lwowski & G Nobbe (eds) *Bankrecht - Schwerpunkte und Perspektiven: Festschrift für Herbert Schimansky* (1999) 821 827.

<sup>15</sup> U Brink *Rechtsbeziehungen und Rechtsübertragung im nationalen und internationalen Effekten giroverkehr* (1976) 51.

<sup>16</sup> See below, 12 4 2 Legal framework.

<sup>17</sup> See below, 12 4 2 Legal framework.

<sup>18</sup> Depotgesetz § 7(1). Their entitlement does not extend to a re-delivery of the original certificates.

<sup>19</sup> Micheler *Property in Securities* 198 n 13.

immediate intermediary.<sup>20</sup> The legislation introduces special rules for shortfalls.<sup>21</sup> In the case of an insolvency of an intermediary, the securities held by the intermediary on behalf of clients are out of reach of the intermediary's general creditors, regardless of whether these have actually been credited to client accounts.<sup>22</sup>

## 12 4 Electronic settlement and transfer

### 12 4 1 Commercial mechanisms

In Germany, trading takes place on electronic trading systems, such as XETRA, operated by the Frankfurt Stock Exchange. Matched transactions are automatically forwarded. As a rule, the clearing of equities transactions and central counterparty services are provided by a clearing institution and central counterparty in the case of stock exchange transactions, notably Eurex Clearing AG. Information on trades, including trade confirmations, is conveyed directly to the central counterparty ("CCP"), which provides clearing and netting services. Settlement can only commence if there are sufficient securities in the CASCADE account of the clearing member on the selling side and sufficient funds in the central bank account of the clearing member on the buying side.<sup>23</sup>

Following clearing, delivery instructions are conveyed to Clearstream. Any instructions to Clearstream are provided by the CCP and not directly by the transacting parties or their custodians or clearing members.<sup>24</sup> As part of settlement, securities are, in the interim, booked to the account of the CCP.<sup>25</sup> In acting as a counterparty to the trade, the CCP does not become the owner of the securities.<sup>26</sup> It merely acts to intermediate possession.<sup>27</sup> It becomes the contracting party to both the selling clearing member and the buying clearing member, thereby shouldering the risk of late performance or non-performance.<sup>28</sup> Delivery of securities to the

<sup>20</sup> 198.

<sup>21</sup> 199-200.

<sup>22</sup> Depotgesetz § 32.

<sup>23</sup> See Clearstream *Allgemeine Geschäftsbedingungen der Clearstream Banking AG* (25 September 2017) B XX(2).

<sup>24</sup> In terms of EUREX Clearing AG *Clearing Bedingungen: Allgemeine Bedingungen* (January 2018) 1.4.2 (3) participants or customers of the clearing agency must provide a power of attorney to that effect to EUREX.

<sup>25</sup> N Horn "Die Erfüllung von Wertpapiergeschäften unter Einbezug eines Zentralen Kontrahenten an der Börse: Sachenrechtliche Aspekte" (2002) 20 *WM* 1 4.

<sup>26</sup> EUREX *Allgemeine Bedingungen* 1.4.2 (4)(a); Horn (2002) *WM* 19.

<sup>27</sup> EUREX *Allgemeine Bedingungen* 1.4.2 (4)(a).

<sup>28</sup> Horn (2002) *WM* 4.

purchaser's clearing member will therefore always come from the account of the CCP.

On settlement day, delivery instructions (for value) are sent by the CCP to Clearstream. Trades are settled on T+2 on a DVP basis and in batches. Before settlement can take place, the internal central bank accounts must be funded by customers or their settlement banks. A reservation of sufficient liquidity takes place in the internal cash settlement accounts maintained by Clearstream.<sup>29</sup> This reservation is forwarded to TARGET2, which transfers the reserved funds into an RTGS sub-account and notifies Clearstream that sufficient funds are available.<sup>30</sup> Once the settlement cycle begins, funds are settled through an entry in the internal cash settlement accounts, the balances of which are subsequently offset against the central bank accounts.<sup>31</sup>

At the same time, securities are delivered through book entries in the relevant accounts of the clearing members (intermediated by entries in the CCP's account). The delivery in the top-tier consists of the netted transactions and amounts. This tier therefore sees far fewer account entries and transfers than the lower tiers. Following successful settlement, Clearstream provides a list of settled transactions ("Regulierungsliste") to Eurex, which in turn provides that information to clearing members in a settled delivery report ("Ist-Lieferreport").<sup>32</sup> Based on this report, clearing members will make entries in their own accounts.<sup>33</sup> The volume of these entries will be significantly larger, as clearing members hold either directly for investors or for other custodians.<sup>34</sup>

## 12 4 2 Legal framework

According to the general terms and conditions of Eurex Clearing, the transfer of ownership takes place when three requirements are met: 1. The CSD has made all relevant book-entries; 2. The relevant payment has been made; and 3. The clearing

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<sup>29</sup> Clearstream *Kundenhandbuch* 4.3, 4-6.

<sup>30</sup> 4.3, 4-6.

<sup>31</sup> 4.3, 4-6.

<sup>32</sup> See Eurex Clearing AG *Glossary* <<http://www.eurexclearing.com/clearing-en/resources/glossary>> (accessed 29-09-2018).

<sup>33</sup> In practice, these entries are frequently made upon receipt of the pending delivery report ("Soll-Lieferreport") issued before settlement; Horn (2002) *WM* 21. Also see Eurex Clearing AG *Glossary* <<http://www.eurexclearing.com/clearing-en/resources/glossary>> (accessed 29-09-2018).

<sup>34</sup> Horn (2002) *WM* 18.

members (or other customers of the CCP) have received access to the list of all settled transactions compiled by the CSD.<sup>35</sup> These requirements do not replace the legal requirements for transferring securities. Instead, legal commentators have reconciled the statutory position with established legal requirements for transfer.

Before proceeding, it is necessary to determine whether shares and securities can still be classified as things (“Sachen”). As described above, the entire system, including the notion of immobilisation, is constructed on the theory of securities as movable things – a classification which makes possible the application of the law of things in the first place. What influence does the immobilisation of certificates have on their proprietary classification?

Certificates continue to exist, albeit not in individual form. In addition, certificates are ordinarily held collectively by a custodian. Securities viable for collective deposit are always fungible.<sup>36</sup> When such fungible securities are mixed, it becomes impossible to connect the individual certificates to their owners. When held as a global certificate, individualisation is similarly impossible.

The question of the continued classification of shares and other securities as tangibles surfaced in tandem with the development of collective deposit. Only after the legal uncertainties had been untangled in a satisfactory fashion was the way cleared for large-scale collective deposits. A significant contribution to the clarification endeavor was made by Schultz and Opitz in an opinion that also served as the catalyst for the new Depotgesetz.<sup>37</sup> They insisted that a system of collective deposit can be reconciled with principles of the law of things and strongly rejected constructions based solely on the basis of personal claims.<sup>38</sup> Instead of having a property interest in an individual share certificate, the owner has a co-ownership interest in a pool of securities (“Miteigentum am Sammelbestand”).<sup>39</sup> This construction simultaneously means that custodians do not have any ownership

<sup>35</sup> EUREX *Allgemeine Bedingungen* ch 1 s 1, 1.4.2 (4)(b)(aa)-(cc).

<sup>36</sup> Depotgesetz § 1(1) and BGB § 91.

<sup>37</sup> Schultz & Opitz “Sammeldepots beim Kassenverein” in Opitz *Fünzig Deptrechtliche Abhandlungen* 1.

<sup>38</sup> Schultz & Opitz “Sammeldepots beim Kassenverein” in Opitz *Fünzig Deptrechtliche Abhandlungen* 1, 1-2 write: “Den Depotinhaber nur auf einen persönlichen Anspruch zu verweisen, unterliegt den schwersten Bedenken. Das Eigentumsrecht des Depotinhabers an seiner Aktie ist ein so grundsätzliches, daß es ihm zwangsweise nicht genommen werden kann”.

<sup>39</sup> Depotgesetz § 6(1); BGB §§ 741, 1008. Schultz & Opitz “Sammeldepots beim Kassenverein” in Opitz *Fünzig Deptrechtliche Abhandlungen* 2; G Opitz *Depotgesetz: Gesetz über die Verwahrung und Anschaffung von Wertpapieren vom 4. Februar 1937* 2 ed (1955) 151.

interests in deposited securities. The relationship between custodians and their customers is therefore one of regular deposit.<sup>40</sup> The co-ownership interest is expressed as a fraction of the entire bulk (“Sachgesamtheit”) of securities of the same type, being the face value of the certificates deposited (“Wertpapierennennbetrag”), or alternatively of the number of certificates deposited (“Stückzahl”).<sup>41</sup> Co-ownership interests are created as soon as the certificates are deposited and received to form part of collective custody, irrespective of the will of the owner or depositor, and depend neither on the actual commingling in terms of §§ 947 and 948 BGB, nor on contractual agreement to that effect between the parties.<sup>42</sup> Should a security be designated for third-party, collective custody, the co-ownership interest will be established once the certificates are delivered to, and received by the collective depository.<sup>43</sup> Once certificates have been admitted to a collective deposit, the co-owner cannot demand the same certificates back.<sup>44</sup> Instead, the depositor (co-owner) can demand that his depository release securities amounting to his appropriate fraction of the bulk.<sup>45</sup> Ordinarily, any rights that the owner had in the separate thing are extinguished;<sup>46</sup> should the separate thing have been burdened with rights in favour of third parties, however, these continue to exist in relation to the co-ownership interest.<sup>47</sup> The co-ownership rights always vest in the former owner; even if securities are deposited by a third party and her name is entered on the records of the depository, she will not become co-owner.<sup>48</sup>

The mechanisms of transferring movable property dictate that possession is of utmost importance. In addition to a co-ownership interest, the previous owner is said to have conceptual co-possession (“Mitbesitz”) of the commingled certificates. Unlike co-ownership, which always exclusively accrues to the previous owner (the owner of

<sup>40</sup> Brink *Effektengiroverkehr* 51.

<sup>41</sup> Depotgesetz § 6(1) trumps BGB § 742.

<sup>42</sup> Depotgesetz § 6(1): “so entsteht mit dem Zeitpunkt des Eingangs bei dem Sammelverwahrer für die bisherigen Eigentümer Miteigentum”; D Einsele *Wertpapierrecht als Schuldrecht: Funktionsverlust von Effektenurkunden im internationalen Rechtsverkehr* (1995) 24; Heinsius et al *Depotgesetz* 134 [3]; Opitz *Depotgesetz* 152.

<sup>43</sup> Einsele *Wertpapierrecht als Schuldrecht* 25; Heinsius et al *Depotgesetz* 137 [7]; Opitz *Depotgesetz* 149 clarifies that the decisive factor is the ability of the collective depository to admit the securities to collective deposit and not the actual admission.

<sup>44</sup> Depotgesetz § 7(1). This provision deviates from the default position in BGB § 749.

<sup>45</sup> Read BGB § 985 with Depotgesetz § 7(1). This demand can only be directed at the immediate depository, who can in turn direct it at his intermediary and so forth.

<sup>46</sup> § 949 BGB.

<sup>47</sup> § 949 BGB; Heinsius et al *Depotgesetz* 139 [10].

<sup>48</sup> Heinsius et al *Depotgesetz* 141-142 [15]; Einsele *Wertpapierrecht als Schuldrecht* 29. A presumption of ownership in § 1006 BGB is however created in favour of the depositor; Einsele *Wertpapierrecht als Schuldrecht* 29.

the individual certificate before it is deposited), possession diverges: Direct possession (“unmittelbarer Besitz”) vests in the CSD, primary indirect possession (“erststufiger mittelbarer Besitzer”) settles in the intermediary depository, while the depositor becomes the secondary indirect possessor (“zweistufiger mittelbarer Besitzer”),<sup>49</sup> provided there is only one intermediary positioned between the final investor and the CSD.<sup>50</sup> Every custodian intermediates possession to the same object (the share), just in relation to different persons.<sup>51</sup> The possession of the intermediary depositories as well as the depositor is no longer physical in nature but is instead derived from the physical possession of the certificate or global certificate by the CSD. The CSD, and every other intermediary in the chain, intermediate possession (“Besitzmittlung”). Possession is therefore merely abstract and conceptual (“begrifflich”).

Although the German system of co-ownership and co-possession therefore eliminates any individualised property right in a specific, identifiable asset,<sup>52</sup> it does not sever the link between the rights of the investor and the shares deposited at the top tier. The investor does not hold a new and separate asset (an interest in a share), but rather continues to have ownership rights in the shares themselves, even if these rights are intermediated. The difference is best illustrated by way of example.<sup>53</sup> Company A issues 1000 shares all deposited with a CSD. If an intermediary holds 100 of these shares, it would amount to a 10 percent undivided share of the Company A shares issued. If a client of the intermediary holds 50 of the 100 shares of the intermediary, he does not hold a 50 percent undivided share of the intermediary’s undivided portion, but rather a 5 percent interest in the shares held by the CSD.

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<sup>49</sup> Heinsius et al *Depotgesetz* 125 [68]; A Will “Depotgeschäft” in S Kümpel & A Wittig *Bank- und Kapitalmarktrecht* 4 ed (2011) 2323 2347 [18.101]; Brink *Effektengiroverkehr* 53. For definitions of “mittelbarer Besitz” and “mehrstufiger mittelbarer Besitz” see § 868 BGB and § 871 BGB respectively. In German there is usually talk of “Vermittlung des Mitbesitzes” by the CSD and other intermediaries and these are also referred to as “Besitzmittler”.

<sup>50</sup> If there are several intermediaries between the depositor and the CSD, there may be more levels of indirect possession.

<sup>51</sup> Horn (2002) *WM* 10.

<sup>52</sup> M Dubovec *The Law of Securities, Commodities and Bank Accounts: The Rights of Account Holders* (2014) 63.

<sup>53</sup> The example is adapted from Dubovec *Securities, Commodities and Bank Accounts* 64. Also see Horn (2002) *WM* 8.

Ordinarily, ownership in securities certificates as movable tangibles is transferred through delivery and an agreement to transfer;<sup>54</sup> this practice remains largely unchanged, but is modified to accommodate the alteration of ownership and particularly possession.

To satisfy the requirement of delivery, the transfer of actual physical possession from the seller to the buyer is ordinarily required.<sup>55</sup> An alternative to the transfer of possession was mentioned above, namely the assignment of the right to demand the release of the share certificates from a third party in terms of § 931 BGB. This is not the construction favoured by leading authors.<sup>56</sup> Instead, possession is still said to be transferred through the default mechanism described in BGB § 929, sentence 1, but an instruction (“Weisung”) takes the place of delivery.<sup>57</sup> To exemplify with the aid of a simple two-step construction in which the intermediary of the seller is simultaneously the final depository: The seller instructs his intermediary, as the direct possessor, to no longer hold in his favour and instead possess for the depository of the buyer.<sup>58</sup> Decisive is that the direct possessor adjusts his intention to intermediate possession for the buyer. Two situations need to be distinguished where a CSD is the direct possessor: 1. where the buyer and seller make use of the same clearing member or custodian; and 2. where they make use of different clearing members or custodians. In the first case, only a shifting of intention of the clearing member or custodian is decisive in bringing about a change in possession; the CSD continues to hold for the same financial institution.<sup>59</sup> The second case requires a shifting of intention of both the CSD and the clearing member or custodian.<sup>60</sup> It is important to note that each intermediary only intermediates possession for its respective client (for example the

<sup>54</sup> BGB § 929; see above, 8 3 4 3 The transfer of shares.

<sup>55</sup> See above, 8 3 4 3 The transfer of shares.

<sup>56</sup> Will “Depotgesetz” in *Bank- und Kapitalmarktrecht* 2364-2365 [18.193]. Although this method of transfer is possible, it does not provide adequate protection to good faith purchasers.

<sup>57</sup> Clearstream *Allgemeine Geschäftsbedingungen* XXI(1); Will “Depotgesetz” in *Bank- und Kapitalmarktrecht* 2365 [18.193]; Heinsius et al *Depotgesetz* 149 [35], 169 [71]; Horn (2002) *WM* 9; Opitz *Depotgesetz* 169; BGH (1959) *NJW* 35, 1536, 1539; BGH (1971) *NJW* 1608, 1609; BGH (1985) *NJW* 376, 378.

<sup>58</sup> Will “Depotgesetz” in *Bank- und Kapitalmarktrecht* 2365 [18.193]; Horn (2002) *WM* 9; Clearstream *Allgemeine Geschäftsbedingungen* XXI(1); Opitz *Depotgesetz* 169; Einsele *Wertpapierrecht als Schuldrecht* 96. Also see BGH (2004) *NJW* 3340, 3341; BGH (1971) *NJW* 1608, 1609 on the transfer of indirect possession (not in the context of shares): “Richtig ist allerdings, daß dem Übergabefordernis i.S dieser Vorschrift [BGB § 929] auch dadurch genügt werden kann, daß der unmittelbare Besitzer der Sache ... das bisher bestehende Besitzmittlungsverhältnis zum Eigentümer der Sache auf dessen Weisung hin aufgibt und künftig nur noch dem neuen Erwerber den Besitz an der Sache mittelt”.

<sup>59</sup> Horn (2002) *WM* 9; Opitz *Depotgesetz* 170.

<sup>60</sup> Horn (2002) *WM* 9.

CSD for the clearing member and the clearing member for the custodian bank and so forth), thus each intermediary will have to adjust its intention individually.<sup>61</sup> Each intermediary knows only the identity of its own clients. In addition, the quantitative scope of its intention does not equal that of other intermediaries. For these reasons the CSD, for example, cannot be said to shift its intention to possess for the clients below its own clearing members.<sup>62</sup>

Following clearing and settlement, the CSD will make corresponding book entries – the shares sold will be removed from the account of the selling clearing member and will be entered on the account of the buying clearing member.<sup>63</sup> The book entry serves to signal the shift in intention.<sup>64</sup> The result is the termination of the indirect possessory relationship with the previous member and in its place the establishment of a possessory relationship with the current member.<sup>65</sup> Similar entries are made by members and other custodians in their own accounts. It is argued that the book entries provide for sufficient publicity as required by BGB § 929.<sup>66</sup>

Coupled with the transfer of possession is the agreement to transfer co-ownership, which stands separate from the obligatory agreement. For the agreement to be effective, the parties need to identify the exact objects to be transferred.<sup>67</sup> Individualisation is no longer possible; the requirement of certainty is hence modified in the case of co-ownership interests, so that it is met if the fraction of the bulk has been specified.<sup>68</sup> In a system typified by an indirect holding and indirect exchange facilitated by a stock exchange, the depositor depends on the intermediaries at various levels for an agreement to come into being. The intermediaries act as representatives for the buyer and seller.<sup>69</sup> The instruction by the seller (the depositor) to his intermediary to cease holding for him and instead hold in favour of the buyer is at the same time an offer for purposes of the real agreement.<sup>70</sup> Subsequently, the instruction is conveyed to the direct intermediary of the buyer, who, as her

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<sup>61</sup> 9-10.

<sup>62</sup> 18.

<sup>63</sup> Also see § 14 Depotgesetz.

<sup>64</sup> BGH (2004) *NJW* 3340, 3341; Horn (2002) *WM* 9.

<sup>65</sup> Heinsius et al *Depotgesetz* 149 [35].

<sup>66</sup> Brink *Effektengiroverkehr* 82-83, 97; Heinsius et al *Depotgesetz* 149 [35].

<sup>67</sup> See above, 8 3 4 3 The transfer of shares n 302.

<sup>68</sup> Opitz *Depotgesetz* 155 [13]; Einsele *Wertpapierrecht als Schuldrecht* 40; Micheler *Property in Securities* 201; S Kümpel "Der Bestimmtheitsgrundsatz bei Verfügungen über Sammeldepotguthaben – zur Theorie des Bruchteilseigentums sui generis" (1980) 16 *WM* 422, 425-426.

<sup>69</sup> Heinsius et al *Depotgesetz* 148 [35].

<sup>70</sup> Heinsius et al *Depotgesetz* 148 [35]; Horn (2002) *WM* 4 11.

representative, ordinarily has the power to accept the shares for deposit and with it, to accept the offer, which concludes the real agreement.<sup>71</sup> If a CSD is involved, the offer is conveyed by the seller's intermediary to the CSD and is immediately regarded to have been transmitted to the buyer's intermediary.<sup>72</sup> The offer to transfer co-ownership ("Übereignungsofferte") is deemed to be accepted once the buyer's intermediary has unconditionally accepted to act as indirect possessor for the buyer.<sup>73</sup> The transfer of co-ownership therefore takes place directly between the buyer and the seller. At no time do the intermediaries acquire ownership or co-ownership. It is only possession, but not ownership, that is intermediated. Chun therefore writes that "there is no legal intermediation of ownership, but mere conceptual intermediation of possession".<sup>74</sup>

In transactions concluded on the stock exchange via a CCP, the settled delivery report issued by the CCP is essential to found both, agreement and delivery. As the processing of transactions takes place directly between the CCP and the CSD, the settled delivery report is construed as either the acceptance of the offer by the CCP as representative of the purchaser,<sup>75</sup> or as the receipt of the offer by the CCP as messenger receiving delivery on behalf of the purchaser.<sup>76</sup> Furthermore, it communicates to the clearing members the shifting of intention of the CSD and as such forms the basis of the shifting of intention of the clearing members themselves.<sup>77</sup> In terms of this construction, co-ownership (brought about by agreement and delivery) and control at the top tier (dependent only on delivery, specifically on possession) pass at the same time namely when the settled delivery report is made available.

There is some debate on whether a book entry is required for a valid transfer of co-ownership. In terms of § 24 Depotgesetz, if an intermediary buys securities either

<sup>71</sup> Heinsius et al *Depotgesetz* 148 [35].

<sup>72</sup> Will "Depotgesetz" in *Bank- und Kapitalmarktrecht* 2367 [18.201].

<sup>73</sup> Will "Depotgesetz" in *Bank- und Kapitalmarktrecht* 2367 [18.201]; Horn (2002) *WM* 11.

<sup>74</sup> Chun *Cross-border Transactions* 158.

<sup>75</sup> D Einsele *Bank- und Kapitalmarktrecht: nationale und internationale Bankgeschäfte* 3 ed (2014) 513-514, [27].

<sup>76</sup> Horn (2002) *WM* 21.

<sup>77</sup> Horn (2002) *WM* 21, 23. There is disagreement on whether an entry based on the pending delivery report issued before settlement takes place is legally valid to found possession – see S Schwarz *Globaler Effektenhandel: Eine rechtsstaatliche und rechtsvergleichende Studie zu Risiken, Dogmatik und Einzelfragen des Trading, Clearing und Settlement bei nationalen und internationalen Wertpapiertransaktionen* (2016) 205-307. Even if this is so, the fact that the offer is only conveyed to the clearing member when the settled delivery report is issued means that ownership does not transfer at an earlier point in time – Schwarz *Globaler Effektenhandel* 307.

as commission agent or in its own name on behalf of a client, co-ownership transfers to the client if the agent makes an account entry, provided that it has not transferred at an earlier point in time in terms of the civil law.<sup>78</sup> Micheler argues that the section provides a basis for determining the acquisition of an ownership interest outside the rules of possession.<sup>79</sup> Yet, it is also flexible enough to accommodate the rules on possession if co-ownership passes by these at an earlier point in time. This raises the question whether an entry by an intermediary is required for a transfer of co-ownership? According to the general terms and conditions of the CCP, co-ownership passes once: 1. The central depository has made account entries; 2. The payment has been finalised; and 3. The settled delivery report has been made available to the clearing members.<sup>80</sup> According to Einsele this means that account entries alone are not sufficient.<sup>81</sup> Due to netting, book entries at CSD level are also few and far-between. The decisive factor for the transfer of co-ownership, Einsele finds, is therefore the settled delivery report, not the actual book entries made by the custodians.<sup>82</sup> The report sets out the detailed transactions. Co-ownership can therefore pass before account entries have been made or even without them.<sup>83</sup> Micheler, however, indicates that account entries are decisive for the transfer of co-ownership<sup>84</sup> and Lehmann argues that account entries should be the deciding legal factor.<sup>85</sup> He finds that the alleged intention to possess and therefore a construction based on a shifting of intentions is a fiction.<sup>86</sup> Such a change, he argues, can only be effected with legislative intervention.<sup>87</sup>

## 12 5 Protection of bona fide purchasers of shares

The possibility of acquiring deposited shares and securities in good faith is not addressed by the Depotgesetz, but must instead be resolved with reference to the

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<sup>78</sup> Depotgesetz § 24(2). The section does not apply if investors purchases securities in their own name and without the use of intermediaries.

<sup>79</sup> Micheler *Property in Securities* 205.

<sup>80</sup> EUREX *Allgemeine Bedingungen* ch 1, s 1, 1.4.2(4)(b)(aa)-(cc). Also see Einsele *Bank- und Kapitalmarktrecht* 513, [27].

<sup>81</sup> Einsele *Bank- und Kapitalmarktrecht* 513, [27].

<sup>82</sup> 513, [27].

<sup>83</sup> 513, [27].

<sup>84</sup> Micheler *Property in Securities* 208-209.

<sup>85</sup> M Lehmann *Finanzinstrumente: Vom Wertpapier- und Sachenrecht zum Recht der unkörperlichen Vermögensgegenstände* (2009) 416-417. Micheler *Property in Securities* 205-206, also regards the account credits as decisive.

<sup>86</sup> Lehmann *Finanzinstrumente* 416-417.

<sup>87</sup> 417.

general rules set out in the BGB.<sup>88</sup> As illustrated above, the protection of *bona fide* purchasers was a central motivation for advocating for the application of the law of things to securities in the first place. Traditionally, a purchaser is protected if he acts in good faith and if he has possession of the thing to be transferred. Possession creates an impression of ownership. Co-ownership and co-possession of securities held collectively, circumscribed as a fraction of the bulk, are, however, incapable of physical recognition.<sup>89</sup> A lack of good faith acquisition, it is feared, will erode the trust in, and impede the functioning of the system.<sup>90</sup> Where securities are held in collective deposit therefore, the book entry is seen by many academic authors as a viable alternative medium for publicity. An account entry is considered to create a legally relevant impression (“Rechtsschein”) that is the basis of a purchaser’s good faith and thus performs a function normally assumed by physical possession.<sup>91</sup> Other authors dispute that account entries create a sufficient impression on which a good faith acquisition can stand.<sup>92</sup> Despite the academic debate on this question, the decision in favour of good faith acquisition of collectively held securities is, at least in part, a policy choice.

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<sup>88</sup> The Depotgesetz only contains a provision in § 4(1), stipulating that a third-party depositor (i.e. a collective depository) is presumed to know that the securities do not belong to the intermediary. See Einsele *Wertpapierrecht als Schuldrecht* 98-99.

<sup>89</sup> I Koller “Der gutgläubige Erwerb von Sammeldepotanteile an Wertpapieren am Effekten giroverkehr, 1. Teil” (1972) *Der Betrieb* 1857 1860; A Hueck & C-W Canaris *Recht der Wertpapiere* 12 ed (1986) 16.

<sup>90</sup> See for example Than “Wertpapierrecht ohne Wertpapiere” in *Festschrift Schimansky* 832-833; Horn (2002) *WM* 12.

<sup>91</sup> Heinsius et al *Depotgesetz* 180-181 [91]; Hueck & Canaris *Wertpapiere* 16; Brink *Effekten giroverkehr* 102-103; F Fabricius “Zur Theorie des stückelosen Effekten giroverkehrs mit Wertrechten aus Staatsanleihen” (1963) 162 *AcP* 456 482; Horn (2002) *WM* 11-12, 13-14; Micheler *Property in Securities* 213.

<sup>92</sup> Einsele *Bank-und Kapitalmarktrecht* 518 [35]. Einsele criticises that the book entries cannot be accessed by the public and therefore do not create the publicity necessary to create an impression of ownership; see also W Zöllner “Zurückdrängung des Verkörperungselements bei den Wertpapieren” in L Raiser & F Baur (eds) *Funktionswandel der Privatrechtsinstitutionen: Festschrift für Ludwig Raiser zum 70. Geburtstag* (1974) 249 261-267.

## Chapter 13: The effect of systemic intermediation in South Africa

### 13 1 Overview of the commercial structures

South African law continues to make provision for certificated and uncertificated securities.<sup>1</sup> Nonetheless, the majority of securities are issued in uncertificated form.<sup>2</sup> Unless the Companies Act provides otherwise, the same provisions apply to both certificated and uncertificated securities.<sup>3</sup> Likewise, the rights and obligations of holders of securities do not differ.<sup>4</sup>

Uncertificated securities are defined in s 1 of the Financial Markets Act as:

“securities that are not evidenced by a certificate or written instrument; or certificated securities that are held in collective custody by a central securities depository or its nominee in a separate central securities account, and are transferable by entry without a certificate or written instrument”.

Although the definition makes provision for dematerialisation (part (a)) and immobilisation (part (b)), South Africa has migrated towards the dematerialisation of shares and other securities.

At the apex of the pyramid of securities holding is the central securities depository (CSD). A CSD is defined as “a person who constitutes, maintains and provides an infrastructure for holding uncertificated securities which enables the making of entries in respect of uncertificated securities, and which infrastructure includes a securities settlement system”.<sup>5</sup> Strate is the only CSD in South Africa. Strate was established in 1999 by the JSE and four major commercial banks. During 2003 it merged with UNEXCor, a settlement system servicing the bonds market and operated by the Bond Exchange of South Africa (BESA), and Central Depository Limited to become Strate Limited.<sup>6</sup> The JSE continues to be the biggest shareholder of Strate Limited.

<sup>1</sup> See s 49(2) and ss 51-53 of the Companies Act 71 of 2008.

<sup>2</sup> M Vermaas “The Reform of the Law of Uncertificated Securities in South African Companies Law” (2010) *Acta Juridica* 87 87-88. Also see s 33(2) of the Financial Markets Act 19 of 2012 in terms of which new issues of listed securities must be in uncertificated form.

<sup>3</sup> Companies Act 71 of 2008 s 49(3)(b); In s 49(4) it is expressly stated that ss 52-55 only apply to uncertificated securities.

<sup>4</sup> Companies Act 71 of 2008 s 49(3)(a); Financial Markets Act 19 of 2012 s 33(4).

<sup>5</sup> Financial Markets Act 19 of 2012 s 1.

<sup>6</sup> See, L Swart & VA Lawack-Davids “Understanding the South African Financial Markets: An Overview of the Regulators” (2010) *Obiter* 619 632.

Below the CSD are a number of central securities depository participants (“CSDP’s” or “participants”), being “person[s] authorised by a licensed central securities depository to perform custody and administration services or both, in terms of the central securities depository rules”.<sup>7</sup> The participants are mainly large financial institutions such as banks.<sup>8</sup> Investors cannot open accounts directly with the CSD.<sup>9</sup> Rather participants hold securities for their clients, who may be final investors or their nominees.<sup>10</sup>

Strate may only open and manage central securities accounts for participants.<sup>11</sup> A “central securities account” is defined as:

“an account that reflects the number or nominal value of securities of each kind deposited and all entries made in respect of such securities, held by the licensed central securities depository for a participant or external central securities depository in the name of—

- (a) a participant;
- (b) an external central securities depository; or
- (c) any other persons as determined in the depository rules”.<sup>12</sup>

Participants must distinguish own securities from client’s securities and deposit them in separate central securities accounts.<sup>13</sup> Client securities may be held either collectively or individually.<sup>14</sup> In collective deposit, securities of the same kind become comingled and identifying and allocating securities to specific clients becomes impossible.<sup>15</sup>

Clients, in turn, open securities accounts with participants.<sup>16</sup> Participants may open and keep securities accounts in their own name, in the name of clients, including own name clients and in the name of nominees.<sup>17</sup> Own name clients are strictly end

<sup>7</sup> S 1.

<sup>8</sup> See Strate <<http://www.strate.co.za/strate/supervision/participants>> (accessed 29-09-2018) for a full list of participants.

<sup>9</sup> *Strate Rules of Strate Pty (Ltd)* (September 2017) 6.2.2.1.

<sup>10</sup> This appears from the definition of “client” in s 1 of the Financial Markets Act 19 of 2012: “any person to whom a regulated person provides securities services, and includes a person that acts as an agent for another person in relation to those services”. Many investors hold securities in long chains of brokers and nominees.

<sup>11</sup> *Strate Rules* 6.2.2.1.

<sup>12</sup> Financial Markets Act 19 of 2012 s 1(1).

<sup>13</sup> *Strate Rules* 5.1.5-5.1.8; 6.2.2.3.

<sup>14</sup> 5.1.5.

<sup>15</sup> Vermaas (2010) *Acta Juridica* 94.

<sup>16</sup> See the definition of “Securities Account” in rule 1.2 of the *Strate Rules*. See further rule 6.2.2.

<sup>17</sup> See the definition of “Securities Account” in rule 1.2 of the *Strate Rules*.

investors and therefore maintain a direct relationship with an issuer of securities.<sup>18</sup> The identity of the investor will be recorded at participant level, but the investor will not have a segregated securities account.<sup>19</sup>

In addition, client accounts may also be held on an individual basis at central securities account level in the form of segregated depository accounts. Such accounts are opened by the CSD upon the request of a participant.<sup>20</sup> They are opened in the name of a client, but must be operated through a participant.<sup>21</sup>

As a result of the above holding structure, the South African securities holding system is classified as a mixed system providing for a combination of transparent and non-transparent holdings.<sup>22</sup> The holding mechanisms provide investors with the option of maintaining a direct relationship with the issuer. More frequently, however, shares are held indirectly and in a non-transparent fashion.

The central legislative instrument for regulating the custody and administration of securities is the Financial Markets Act. The Act focuses on the top tiers – central securities depositories and participants. Lower-tier intermediaries are, however, caught in the net of the Financial Advisory and Intermediary Services Act 37 of 2002. By definition they are “financial services provider[s]”<sup>23</sup> that render an intermediary service (with or without furnishing advice) by “buying, selling or otherwise dealing in ..., managing, administering, keeping in safe custody, maintaining or servicing a financial product purchaser by a client from a product supplier or in which the client has invested”.<sup>24</sup> “Financial product[s]” include shares, debentures and all securities as defined in s 1 of the Financial Markets Act.<sup>25</sup> The Act provides a mechanism for the authorisation and licensing of intermediaries and provides guidelines for a code of conduct.

<sup>18</sup> See Strate Directive SA.4: Requirements for Own Name Clients *Special Gazette* No S1-2018 of 15-05-2018; Also see UNIDROIT *Study LXXVIII – Doc. 44: Working Paper Regarding So Called “Transparent Systems”* (October 2006) 8.

<sup>19</sup> All securities of the same kind held by a participant are therefore pooled and recorded together in the account held by the participant with the CSD.

<sup>20</sup> See the definition of “Segregated Depository Account” in rule 1.2 of the Strate *Rules*. Generally, see rule 6.2.1.

<sup>21</sup> See the definition of “Segregated Depository Account” in rule 1.2 of the Strate *Rules*.

<sup>22</sup> Vermaas (2010) *Acta Juridica* 96-97 and n 55; UNIDROIT *Study LXXVIII – Doc. 44* 7-8.

<sup>23</sup> See the definition in the Financial Advisory and Intermediary Services Act 37 of 2002 s 1.

<sup>24</sup> See the definition of intermediary service in s 1 of the Financial Advisory and Intermediary Services Act 37 of 2002. Only the relevant part of the definition [(b)(i)] has been quoted.

<sup>25</sup> See the definition in the Financial Advisory and Intermediary Services Act 37 of 2002 s 1.

## 13 2 Intermediation – a legal perspective

### 13 2 1 Framework for the analysis

Inquiries into the legal characterisation- and impact of systemic intermediation on securities transfer and holding mechanisms have thus far received scant attention from South African legislators, regulators and legal academics.

Pragmatism and functionality drive markets. Conceptual and doctrinal foundations, on the other hand, are the domain of the law. The sphere of shares and securities is shaped by a constant compromise between functionality, doctrine and conceptual soundness. As a response to the systemic intermediation of securities holding systems, two main approaches to legal design have emerged, a predominantly functional one and a doctrinal approach.<sup>26</sup>

The US approach is said to be primarily a functional one. Traditional principles of deposit, bailment and negotiability<sup>27</sup> were jettisoned in favour of a legal structure designed to give legal recognition to commercial realities. A functional approach addresses legal questions and uncertainties by providing tailor-made solutions.<sup>28</sup> Certainty and predictability of legal rules are paramount.

A doctrinal approach, on the other hand, can be found in the solutions developed in England and Germany. By their reliance on general law and existing legal concepts, such as equity and trusts, or alternatively deposit, both countries have attempted to find legal solutions grounded in existing doctrinal structures. This approach offers more flexibility and continuity by facilitating not only the resolution of current problems, but also the development of adequate laws for future commercial practices.<sup>29</sup> The doctrinal approach depends heavily on robust academic debate. It also holds the risk that existing legal concepts may become stretched.

It is almost impossible, however, to view functional and doctrinal approaches in isolation. Functionalism must not be confused with formalism. The UCC, for example

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<sup>26</sup> Also see below, 17 1 A functional approach and 17 3 Models of Intermediation.

<sup>27</sup> Negotiable instruments law was itself a functional solution to the demands of commercial practice that developed from the middle ages well into the sixteenth century before receiving legal recognition. On the history of negotiable instruments law, see WS Holdsworth "The Origins and Early History of Negotiable Instruments, Part 1" (1915) 121 *LQR* 12.

<sup>28</sup> M Khimji "The Role of Legal Concepts in Commercial Law: Comments on Spink, Rogers and Scavone" (2007) 45 *Can Bus LJ* 94 95.

<sup>29</sup> 95.

states in functional, not categorical terms what it means to hold securities through an intermediary, by setting out the package of rights that constitute a security entitlement.<sup>30</sup> An enquiry into whether a transaction is covered by article 8 depends not on its categorisation by the parties themselves, but on what it seeks to accomplish. So perceived, functionalism incorporates a certain measure of flexibility meant to catch transactions not specifically defined or not even thought of yet.<sup>31</sup> Even functionally designed pieces of legislation include conceptual reasoning to counter the impossibility of comprehensive regulation.<sup>32</sup> A conceptual basis will also develop through case law and academic debate.

In the same vein, the scale of the changes brought about by commercial practice almost always necessitates some functional legislative intervention. In Germany, the principles of deposit applicable to securities transactions are, for example, contained in specific legislation. General law and existing legal concepts can only be stretched so far. English law, while having retained the concept of the trust, recognises that transfer mechanisms can no longer be sought in the traditional rules on assignment.<sup>33</sup>

Whether designing functional or doctrinal legal rules, it is useful to formulate the objectives of a model of holding. The overarching, functional aim remains the ability to split control of shares from ownership thereof, or more specifically, the ability to enforce performance from the entitlement to enjoy its benefits.<sup>34</sup> To achieve this split in an environment of systemic intermediation, clarity on the certainty- and protection of rights of investors must be gained. A holding model must address: 1. How a company will perform; 2. From whom the investor may claim performance; 3. Its impact on both the holding and ownership of shares; 4. The protection of the investor's rights from the creditors of the intermediary; 5. The protection of investors when an intermediary becomes insolvent; and 6. The impact of the model on transfer mechanisms.

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<sup>30</sup> See JS Rogers "Policy Perspectives on Revised U.C.C Article 8" (1996) 48 *UCLA LR* 1431 1450.

<sup>31</sup> The prefatory note to the 1994 revision of UCC § 8 clearly states that "[o]ne of the objectives of the revision ... is to devise a structure of commercial law rules for investment securities that will be sufficiently flexible to respond to changes in practice over the next few decades"; UCC § 8 Prefatory Note – 1994 Revision II A.

<sup>32</sup> Khimji (2007) *Can Bus LJ* 95.

<sup>33</sup> See for example E Micheler "The Legal Nature of Securities: Inspirations from Comparative Law" in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 131 147; M Smith & N Leslie *The Law of Assignment* 2 ed (2013).

<sup>34</sup> See above, 8 5 Taking stock.

### 13 2 2 Asset transformation

The economic theory of intermediation reveals that the involvement of intermediaries regularly results in a transformation of the assets being intermediated.<sup>35</sup> This transformation can differ in nature and scope depending on the type of intermediaries involved. The main functions of relationship-based intermediaries in the securities holding chain include the provision of access to securities holding, clearing and settlement systems as well as a reduction in costs through pooling.<sup>36</sup>

A transformation of the share must be distinguished from the creation of new assets in the holding chain. The presence of relationship-based intermediaries necessarily transforms securities. The pertinent question is whether this transformation is accompanied by the creation of new assets.

Lastly, it must be assessed how the transformation impacts on the nature of intermediary relationships. Do the intermediaries become owners of assets, possessors thereof or do they hold them as a result of contractual ordering?

### 13 2 3 The South African indirect holding system

#### *13 2 3 1 Opening remarks*

The Financial Markets Act was promulgated to “regulate and control ... the custody and administration of securities”,<sup>37</sup> amongst other objectives and functions. To achieve this, it does not follow a comprehensively functional approach comparable to article 8 of the UCC. Rather, it regulates certain aspects of the relationship between investors, custodians (authorised users, participants or their nominees) and a central securities depository. A plain reading of the provisions leaves several questions unanswered and calls for further analysis and interpretation. The provisions of the Act must be scrutinised to determine the nature of the intermediation undertaken i.e. whether intermediaries become owners, possessors or contractual intermediaries. Concepts such as deposit, agency and co-ownership all feature in the provisions of the Act. The traditional basis of shares has been examined above.<sup>38</sup> It must be determined whether this framework is still conceptually sound or in need of revision.

<sup>35</sup> See above, 9 3 1 The economic theory of intermediation.

<sup>36</sup> On the functions, see above, 9 3 1 The economic theory of intermediation as well as 9 3 2 Relationship-based and systemic intermediation.

<sup>37</sup> Financial Markets Act 19 of 2012 preamble.

<sup>38</sup> 8 3 5 Transfer and holding in South African law.

Furthermore, any functional additions and amendments to the traditional construct must be identified.

### 13 2 3 2 *Deposit*

The terminology of deposit occurs repeatedly in the Financial Markets Act. Depositories are a typical feature of systems in which securities are immobilised. In such systems depositories physically hold the immobilised securities certificates and are traditionally responsible for their safekeeping. The relationship between a client and his intermediary follows the legal rules of deposit.

The origin of the concept of deposit in the Financial Markets Act can be traced back to the Custody and Administration of Securities Act 85 of 1992 (as read with the Safe Deposit of Securities Amendment Act 38 of 1998). The introduction of a depository system was encouraged by Malan and other academic writers, who were inspired by the developments in Germany and the US. The South African share certificate traditionally fulfils certain functions, such as serving as *prima facie* evidence of the shareholder's rights and facilitating the ease of transfer.<sup>39</sup> It never embodied these rights, but possession thereof by a non-owner could be sufficient to found an estoppel.<sup>40</sup> Therefore, shareholders had some interest in the safekeeping of their certificates to protect them from being stolen, misplaced, falsified, destroyed or lost. To manage these risks, it became customary to deposit share certificates with banks, brokers and other financial institutions.<sup>41</sup> In addition, the depositors offered a variety of administration services in respect of the certificates deposited.<sup>42</sup>

This existing system of deposit was latched onto to devise solutions for the development of a securities holding system. To this end, Malan found that “[a] securities nominee company ... is very similar to a depository”,<sup>43</sup> and further that “[t]here is clearly a need to consolidate the vast safe custody holdings of banks, brokers and other nominees into a central securities nominee or depository system”.<sup>44</sup> Malan went on to outline the main features of a system of deposit:

<sup>39</sup> See above, 8 1 The functions of the share certificate.

<sup>40</sup> See above, 8 4 5 Estoppel and the protection of bona fide purchasers in South African law.

<sup>41</sup> See MR Vermaas *Aspekte van die Dematerialisasie van Genoteerde Aandele in die Suid-Afrikaanse Reg* LLD thesis University of South Africa (1995) 313-314.

<sup>42</sup> 314.

<sup>43</sup> FR Malan “Depositories, Nominees and the Uncertificated Security” (1987) *Moderne Besigheidsreg* 73 78.

<sup>44</sup> 79.

Deposited securities would be reflected on accounts and the transfer of securities would be evidenced by account entries; the system would be able to accommodate uncertificated securities; the securities would continue to be in registered form; *bona fide* purchasers should be protected; depositories should be able to hold securities collectively and to re-deposit them with another depository and a legislative framework should be designed to implement these changes.<sup>45</sup>

Malan and Oosthuizen recognised that the terminology of deposit was not without its problems in the context of shares and securities.<sup>46</sup> Securities, being incorporeal, are not susceptible to a deposit.<sup>47</sup> Only the share certificate is in actual fact placed into deposit. The certificate, they found, must not deter from the fact that the relationship between a depositor and a depository continued to be governed by a contract of mandate.<sup>48</sup> They regarded the terms “deposit” and “safe custody” as practically convenient only.<sup>49</sup>

The Safe Deposit of Securities Act (later known as the Custody and Administration of Securities Act) provided legislative force to a system of collective deposit proposed by Malan and others. Some of the definitions and provisions of the Act continue to exist in almost unchanged form in the Financial Markets Act. The Financial Markets Act defines a “deposit” as “a deposit of securities, and includes a deposit by means of an entry in a securities account or a central securities account”.<sup>50</sup> The definition of deposit encompasses both the deposit of physical share certificates for purposes of dematerialisation, as also seen in English law, and the deposit of securities issued in dematerialised form by way of account entries. Whereas the former relates to a once-off event (dematerialisation) which involves a physical object (the share certificate), the latter is usually associated with defining lasting relationships through a mechanism that does not have any existence in the physical world (account entries).

<sup>45</sup> Malan (1987) *Moderne Besigheidsreg* 78-81. Also see FR Malan & MJ Oosthuizen “The Safe Deposit of Securities” (1989) 4 *TSAR* 502; FR Malan *Collective Securities Depositories and the Transfer of Securities* (1984) 217-239.

<sup>46</sup> Malan & Oosthuizen (1989) *TSAR* 503; Malan *Collective Securities Depositories* 219.

<sup>47</sup> Malan & Oosthuizen (1989) *TSAR* 503-504; Malan *Collective Securities Depositories* 219.

<sup>48</sup> Malan & Oosthuizen (1989) *TSAR* 504; Malan *Collective Securities Depositories* 219.

<sup>49</sup> Malan & Oosthuizen (1989) *TSAR* 504; Malan *Collective Securities Depositories* 219. Also see Vermaas *Dematerialisasie van Genoteerde Aandele* 313 n 3, who argues that the terminology of deposit encourages legal certainty.

<sup>50</sup> Financial Markets Act 19 of 2012 s 1(1). Apart from the omission of the words “for custody and administration”, the definition is identical to the one in the Custody and Administration of Securities Act 85 of 1992, which reads: “‘deposit’ means a deposit of securities *for custody and administration* and includes a deposit by means of an entry in a securities account or a central securities account” (own emphasis).

Depositories of dematerialised securities are not depositories in the traditional sense. They do not take deposit of a corporeal, movable thing, but rather of an entry in a securities account or a central securities account.

The Act further provides that participants and central securities depositories must “administer and maintain a record of uncertificated securities deposited with [them]”.<sup>51</sup> The Act does not extend this duty to lower-tier custodians, who fall within the scope of the definition of deposit by virtue of maintaining and making entries in securities accounts. The system of deposit envisaged by the Act is multi-tiered and allows for the collective holding of securities deposited. A participant must, after receiving a deposit of securities, deposit them with a central securities depository.<sup>52</sup> The mandatory language of the provision is a clear change from the language employed in the Custody and Administration of Securities Act, which provided that “a depository institution ... may, unless the client expressly directs otherwise in writing, deposit them with another depository institution ...”<sup>53</sup> The Financial Markets Act again restricts itself to regulating the top tiers consisting of participants and a central securities depository.

The interaction between the concepts of deposit and holding is far from clear. Terming Strate a depository does not make it an institution positioned in the holding chain between an investor and an issuer of securities as is the case in Germany. The main functions of Strate can be gleaned from the definition of a “central securities depository” in the Financial Markets Act, being primarily the provision of infrastructure for holding uncertificated shares and securities, including a settlement system and a system for “making entries in respect of uncertificated securities”.<sup>54</sup> This makes Strate mainly a system operator, similar to Crest, its UK counterpart.

The same is true of participants. The fact that participants maintain the legally relevant securities registers means that they are (mostly) not entered on such registers. The fact that they are depositories therefore does not mean that they also

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<sup>51</sup> Financial Markets Act 19 of 2012 s 30(2)(o) and s 32(2)(d) (own emphasis). This provision corresponds to s 2(2)(b) of the Custody and Administration of Securities Act 85 of 1992.

<sup>52</sup> Financial Markets Act 19 of 2012 s 32(2)(a).

<sup>53</sup> Custody and Administration of Securities Act 85 of 1992 s 2(2)(a). Of interest is that the original act used the word “shall”, which was changed to “may” only by the 1998 amendment. Note also that the ambit of the Act was wider than can be seen in the Financial Markets Act 19 of 2012. The Act does not provide for a duty of lower tiers to “redeposit”.

<sup>54</sup> See the definition of “central securities depository” in s 1(1) of the Financial Markets Act 19 of 2012. Also see s 30(2)(a) and (b).

stand in the holding chain between an issuer and an investor. As long as the entry on the securities register determines the relationship with the issuer, deposit cannot simultaneously be construed to do so. The concept of deposit is therefore largely irrelevant for determining holding, control and the ability to enforce rights.

Based on the legislative history and the writings of Malan, it is clear that the intention of the legislature was not to bring the principles of the law of deposit to bear on the holding of securities through accounts. This development would be neither historically linear, nor would it address the difficulties posed by electronic holding systems. Nominee holdings of registered, certificated shares were never based on a contract of deposit, but were rather considered in terms of a relationship of principal and agent.<sup>55</sup> Deposit is a concept traditionally used in relation to physical objects. Furthermore, the concept of deposit, especially in relation to fungibles, may have “ownership” implications.<sup>56</sup> For these reasons it may have been more preferable to avoid the terminology of deposit altogether in the context of uncertificated, dematerialised shares. The terminology of deposit, rather than promoting legal certainty, obscures the legal relationships that underlie the collective holding of securities.<sup>57</sup> Malan recognised that the structure of deposit that he designed could facilitate the immobilisation of securities. But he cautioned that “[l]awyers should anticipate the gradual dematerialization of securities and structure the legal framework to accommodate change”.<sup>58</sup> The necessary terminological changes have not been put forward by the Financial Markets Act, which, in many respects, harks back to a piece of legislation that Vermaas found should have rather been titled the “Act on the Immobilisation of Securities”,<sup>59</sup> clearly designed for a different age and different challenges.

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<sup>55</sup> See for example Holmes JA in *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 1 SA 441 (A) 453: “A nominee is an *agent* with limited authority: he holds shares in name only” (own emphasis).

<sup>56</sup> A deposit of an incorporeal constitutes a *depositum irregulare* and upon deposit of the incorporeal, ownership passes.

<sup>57</sup> The term “deposit” also continues to be used in the context of banking transactions, even if these are today more correctly classified as contracts of *mutuum*. In the case of banking however, the practice has developed out of common law contracts of deposit (*depositum*). See WG Schulze “Depositum, Deposit and Deposit-taking Institutions – Birds of a Feather? Not Quite” (2001) 13 SA *Merc LJ* 78.

<sup>58</sup> Malan (1987) *Moderne Besigheidsreg* 81.

<sup>59</sup> Vermaas *Dematerialisasie van Genoteerde Aandele* 313 n 3.

### 13 2 3 3 Agency and mandate

The relationship between a nominee and its client is traditionally thought to be in the nature of agency or mandate.<sup>60</sup> A core feature of agency is that the agent performs certain tasks on behalf of his principal, such as the receipt of dividends and distributions paid by the issuer and the exercise of voting rights. These have to be passed on or managed in compliance with the authority granted by the investor. The term “agency” is not defined in the Financial Markets Act and features only in the definition of “client”, suggesting that clients may act as agents for others.<sup>61</sup>

Agency is adaptable to multi-tiered holdings through the appointment of sub-agents. A principal (mandatory) can expressly authorise his agent (mandatary) to appoint and empower a sub-agent (sub-mandatary).<sup>62</sup> There is some dissent on the governing rule in the absence of such authorisation.<sup>63</sup> Some authorities postulate the general rule that an agent is not entitled to appoint a sub-agent without the requisite authorisation or consent, subject to exceptions.<sup>64</sup> Others suggest that the agent may as a general rule do so, but again subject to exceptions,<sup>65</sup> most notably where “the identity and personal attributes of the performer of the act are of material importance”.<sup>66</sup> This exception can hardly be said to apply to securities holding systems. There should be almost no difference between these approaches, however, as the first one prohibits the appointment of sub-agents subject to certain exceptions and the second one permits it subject to similar or equal limitations.<sup>67</sup> The authority to appoint a sub-agent can also be implied in certain circumstances.<sup>68</sup> Authority may, for example, be implied “[w]here it is the custom or usage in the ordinary course of the type of business to employ a sub-agent”,<sup>69</sup> or “[w]here it becomes necessary to delegate in order to execute the mandate”.<sup>70</sup> Both of these can be said to apply to

<sup>60</sup> See above, 8 3 5 4 Agency.

<sup>61</sup> Financial Markets Act 19 of 2012 s 1(1).

<sup>62</sup> AJ Kerr *The Law of Agency* 4 ed (2006) 189.

<sup>63</sup> In general, see Kerr *Agency* 190.

<sup>64</sup> *Belonje v African Electric Co (Pty) Ltd* 1949 1 SA 592 (E). Also see G Bradfield “Agency” in F Du Bois Wille’s *Principles of South African Law* 9 ed (2007) 983 993; JM Silke *The Law of Agency in South Africa* 3 ed (1981) 307, 311; DJ Joubert & DH van Zyl “Mandate and Negotiorum Gestio” in WA Joubert & JA Faris *LAWSA* 17(1) 2 ed (2009) para 9.

<sup>65</sup> *Strydom v Roodewal Management Committee* 1958 1 SA 272 (O) 273.

<sup>66</sup> 273.

<sup>67</sup> Silke *Agency* 306.

<sup>68</sup> Kerr *Agency* 189; Silke *Agency* 311.

<sup>69</sup> Silke *Agency* 311. Also see *Kennedy v Loynes* (1909) 26 SC 271 at 280; *Gertenbach & Bellow v Mosenthal* (1876) 6 Buch 88 at 91.

<sup>70</sup> Silke *Agency* 311. Also see *Turkstra v Kaplan* 1953 2 SA 300 (T).

modern securities holdings systems, the first because multi-tiered holding structures are customary in modern securities holding systems, and the second one because participants act as gatekeepers to the CSD, making necessary a delegation of authority until the participant is reached.

An alternative to the express or implied consent of the principal is a statutory basis for the appointment of sub-agents. This can be found in § 3 of the German Depotgesetz. Section 32(2)(a) of the Financial Markets Act similarly addresses the duty of participants to redeposit securities with a central securities depository, but is silent on lower-tier custodians.<sup>71</sup> The definition of “client” in the Financial Markets Act indicates that “clients” may also be “agent[s] for another person” and receive benefits and services on behalf of such a person.<sup>72</sup> What is envisaged is therefore the possibility of agency, even multi-tiered, “if the contractual arrangement between the parties indicates this to be the intention”.<sup>73</sup> It does not provide a basis on which an agent may appoint a sub-agent without agreement to that effect.

Much has been written on the relationships between a principal, an agent and a sub-agent. The question whether there is “full privity of contract” between the principal and the sub-agent is particularly contentious. In other words, does a direct relationship come about between the principal and the sub-agent in terms of which the sub-agent would be obliged to account directly to the principal or the principal able to directly sue the sub-agent for a breach of mandate? The answer must be to the negative. In *Turkstra v Kaplan*, Steyn, J categorically finds that the mere fact that a principal has authorised an agent to appoint a sub-agent, whether expressly or by implication, is not sufficient to bring about a contractual relationship between the principal and the sub-agent.<sup>74</sup> Whether or not such a relationship comes into existence depends on the mutual intention of both the principal and the sub-agent that must be determined from the terms of both mandates and the surrounding circumstances.<sup>75</sup> In the absence of such an intention, the sub-agent is accountable to the agent only for proper performance of the mandate and the agent to the principal. Thus, even if the authority of the sub-agent is derived from the authority that the

<sup>71</sup> Financial Markets Act 19 of 2012 s 32(2) reads: “A participant— (a) must, if securities are deposited with the participant, deposit them with a licensed central securities depository”.

<sup>72</sup> See the definition of client in s 1(1) of the Financial Markets Act 19 of 2012.

<sup>73</sup> Definition of “client” in s 1(1).

<sup>74</sup> *Turkstra v Kaplan* 1953 2 SA 300 (T) 304. Also see *Watson v Sachs* 1994 3 SA 655 (A) 661; *Karaolias v Sulam t/a Jack’s Garage* 1975 3 SA 873 (R) 875G.

<sup>75</sup> *Turkstra v Kaplan* 1953 2 SA 300 (T) 304; *Watson v Sachs* 1994 3 SA 655 (A) 662.

agent himself has received from the principal, the relationship between the sub-agent and the agent stands separate from the relationship between the agent and the principal. There is a strong argument to be made that the structure of modern, indirect securities holding systems creates an environment in which there should not be full privity between the principal and the sub-agent. It is probable that the parties will also expressly provide for this no-look-through approach. The Financial Markets Act does not specifically provide for such an effect.<sup>76</sup>

The internal relationship between an investor and an intermediary or between intermediaries is governed by the rules of mandate. Due to the historical development of the concept of agency out of contracts of mandate in South African law,<sup>77</sup> the rights and duties that define agency relationships are largely the same as those that form the basis of contracts of mandate. A mandatary must carry out the mandate and do so in compliance with and within the limits imposed by the contract.<sup>78</sup> In securities holdings the proper performance of the mandate includes the receipt of distributions and the payment thereof to the mandator in the manner agreed to.<sup>79</sup> Secondly, a mandatary must exercise the mandate diligently and with reasonable care.<sup>80</sup> The duty of a mandatary “to perform his functions faithfully, honestly, and with care and diligence”<sup>81</sup> is said to be one of the *naturalia* of a contract of mandate.<sup>82</sup> An undertaking by a mandatary to act with the requisite care and diligence of a reasonable person in the specific circumstances is said to be “implied” into every contract of mandate.<sup>83</sup> The degree of care and diligence required depends

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<sup>76</sup> But see Financial Markets Act 19 of 2012 s 32(2)(j), which reads: “A participant— (j) must exercise the rights in respect of securities deposited by it with a licenses central securities depository in its own name on behalf of a client *when so instructed by the client*” (own emphasis). Also see Custody and Administration of Securities Act 85 of 1992 s 10(2).

<sup>77</sup> See Kerr *Agency* 11 n 80.

<sup>78</sup> Joubert & Van Zyl “Mandate and Negotiorum Gestio” in *LAWSA 17(1)* paras 7-8; Kerr *Agency* 136.

<sup>79</sup> Note that the exercise of voting rights is subject to specific rules aimed at establishing a direct link between investors and issuers for purposes of voting. In terms of s 58(3)(a) of the Companies Act 71 of 2008, a shareholder may appoint two proxies to exercise voting rights. In terms of s 58(3)(b) a proxy may delegate his authority to act on behalf of the shareholder. This section therefore provides for the authority to be delegated through the holding chain until it reaches the investor. Also see A Henderson & K van der Linde “Uncertificated shares: A Comparative Look at the Voting Rights of Shareholders II” (2014) *TSAR* 724.

<sup>80</sup> Joubert & Van Zyl “Mandate and Negotiorum Gestio” in *LAWSA 17(1)* para 10; Kerr *Agency* 136-139.

<sup>81</sup> *David Trust v Aegis Insurance Co Ltd* 2000 3 SA 289 (SCA) 298 para 20.

<sup>82</sup> 298 para 20.

<sup>83</sup> *Bloom’s Woollens (Pty) Ltd v Taylor* 1961 3 SA 248 (N) 253-254; *David Trust v Aegis Insurance Co Ltd* 2000 3 SA 289 (SCA) 298 para 21. Also see the authorities cited by Joubert & Van Zyl “Mandate and Negotiorum Gestio” in *LAWSA 17(1)* para 10 n 11 and Kerr *Agency* 137 n 25.

on the agreement between the parties, the circumstances of the case, trade usage and custom as well as statute.<sup>84</sup>

The duty of the mandatary to act in good faith is closely related to the duty to perform the mandate with reasonable care and diligence.<sup>85</sup> This duty encompasses that “the mandatary must act honestly and properly, in the interests of the mandatary, and must refrain from intentionally causing him or her any harm or injury”.<sup>86</sup> In its most general terms, the duty of good faith therefore establishes a fiduciary relationship between an agent and his principal.<sup>87</sup> The nature of the fiduciary relationship was aptly described in the Canadian decision of *Hodgkinson v Simms*<sup>88</sup> quoted with approval by Heher JA in the case of *Phillips v Fieldstone Africa (Pty) Ltd*<sup>89</sup>:

“Finally, I note that the existence of a contract does not necessarily preclude the existence of fiduciary obligations between the parties. On the contrary, the legal incidents of many contractual agreements are such as to give rise to a fiduciary duty. The paradigm example of this class of contract is the agency agreement, in which the allocation of rights and responsibilities in the contract itself gives rise to fiduciary expectations”.<sup>90</sup>

Heher JA continued:

“There is no magic in the term ‘fiduciary duty’. The existence of such a duty and its nature and extent are questions of fact to be adduced from a thorough consideration of the substance of the relationship and any relevant circumstances which affect the operation of that relationship.”<sup>91</sup>

The fiduciary relationship that exists between custodians and their clients also receives recognition in the Financial Markets Act as read with the Financial Institutions (Protection of Funds) Act 28 of 2001 and the Financial Advisory and

<sup>84</sup> See the authorities cited in 83 above. In general, also see Corbett, JA in *Alfred McAlpine & Son (Pty) Ltd v Transvaal Provincial Administration* 1974 3 SA 506 (A) 531; *Silke Agency* 326-327. Also see the passages from Pothier cited by Kerr *Agency* 137 n 28, 30 on agreement to vary the degree of care and diligence required.

<sup>85</sup> On the duty of good faith, see in general Kerr *Agency* 141-153; Joubert & Van Zyl “Mandate and Negotiorum Gestio” in *LAWSA 17(1)* para 11. Also see *Ulpianus* D 17.1.10pr.

<sup>86</sup> Joubert & Van Zyl “Mandate and Negotiorum Gestio” in *LAWSA 17(1)* para 11.

<sup>87</sup> Kerr *Agency* 141.

<sup>88</sup> [1994] 3 SCR 377 (SCC).

<sup>89</sup> 2004 3 SA 465 (SCA).

<sup>90</sup> *Hodgkinson v Simms* [1994] 3 SCR 377 (SCC) as quoted in *Phillips v Fieldstone Africa (Pty) Ltd* 2004 3 SA 465 (SCA) 477 para 27.

<sup>91</sup> *Phillips v Fieldstone Africa (Pty) Ltd* 2004 3 SA 465 (SCA) 477 para 27.

Intermediary Services Act 37 of 2002. The legislation strengthens the focus on the fiduciary nature of the relationship. Fiduciary duties, existing in private law, have been statutorily reinforced and subjected to a regulatory regime.<sup>92</sup>

The Financial Advisory and Intermediary Services Act calls for a code of conduct to be established for financial service providers.<sup>93</sup> The code sets out general-, as well as more specific duties for custodians of financial products and funds. In general it provides that:

“A provider must at all times render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry”.<sup>94</sup>

Some of the more specific duties that are traditionally categorised under the duty of good faith include: 1. The duty of the agent to act solely in the interest of his principal.<sup>95</sup> 2. This includes a disclosure of any conflicts of interest that may arise out of the performance of the mandate. The agent must also disclose any personal interest he may have in the performance of the mandate.<sup>96</sup> 3. The agent is prohibited from making a secret profit out of the performance of the mandate. He is prohibited

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<sup>92</sup> See, *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003 s 3(1)(d): “the service must be rendered in accordance with the contractual relationship and reasonable requests or instructions of the client”. Also see s 10(1)(e)(i).

<sup>93</sup> *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003. Also see Financial Advisory and Intermediary Services Act 37 of 2002 s 16(1)(a).

<sup>94</sup> *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003 s 2.

<sup>95</sup> On the common law position, see *S v Heller* 1971 2 SA 29 (AD) 43H-44C; *R v Heroldt* 1957 3 SA 236 (A) 258D-G; *R v Milne & Erleigh* (7) 1951 1 SA 791 (A) 828D; *Mallison v Tanner* 1947 4 SA 681 (T) 684. Also see *Silke Agency* 337-339. On the statutory position, see *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003 s 3(1)(d): “the service must be rendered ... with due regard of the interests of the client which must be accorded appropriate priority over any interests of the provider”. Also see the provisions quoted in n 96 and 97 below.

<sup>96</sup> On the common law position, see *Mallison v Tanner* 1947 4 SA 681 (T) 684. On the statutory position, see Financial Advisory and Intermediary Services Act 37 of 2002 s 16(2)(a): “A code of conduct must in particular contain provisions relating to- (a) the making of adequate disclosures of relevant material information, including disclosures of actual or potential own interests”; *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003 s 3(1)(b): “the provider must disclose to the client the existence of any personal interest in the relevant service, or of any circumstance which gives rise to an actual or potential conflict of interest in relation to such service”.

from using or disclosing information, including confidential information, received in the performance of the mandate for his personal benefit.<sup>97</sup>

Section 37(5) of the Financial Markets Act reads: “Any securities held by a central securities depository, participant or nominee for or on behalf of another person, must be segregated and identifiable as belonging to a specific person and are considered to be trust property as defined in the Financial Institutions (Protection of Funds) Act...”. The provisions of the Act apply to “financial institutions” as defined in the Financial Sector Regulation Act 9 of 2017.<sup>98</sup> The definition has been simplified and streamlined as compared to the one provided by the now repealed Financial Services Board Act 97 of 1990. Included within its ambit are financial product providers, financial service providers, market infrastructures, holding companies of financial conglomerates and persons licensed or required to be licensed under a financial sector law. Even if securities held in custody or administered for, or on behalf of, other persons fall within the scope of the definition of “trust property” in the Financial Institutions (Protection of Funds) Act,<sup>99</sup> they have little to do with the legal concept of the trust. The Act applies the concept of “trust property” to both, trusts and agency constructs.<sup>100</sup> The purpose of the Act must therefore be understood to create and strengthen fiduciary duties of the agent.

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<sup>97</sup> On the common law position, see *Peacock v Marley* 1934 AD 1 at 5; *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 at 229; *Transvaal Cold Storage Co Ltd v Palmer* 1904 TS 4 at 33; *Evans and Jones v Johnston* 1904 TH 238 at 244-245; *Jones v East Rand Extension Gold Mining Co Ltd* 1903 TH 325 at 335. Also see *Kerr Agency* 143-153; *Silke Agency* 339-343. On the statutory position, see *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003 s 3(c): “non-cash incentives offered and/or other indirect consideration payable by another provider, a product supplier or any other person to the provider could be viewed as a potential conflict of interest”; also see s 3(f): “the provider involved must not deal with any financial product for own benefit, account or interest where the dealing is based upon advance knowledge of pending transactions for or with clients, or on any non-public information the disclosure of which would be expected to affect the prices of such product.” In addition, s 3(3): “A provider may not disclose any confidential information acquired or obtained from a client or, ... a product supplier in regard to such client or supplier, unless the written consent of the client or product supplier, as the case may be, has been obtained beforehand or disclosure of the information is required in the public interest or under any law.” On confidentiality, also see *Strate Rules* 4.2-4.4.

<sup>98</sup> Financial Sector Regulation Act 9 of 2017 s 1.

<sup>99</sup> “Trust property” is defined as “any corporeal or incorporeal, movable or immovable asset invested, held, kept in safe custody, controlled, administered or alienated by any person, partnership, company or trust for, or on behalf of, another person, partnership, company or trust, and such other person, partnership, company or trust is hereinafter referred to as the principal”; Financial Institutions (Protection of Funds) Act 28 of 2001 s 1.

<sup>100</sup> Section 2(b), for example, refers to “the instrument or agreement by which the *trust or agency* in question has been created” (own emphasis). Likewise, the definition of “trust property” in s 1 indicates that it not only encompasses property administered by a trust, but also such property controlled or administered by a person, partnership or company. This interpretation is in line with the historic use of the term “trust” as inherited from English law and reflected in the Companies Act 61 of 1973. In terms

An agent is furthermore obliged to account to his principal (or a sub-agent to the agent). This includes the duty to maintain accounts and to keep them up-to-date.<sup>101</sup> The form and manner in which the accounts are to be drawn up and maintained can be determined by the contract of mandate, by trade usage or by statute.<sup>102</sup> In addition, an agent must allow the books so maintained to be inspected.<sup>103</sup> According to Schreiner J, “the obligation to permit inspection is a continuing one resting on an agent throughout the agency and even thereafter”;<sup>104</sup> and further, “[n]o doubt the corresponding right must be exercised reasonably and at convenient seasons”.<sup>105</sup> The duty to maintain accounts is particularly important in the context of dematerialised securities, as the account entries have an impact on establishing holding, on transferring ownership and, in the absence of certificates, provide evidence as to both of the above. In this context the account is more than a mere summary of the transactions undertaken by an agent. It is only consistent therefore, that legislation places a strong emphasis on the duty to maintain accounts. The duties of central securities depositories and participants in respect of accounting are primarily set out in the Financial Markets Act and the rules of Strate. A central securities depository and a participant are obliged to maintain accounts.<sup>106</sup> The CSD must notify a participant and the participant must notify its client of any entries made in an account.<sup>107</sup> Participants are obliged to furnish their clients with statements in respect of securities accounts at least twice per annum.<sup>108</sup> A CSD must balance and reconcile the total number and nominal value of uncertificated securities with the

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of s 104 of that Act, a company was not bound to take notice of any trust. The reference to trust was interpreted to mean “nominees” [see the reference to case law in MS Blackman, RD Jooste, CK Everingham, JL Yeats, FHI Cassim & R De La Harpe *Commentary on the Companies Act* (2002) (RS 9 2012) 5-299] and Blackman et al make it clear that a nominee was an agent, not a trustee, 5-299, 5-171. Blackman et al 5-171 and 5-172-1 also explain that “[t]he term ‘beneficial owner’ is derived from the ‘owner’ being regarded as the beneficiary of a fiduciary arrangement with the nominee generally arising out of a constructive trust out of English law” and further “in our law, the nominee as such is not the trustee, but is the agent of the ‘beneficial owner’”. In this context, any reference to the trust concept must therefore be interpreted to reflect the fiduciary nature of the arrangement rather than being in the nature of a formal trust.

<sup>101</sup> See *Krige v Van Dijk’s Executors* 1918 AD 110 at 113; *Hansa v Dinbro Trust (Pty) Ltd* 1949 2 SA 513 (T) 517. Also see *Silke Agency* 331-332.

<sup>102</sup> Joubert & Van Zyl “Mandate and Negotiorum Gestio” in *LAWSA 17(1)* para 12.

<sup>103</sup> *Hansa v Dinbro Trust (Pty) Ltd* 1949 2 SA 513 (T) 514; *Jacobsohn v Simon & Pienaar* 1938 TPD 116 at 120; *Mead v Clarke* 1922 EDL 49 at 51.

<sup>104</sup> *Jacobsohn v Simon & Pienaar* 1938 TPD 116 at 120.

<sup>105</sup> 120.

<sup>106</sup> See Financial Markets Act 19 of 2012 s 30(2)(k) and s 32(2)(b) respectively. For further details on the duty of record-keeping, see *Strate Rules* 5.2.

<sup>107</sup> Financial Markets Act 19 of 2012 s 30(2)(m) and s 32(2)(g) respectively.

<sup>108</sup> *Strate Rules* 5.8.5. Also see *Companies Act* 71 of 2008 s 52(4).

records of the issuer<sup>109</sup> and a participant must do the same with the records of the CSD.<sup>110</sup> Participants and central securities depositories must also, upon being requested to do so, provide information contained in accounts to the registrar and issuer.<sup>111</sup> In addition, they must properly disclose their fees and charges.<sup>112</sup> Lower-tier intermediaries are subject to similar legislative rules on record-keeping.<sup>113</sup>

Part and parcel of the duty to account is the duty of the agent to keep any money or property belonging to the principal separate from own money or property.<sup>114</sup> The principle of separation of property is a cornerstone of modern securities holding systems and is affirmed by legislation. It is given expression by obliging participants to keep own securities and client securities in separate accounts.<sup>115</sup> Client securities must furthermore be segregated and identifiable as belonging to a specific person.<sup>116</sup> The same duty applies by statute to lower-tier custodians.<sup>117</sup> What is unclear from the provisions of the Act and Rules is whether securities must be segregated in such a way that specific securities can be allocated to specific clients or whether it is sufficient if a custodian separates own securities from a pool of collectively held client securities.<sup>118</sup> The wording of the provisions points towards the former interpretation, but this would effectively bar any pooling or collective holdings of securities. Considering the purpose of the duty, which is to prevent the mixing of client property with an agent's property, it can be argued that the latter interpretation can find application as long as client accounts record the holding of each client in relation to the pool.

<sup>109</sup> Financial Markets Act 19 of 2012 s 30(2)(n).

<sup>110</sup> Financial Markets Act 19 of 2012 s 32(2)(k). Also see the corresponding right of the CSD to access the records of participants – s 30(2)(p). Also see *Strate Rules* 5.3

<sup>111</sup> Financial Markets Act 19 of 2012 s 32(2)(h) and s 30(2)(s) respectively. Also see *Strate Rules* 6.3.4-6.3.7. Also see Companies Act 71 of 2008 s 52(1)-(3), which determine that any request for information must be made via the company.

<sup>112</sup> Financial Markets Act 19 of 2012 s 30(2)(r) and s 32(2)(f).

<sup>113</sup> See Financial Advisory and Intermediary Services Act 37 of 2002 s 16(20)(b) as read with *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003 s 3(1)(a), 3(2)(a).

<sup>114</sup> *Pretorius v Van Beeck* 1926 OPD 197 at 198-199.

<sup>115</sup> Financial Markets Act 19 of 2012 s 32(2)(m) and s 37(5); *Strate Rules* 6.2.2.3.

<sup>116</sup> Financial Markets Act 19 of 2012 s 32(2)(m) and s 37(5); *Strate Rules* 6.2.2.3.

<sup>117</sup> *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003 s 10(1)(e)(ii): A provider must take reasonable steps to ensure—“(ii) that client financial products or funds are readily discernible from private assets or funds of the provider”.

<sup>118</sup> See also RA de la Harpe “Securities Registration and Transfer (ss 49-56)” in JL Yeats (ed) *Commentary on the Companies Act of 2008* (OS 2018) 2-506 2-1019.

In the common law, the failure by the agent to separate the principal's property or proceeds from own property results in the allocation of the property of the agent to the principal unless and until the agent properly distinguishes it.<sup>119</sup> It is submitted that this rule stands. Legislation firstly demands that participants hold sufficient securities; that is securities of the same kind equal to the total number or nominal value of own and client securities.<sup>120</sup> Secondly, where there are insufficient securities in the event of an insolvency of a participant, the loss sharing rules state that the shortfall must in the first place be made up by the participant's own securities.<sup>121</sup>

Lastly, the duty to account encompasses a duty to deliver to the principal any property or monetary or non-monetary benefits received in the performance of the mandate.<sup>122</sup> This rule applies not only upon the termination of the relationship, but also continuously as a transaction is completed or as funds and benefits are received.<sup>123</sup> The rules of Strate therefore provide that "all interest, dividend, capital redemption payments and all other entitlements" received by a participant from an issuer, must be paid to a client.<sup>124</sup> Likewise, "all notices, reports and circulars regarding rights and other benefits" received from an issuer must be conveyed to clients within a reasonable time.<sup>125</sup>

Where commercial changes are far-reaching, the question arises whether existing legal rules and concepts continue to be apposite? The scrutiny of agency principles shows that the principles of agency and contracts of mandate provide a comprehensive, flexible and convenient framework for the indirect holding of securities in accounts. Furthermore, the legislative framework neglects to regulate lower-tier holdings. There is clear evidence that the doctrinal framework has been modified and supplemented by legislation. It may be appropriate to conclude that the relationship has become one of "statutory agency". Yet, this should not detract from the fact that, in practice, contracts still form the basis of custody relationships and that the parties continue to have significant scope to shape their contractual relations.

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<sup>119</sup> *Pretorius v Van Beeck* 1926 OPD 197 at 198-199. Also see *Silke Agency* 333 and the cases cited there.

<sup>120</sup> *Strate Rules* 5.1.1.

<sup>121</sup> 5.1.2 and 16.5.2.1.

<sup>122</sup> *Krige v Van Dijk's Executors* 1918 AD 110 at 113.

<sup>123</sup> *Kerr Agency* 155.

<sup>124</sup> *Strate Rules* 5.8.3. Also see *General Code of Conduct for Authorised Financial Services Providers and their Representatives* Notice 80 GG 25299 of 08-08-2003 s 10(1).

<sup>125</sup> *Strate Rules* 5.8.4.

Contracts, it was argued at the end of Part 1 are sufficiently flexible to accommodate statutory requirements.<sup>126</sup> The same argument can be advanced here. To deny therefore that the common law principles of the law of agency continue to play a role would not only be a negation of reality but would also deprive the parties of additional protection provided by the common law. At the same time, it will be argued in Part 3 that it is important to recognise that the legislative provisions require us to reconceptualise the agency construct as a dynamic management and administration function.<sup>127</sup> This includes taking cognisance of the fact that agents administer the same type of asset for a large client base and that it is more efficient and cost effective therefore, to manage these assets together in a pool. Traditional agency rules, aimed at more individualised principal-agent relationships, must be adapted to accommodate such practices.

#### 13 2 3 4 Ownership and holding

Ownership is a legal concept. The term has been used liberally in this thesis thus far and without explanation. Technically ownership is a real right that confers comprehensive control over a thing.<sup>128</sup> More specifically, ownership expresses the *legal* ability to exercise control over a thing.<sup>129</sup> Colloquially it is also used in relation to incorporeal legal objects (patrimonial objects). For lack of better terminology a person who has comprehensive control over an incorporeal is said to be the owner thereof. In *Oakland Nominees* Holmes, JA found that “[a]lthough ‘ownership’ may, juristically, not be accurate in relation to the rights of the person in whom the shares vest, for convenience the descriptive labels of ‘owner’ and ‘ownership’ will be retained in this judgment”.<sup>130</sup> This thesis purports to use ownership in the same sense i.e. in relation to the holding of personal rights as opposed to corporeal things.

Where the person that is entitled to the benefits flowing from shares at the same time exercises the ability to enforce and receive performance of such benefits, it is of little importance to analyse ownership. Where the entitlement to benefits and the ability to enforce them diverge, the situation becomes somewhat more complicated.

<sup>126</sup> See above, 6 3 The obligatory realms of shares and some conclusions.

<sup>127</sup> Also see below, Part 3, 3 4 4.

<sup>128</sup> See PJ Badenhorst, JM Pienaar & H Mostert *Silberberg and Schoeman's The Law of Property* 5 ed (2006) 91 and the authorities cited there.

<sup>129</sup> Badenhorst et al *Silberberg & Schoeman's Property* 3. Also see Blackman et al *Commentary on the Companies Act* 5-172-1 n 1.

<sup>130</sup> *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 1 SA 441 (A) 447H.

An additional level of complexity is added if there are several persons positioned between the person taking receipt of benefits and the person ultimately entitled to them. In these situations it is of utmost importance to determine the meaning and scope of ownership with care and precision.

Thévenoz identifies two possible “ownership” models of intermediated systems: One where the investor is the full owner (he uses the terminology legal owner)<sup>131</sup> of the securities held by the top-tier custodian; and the other where the investor holds only a derivate interest in the holding of his own intermediary and the top-tier custodian is the legal owner thereof.<sup>132</sup> He terms the first model “direct ownership” and the second one “multi-tiered entitlements”. German law provides an example of the first model and English and US law are examples of the second. In the “direct ownership” model Thévenoz finds that investors maintain “direct” relationships with issuers, but depend on intermediaries in the exercise of their rights.<sup>133</sup> This applies regardless whether the holding systems are transparent or intransparent.<sup>134</sup> He describes intermediaries in this model as “book-keepers or agents for investors” and as “mere instrumentalities in the investor’s ownership of and control over his securities”.<sup>135</sup> The “direct ownership” model may “modif[y] the form of ownership, but does not change the identity of the owners”.<sup>136</sup>

Thévenoz links the development of “multi-tiered entitlements” to the existence of registered shares as opposed to bearer shares and to the ability of a legal system to accommodate a split between legal and beneficial tile. In this sense, South African law is a hybrid. Its shares are predominantly in registered form. A dual conception of ownership is foreign to South African law.<sup>137</sup> Even if registration does establish a direct relationship between the issuer and the custodian-shareholder, the shareholder acts as a mere conduit for the exercise of rights and the benefits received. South African law cannot and does not therefore accommodate a split between legal and

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<sup>131</sup> L Thévenoz “Intermediated Securities, Legal Risk, and the International Harmonization of Commercial Law” (2008) 13 *Stan JL Bus & Fin* 384 404.

<sup>132</sup> 404.

<sup>133</sup> 406.

<sup>134</sup> 406.

<sup>135</sup> 405.

<sup>136</sup> 405.

<sup>137</sup> Any reference to “legal ownership” in the Strate rules is therefore misplaced.

beneficial title. That the South African model is therefore one of “direct ownership” as opposed to “multi-tiered entitlements” will be shown below.<sup>138</sup>

In conceptualising a system of deposit for South Africa, Malan and Oosthuizen categorically state that a collective securities depository does not become the “owner” of securities deposited with it or registered in its name.<sup>139</sup> Investors become co-owners of the certificates held in collective deposit as well as joint holders of the body of securities held collectively.<sup>140</sup> The concept of co-ownership initially developed in relation to share certificates and draws on the law of things, based on which former owners of units mixed subsequent to a *confusio* become co-owners of the mixture, whether they have consented to their mixing or not.<sup>141</sup> This result has been approximated in statute.<sup>142</sup>

Regarding the incidence of ownership and co-ownership, it is provided in section 36 of the Financial Markets Act that:

“(2) (a) No central securities depository or participant may become the owner, co-owner, holder, pledgee or cessionary for the purpose of securing a debt, of securities merely because of—

- (i) a deposit of securities; or
- (ii) the registration in its name of—
  - (aa) securities;
  - (bb)-(ee) ...”<sup>143</sup>

It is further provided in section 37(1):

“Where securities of any kind are deposited with a participant or with a central securities depository, or accrue to the owner of securities of the same kind held collectively by a participant, authorised user, nominee or external securities depository in a securities account or by a central securities depository in a central securities account, *the person*

<sup>138</sup> Vermaas (2010) *Acta Juridica* 93 n 104 comes to the same conclusion.

<sup>139</sup> Malan & Oosthuizen (1989) *TSAR* 505-506; Malan (1987) *Moderne Besigheidsreg* 79.

<sup>140</sup> Malan & Oosthuizen (1989) *TSAR* 505-506; Malan (1987) *Moderne Besigheidsreg* 79. Also see Vermaas *Dematerialisasie van Genoteerde Aandele* 385.

<sup>141</sup> See Vermaas *Dematerialisasie van Genoteerde Aandele* 385-386 and the sources cited in n 21.

<sup>142</sup> Vermaas *Dematerialisasie van Genoteerde Aandele* points out that the rules of the law of things do not apply because shares do not fall within the *numerus clausus* of rights that are acknowledged to be property.

<sup>143</sup> This section is virtually identical to s 10(4)(a) of the Custody and Administration of Securities Act 85 of 1992.

*who was the owner of the securities at the time of deposit or accrual becomes entitled to an interest as co-owner of all the securities of the same kind comprised in the securities account or central securities account, as the case may be.*<sup>144</sup>

Section 36(2)(a) is not confined to ownership; it indicates that neither registration nor deposit are sufficient to found ownership, co-ownership or holding.<sup>145</sup> From the perspective of relevant company law provisions, this is not entirely accurate – registration does found holding. What the section does imply, however, is that for such ownership, co-ownership or holding to come into existence, something more is required between the parties to give effect to holding arrangements, such as a contractual agreement between the parties. That is the one important take-away of the section; that the Act does not purport to be the only instrument regulating the relationship between the parties. Private law must continue to play a role. This is also particularly true for structuring lower-tier holdings. The Strate Rules used to give recognition to this principle by obliging participants to obtain client mandates, which governed the relationship between participants and their clients.<sup>146</sup> This requirement has fallen away. The other important take-away from section 36(2)(a) is that that ownership remains in the investor.

Section 37(1) confirms this by stating that only the person who was the owner of securities at the time of deposit, not the CSD, participants or other intermediaries, becomes co-owner thereof. Other than that, the section addresses the question as to how co-ownership is structured in the case of collective holdings of securities. The co-ownership interest is calculated by determining the proportion that the number or nominal value of securities deposited bears to the total number or nominal value of securities of the same kind held by a custodian.<sup>147</sup> The co-ownership interest is therefore determined to be the undivided fraction of an entire bulk. The section clearly displays the influence of the German conception of securities deposit that probably made its way into the Act via writers such as Malan. While ownership remains in the investor, the collective holding of securities at intermediary level, coupled with the elimination of share certificates and the resulting evidentiary void,

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<sup>144</sup> Own emphasis in italics. This section is very similar to s 4(1) of the Custody and Administration of Securities Act 85 of 1992. The section however expressly does not apply to uncertificated securities – see s 4(3A).

<sup>145</sup> The instances of pledge and cession are ignored for the time being.

<sup>146</sup> See *Strate Rules of Strate Pty (Ltd)* (February 2014) 5.7.1-5.7.4.

<sup>147</sup> Financial Markets Act 19 of 2012 s 37(3).

make it impossible to allocate specific securities to specific investors. The ownership of specific securities is therefore replaced by a co-ownership in a pool of securities of the same kind held by an intermediary. The Financial Markets Act does not clarify at which level of intermediation this co-ownership interest must be determined, referring only to co-ownership “of all the securities of the same kind comprised in the securities account or central securities account, as the case may be”.<sup>148</sup> The definition of “securities accounts” includes accounts kept by nominees for their clients and is therefore so wide that its ambit appears to found a co-ownership interest at every tier of intermediation. This would result in a duplication of co-ownership interests. The principles of property law do not, however, permit more than one person to be owner of the same asset at the same time. Rather, the co-ownership interest should be calculated with reference to the positions recorded in the records that constitute the uncertificated securities register.<sup>149</sup> This position is supported by a reading of the Strate Rules, which clearly intend the transfer of ownership to take place through a debiting and crediting of the accounts in the uncertificated securities register.<sup>150</sup>

Even if the determination of co-ownership takes place at the level of uncertificated securities registers, co-ownership vests in the investors, not in the shareholders acting as nominees. The entry at register-level determines both the numerical proportion of an investor’s interest and facilitates a transfer thereof, but without necessitating that the entry be made in the name of the co-owner. It therefore retains its status of evidencing ownership.

Ownership continues to vest in the investor and mutates to a co-ownership interest in the total number or nominal value of securities held in collective custody by a participant or central securities depository. The uncertificated securities register continues to found holding. This makes the shareholder the direct holder of securities and all other custodians, including the investor, indirect co-holders. Holding or co-holding is therefore a combination of the entitlement to receive benefits on behalf of the owner and a package of duties owed by the holder to its client. These duties flow from agency relationships and were examined above.

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<sup>148</sup> S 37(1).

<sup>149</sup> See below, 13 2 4 Registration.

<sup>150</sup> Strate *Rules* 7.3.3.1, 7.3.3.2. The subregisters and SDA register, which are the uncertificated securities register, are also defined as registers of ownership, indicating that ownership passes at this tier.

The status of lower-tier intermediaries in the holding chain is not addressed conclusively in the Financial Markets Act. Its determination must, therefore, fall back on private law. The rules of agency dictate that agents do not become owners of the incorporeals they manage and administer. The Act's position on ownership is therefore consistent with the common law position – ownership does not pass to intermediaries. To interpret the “register of ownership” phrase used in the definitions of “SDA register” and “subregister” of the CSD Rules as meaning to confer ownership on custodians would run counter to the private law principles of agency and mandate as well as to the relevant provisions in the Financial Markets Act. Such a model is conceivable, as the US example shows, but would require, particularly in the South African context, far more significant and pervasive legislative intervention.

### *13 2 3 5 New assets?*

In early South African law, a conflation of shares with share certificates was strictly avoided. The holding and transfer of shares never had any property, or ownership implications. Shares were not transferred as movable property. Neither did ownership pass to a holder of shares. Multi-tiered structures change the way in which shares are held, or formulated differently, how we perceive and exercise the personal relationship between an issuer and an investor. The indirect manner of holding shares introduces the concept of account credits. An account credit is not a share or security. It rather represents all the duties of an agent, or stated inversely, all the rights that a client has against his custodian. It is also a numerical representation of the proportion of higher-tier holdings. This numerical value, at the same time, gives an indication of the client's proportion of dividends or monetary contributions received by the custodian in bulk. At the same time, some rights against third parties are built into this relationship, such as protective measures against a custodian's creditors. The law of accounts<sup>151</sup> is a law of relationships. To conceive of account credits as assets in their own right may be a helpful fiction, but it would lead to the same conceptual fault that was perpetuated by the conflation of the share with the share certificate. The transformation of assets and the creation of new assets will be considered from a theoretical angle in Part 3.<sup>152</sup>

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<sup>151</sup> On the “law of accounts”, see 17 2 A law of accounts.

<sup>152</sup> See below, 17 3 4 Transformation of assets and the creation of new assets and rights.

This conclusion does not imply that shares themselves are not transformed. On the obligation side, shares are held indirectly, the holding of which is recorded in accounts. On the asset side of shares, intermediation affects how shares are transferred, burdened for purposes of providing security or otherwise dealt with in relation to third parties and the world at large. Furthermore, the concept of “ownership” of a share is replaced by co-ownership of a notional unit of a pool of shares of the same type.

### 13 2 4 Registration

The duties of record-keeping are spread amongst several parties – the CSD, participants, issuers and clients. The status of the numerous records must be determined with reference to legislation and the rules of Strate. The logical point of departure is the definition of the “uncertificated securities register”, being “the record of uncertificated securities administered and maintained by a participant or central securities depository, as determined in accordance with the rules of a central securities depository, and which forms part of the relevant company’s securities register”.<sup>153</sup> It follows, that the Companies Act and the Financial Markets Act make provision for two alternatives; the records compiled by the CSD or the records maintained by the participants.<sup>154</sup> Both pieces of legislation do not determine with finality which one of these records is the legally relevant uncertificated securities register. Similarly, the term “records” is too widely defined to be of assistance.<sup>155</sup>

Section 30(2)(o) of the Financial Markets Act demands that a CSD “administer and maintain a record of uncertificated securities deposited with it”. At the same time, it is “entitled to access the records of the uncertificated securities administered and maintained by its participants”,<sup>156</sup> while also having to “balance and reconcile ... its uncertificated securities register with the records of the issuer”.<sup>157</sup> In addition to the record maintained by the CSD, each participant must “administer and maintain a

<sup>153</sup> See Companies Act 71 of 2008 s 1, also see ss 50(3) and 50(3)(a); Financial Markets Act 19 of 2012 s 1(1); *Strate Rules* 1.2.

<sup>154</sup> Refer particularly also to the definition of “uncertificated securities register” in s 1 of the Companies Act 71 of 2008 and s 1 (1) of the Financial Markets Act 19 of 2012 and the wording of section 50(3) of the Companies Act.

<sup>155</sup> *Strate Rules* 1.2 Definitions: “Records’ means those records of the CSD, Participants, Issuers and Clients which relate to the Business of the CSD or Participants in terms of the Act”.

<sup>156</sup> Financial Markets Act 19 of 2012 s 30(2)(p).

<sup>157</sup> S 30(2)(n). For the corresponding obligation of the issuer, see s 34(d).

record of all securities deposited with it”<sup>158</sup> and must furthermore “record all securities of the same kind deposited with it in an uncertificated securities register if so required by the depository rules”.<sup>159</sup> To ensure uniformity across the fragmented records, the participants are in turn obliged to reconcile the totals of their own securities accounts with those of the central securities accounts on a daily basis.<sup>160</sup>

The decisive record is clearly not the one maintained by the issuing company. In terms of the Companies Act, the issuer is merely obliged to record the total number of uncertificated securities issued.<sup>161</sup> The Financial Markets Act similarly requires only “the total number and, where applicable, the nominal value of each kind of uncertificated securities issued”<sup>162</sup> to be recorded. These details must be regularly reconciled with the records compiled by the CSD.<sup>163</sup> The company does not record any details of its shareholders.

Of critical importance in determining the legal relevance of the records maintained by the CSD and participants are the definitions of “SDA Register” and “Subregister” in the CSD Rules:

“‘SDA Register’ means the record of Uncertificated Securities held in a Segregated Depository Account *kept by the Strate* in terms of the Strate Rules, which is the register of ownership for the equity Securities deposited therein, and is deemed to be the Uncertificated Securities Register, where applicable”<sup>164</sup>

“‘Subregister’ means the record of equity Uncertificated Securities held in a Securities Account *kept by a Participant* in terms of the Strate Rules, which is the register of ownership for the Securities Deposited therein, and is deemed to be the Uncertificated Securities Register, where applicable”<sup>165</sup>

This means that, in relation to segregated depository accounts,<sup>166</sup> the SDA register administered and maintained by Strate is the uncertificated securities register and therefore the decisive legal record. In relation to all other securities, it is the various

<sup>158</sup> S 32(2)(d).

<sup>159</sup> S 32(2)(e).

<sup>160</sup> S 32(2)(k); also see *Strate Rules* 5.3.

<sup>161</sup> Companies Act 71 of 2008 s 50(2)(a).

<sup>162</sup> Financial Markets Act 19 of 2012 s 34(a).

<sup>163</sup> S 34(d).

<sup>164</sup> (own emphasis).

<sup>165</sup> (own emphasis).

<sup>166</sup> See above, 13.1 Overview of the commercial structures, as well as the definition of “Segregated Depository Account” in the *Strate Rules* 1.2.

subregisters kept by the participants that comprise the uncertificated securities register. The process of registration of uncertificated securities takes place in a fragmented fashion and is not undertaken centrally by a CSD or system operator.<sup>167</sup> In principle, these fragmented records, which together make up the uncertificated securities register, must contain the same details as the securities register maintained by the issuing company for its certificated securities.<sup>168</sup>

The shareholders are therefore those persons recorded on participant-, or CSD level. They meet the definition of a “shareholder”<sup>169</sup> as they are firstly entered as such on the uncertificated securities register and secondly, they are holders.<sup>170</sup> Dividends and other payments can be made by the company directly to shareholders based on the information provided in the uncertificated securities register. Strate also offers a corporate action service in terms of which the distribution of benefits and other corporate actions will be administered by Strate. Shareholders who receive payments on behalf of their own clients must ensure that they forward the payments. The same is true for information issued by a company.<sup>171</sup>

The uncertificated securities register becomes part of the securities register of the company. The company obtains access to the uncertificated securities register through the CSD.<sup>172</sup>

The evidentiary value of the uncertificated securities register is the same as in relation to certificated shares – the register is “sufficient proof of the facts recorded in it” and can be rebutted.<sup>173</sup>

In South Africa and elsewhere an increasing trend to require beneficial interest disclosures in the context of non-transparent holding patterns can be observed. The statutory definition of “beneficial interest” extends beyond the common usage of the term and includes persons who are deemed to be beneficial interest holders in terms

<sup>167</sup> See Vermaas (2010) *Acta Juridica* 95.

<sup>168</sup> Companies Act 71 of 2008 s 50(3)(b) as read with s 50(2)(b). The Strate *Rules* may determine that additional information has to be recorded – see s 50(3)(b)(ii) and Strate *Rules* 6.3.3 and 5.2.

<sup>169</sup> See the definition of a shareholder as discussed above, 8 2 4 Registration in South African law.

<sup>170</sup> On holding, see above, Chapter 7: Introduction and a prospect of the discussion.

<sup>171</sup> In terms of information issued by companies, the JSE Limited *Listing Requirements* 3.44 require that all prescribed information be made available directly to all holders. But also see JSE *Listing Requirements* 3.49, in terms of which circulars and pre-listing statements must be distributed directly to all “beneficial holders” who have selected the direct service. Also see above, 13 2 3 3 Agency and mandate.

<sup>172</sup> Strate *Rules* 6.8.4.

<sup>173</sup> Companies Act 71 of 2008 s 50(4). Also see Strate Rules 6.11.6 and 6.13.8.8

of the Act.<sup>174</sup> It has been criticised that the definition is too wide and that it includes in its ambit even those shareholders that act merely as nominees.<sup>175</sup> The disclosure requirements set out in sections 56(3) to 56(7) are aimed at enhancing the transparency of nominee holdings. If a registered shareholder is not simultaneously the beneficial interest holder of the securities, the registered holder must disclose the identity of the person on whose behalf she holds the securities as well as the identity of all beneficial interest holders in respect of that security and the extent of the beneficial interest.<sup>176</sup> The company must establish and maintain a register of these disclosures.<sup>177</sup> These disclosure requirements are not novel.<sup>178</sup> The real novelty lies in the fact that, by regulation, any disclosures are determined to become part of the securities register.<sup>179</sup> Nonetheless, these duties of disclosure are said not to change the system to a transparent one.<sup>180</sup> The duties of disclosure should also not have an impact on the default rules of privity in the case of sub-agency.<sup>181</sup> The disclosure, however, makes known to the issuer that the shareholder acts as a nominee.<sup>182</sup> Disclosure can also be said to strengthen the conclusion that the investor retains ownership, or more accurately becomes the co-owner of shares, and that such co-ownership is determined at the level of registration, even if the owner is not entered on the register.<sup>183</sup>

<sup>174</sup> See the definition of “beneficial interest” in s 1 as well as the deeming provisions in s 56(2) of the Companies Act 71 of 2008.

<sup>175</sup> R Rachlitz “Disclosure of Ownership in South African Company Law” (2013) 3 *Stell LR* 406 412-413; FHI Cassim, MF Cassim, R Cassim, R Jooste, J Shev & J Yeats *Contemporary Company Law* 2 ed (2012) 252. If this is indeed the case, even nominees would not be obliged to make disclosures in terms of s 56(2) of the Companies Act 71 of 2008, effectively rendering the provision redundant. According to Rachlitz the provision should therefore be interpreted to require disclosure where the person registered is not the only holder of a beneficial interest, see Rachlitz (2013) *Stell LR* 418.

<sup>176</sup> Companies Act 71 of 2008 s 56(3); For a critical analysis of this provision see Rachlitz (2013) *Stell LR* 417-418.

<sup>177</sup> Companies Act 71 of 2008 s 56(7)(a).

<sup>178</sup> See s 140 of the Companies Act 61 of 1973 for similar provisions.

<sup>179</sup> See Companies Regulations, 2011 GN R 619 in GG 36759 of 20-08-2013 reg 32(3); See also Rachlitz (2013) *Stell LR* 418-419 who argues that the Act itself does not make provision for the inclusion of such disclosures in the securities register except in the context of the issue of securities other than shares; see Companies Act 71 of 2008 s 50(2)(b)(iv)(bb).

<sup>180</sup> UNIDROIT *Study LXXVIII – Doc. 44* 8.

<sup>181</sup> See above, 13 2 3 3 Agency and mandate.

<sup>182</sup> Also see above, 8 3 5 4 Agency, representation and mandate, the text to n 375.

<sup>183</sup> Also see below, 13 2 5 2 2 Account entries.

## 13 2 5 Electronic settlement and transfer

### 13 2 5 1 Commercial mechanisms

In the secondary market, buying and selling positions are matched anonymously during the trading process. The matched trade then passes from the trading platform and clearing system of the Johannesburg Stock Exchange (JSE) to SAFIRES (South African Financial Instruments Real-time Electronic Settlement), the electronic settlement processing system of Strate. The JSE sends settlement orders (known as broker nett settlement orders) to SAFIRES in batch. Simultaneously the buyer and seller will send settlement instructions to their respective custodians, who may be participants. The buyer will instruct his custodian to settle his purchase of shares and the seller will instruct her custodian to settle her sale of shares. The settlement may only proceed if a participant has a valid instruction from its client. Client instructions may be in the form of an authorising instruction, a standing or general instruction, a BEE instruction or any other valid instruction.<sup>184</sup> An authorising instruction is given by the client in respect of every individual transaction. A BEE instruction is a client instruction also given by a client in respect of every individual transaction, but in terms of a BEE contract concluded in terms of the rules of the JSE. BEE instructions are required in the context of BEE Securities or BEE Ownership Schemes, both of which are intended to encourage broad-based black economic empowerment through the participation of “black persons” in securities ownership. A standing instruction is a general or blanket instruction that covers any transaction. All instructions need to be in writing or otherwise recorded. The CSD will send the corresponding broker nett settlement orders (originating from the JSE) to the participants in bulk.<sup>185</sup> The participants will match the instructions received from their clients to the settlement orders received from the CSD. The participant of the seller will also verify the availability of sufficient shares in the securities account of the seller. SAFIRES will then require the participant to commit to settlement orders.<sup>186</sup> Commitment is a conditional undertaking by the participant that the transaction will

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<sup>184</sup> See the definition of “Client Instruction” in Strate *Rules* 1.2.

<sup>185</sup> Strate Directive SC.1: Operational Market Windows – On-market – Equities – JSE *Special Gazette* No S14-2016 of 25-11-2016 3.1.7, 3.1.8, 3.3.1.4.

<sup>186</sup> Strate Directive SC.1: Operational Market Windows – On-market – Equities – JSE *Special Gazette* No S14-2016 of 25-11-2016 3.3.1.3. See also Strate *Rules* 7.3.2. For a brief overview of the clearing and settlement process in South Africa, see Z Botha “Financial Market Terminology, Technicalities and Theories” in K Van Wyk, Z Botha & I Goodspeed (eds) *Understanding South African Financial Markets* 5 ed (2015) 199 216-217.

settle on settlement day i.e. that sufficient securities or funds are available to settle. On settlement day, SAFIRES seeks confirmation from the participant about the availability of securities. This process is known as reservation. Upon receiving such confirmation, SAFIRES sends a payment order to the South African Reserve Bank (SARB). Verification, confirmation and reservation are part of the process of clearing.

Payment is facilitated by SAMOS (South African Multiple Organ Settlement), the SARB's electronic settlement system, using central bank money.<sup>187</sup> Each participant makes use of a settlement bank, which has an account in SAMOS. The SARB through the SAMOS system serves as an intermediary facilitating the transfer of funds from one settlement bank to another.<sup>188</sup> As soon as the SAMOS window opens, a payment advice is sent to the participants.<sup>189</sup> The participant must, within 30 minutes of receiving the payment advice from the CSD, instruct its settlement bank to fund its SAMOS account with the amount in question.<sup>190</sup> Equity securities are settled at pre-determined times of the day (known as payment runs or payment windows) on the basis of multilateral netting. This means that the interbank obligations between the various settlement banks are calculated by SAFIRES and submitted for settlement to SAMOS.<sup>191</sup> The account of the settlement bank on the buyer's side (the "paying bank") will be debited with the stipulated amount in Rand and the account of the settlement bank on the seller's side (the "receiving bank") will be credited with the same amount. Once settlement through SAMOS is complete, a payment confirmation is sent from SAMOS to SAFIRES.

Strate will then make the relevant entries in its records. Thereafter, a participant must, upon receipt of an authenticated instruction from Strate advising it of the completion of the transaction, complete a corresponding entry in its records.<sup>192</sup> An

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<sup>187</sup> Central bank money is money that has been completely dematerialised and takes the form of "credits to electronic demand deposit accounts at central banks". If the credit is to the demand deposit account at a commercial bank it is known as commercial money. See RD Guynn "Modernizing Securities Ownership, Transfer and Pledging Laws" 17; See generally on the structure of payment systems PR Woods *Set-off and Netting, Derivatives, Clearing Systems* 2 ed (2007) 265-283.

<sup>188</sup> For a brief overview of the role of central banks in payment systems see Bank for International Settlements *The Role of Central Bank Money in Payment Systems* (August 2003) 2-3, 9-11.

<sup>189</sup> Strate Directive SC.1: Operational Market Windows – On-market – Equities – JSE *Special Gazette* No S14-2016 of 25-11-2016 3.1.5.

<sup>190</sup> Strate Directive SC.1: Operational Market Windows – On-market – Equities – JSE *Special Gazette* No S14-2016 of 25-11-2016 3.4.3.

<sup>191</sup> Committee on Payment and Settlement Systems (CPSS) "CPSS Red Book - Payment, Clearing and Settlement Systems in South Africa" in Bank for International Settlements (BIS) *Payment Clearing and Settlement Systems in the CPSS Countries* (2012) 390-391.

<sup>192</sup> Strate *Rules* 6.2.2.5.

“authenticated instruction” is defined as “any instruction sent or received through the SAFIRES system”.<sup>193</sup>

### 13 2 5 2 Legal framework

#### 13 2 5 2 1 Legislative provisions

In the context of certificated shares, shares are traditionally transferred by cession,<sup>194</sup> while the statutory provisions are concerned with a change in holding as evidenced by registration.<sup>195</sup> A change in registration, even if not completely divorced from a transfer of shares, nonetheless stands separately from it. At the same time, the introduction of tiered, decentralised systems of registers and the concept of account entries makes it increasingly difficult to neatly separate a change in holding from a transfer of ownership.<sup>196</sup>

The impression of a sweeping change of the status quo is created by a plain reading of the relevant statutory provisions. Where shares are in dematerialised form, s 53(2) of the Companies Act states that *ownership* of shares is transferred by:<sup>197</sup>

- “(a) debiting the account in the uncertificated securities register from which the transfer is effected; and
  - (b) crediting the account in the uncertificated securities register to which the transfer is effected,
- in accordance with the rules of a central securities depository.”

The Companies Act, however, variably refers to the “[r]egistration of uncertificated securities” in section 52, the “*transfer* of uncertificated securities in an uncertificated securities register” in s 53(1) and the “[t]ransfer of ownership in any uncertificated securities” in section 53(2) (own emphasis). Nowhere is the difference elucidated.

The CSD Rules similarly refer to the “transfer of ownership”<sup>198</sup> and go on to emphasise that “[a] transferee becomes the *owner* of the Securities upon the

<sup>193</sup> 1.2.

<sup>194</sup> See above, 8 3 5 2 The transfer of shares.

<sup>195</sup> 8 3 5 3 The change in registration and holding.

<sup>196</sup> Also see De la Harpe “SS 49-56” in *Commentary on the Companies Act 2-1032*: “it can be argued that there is a closer association between ownership interests and registered title in respect of uncertificated securities than there is in respect of certificated securities”.

<sup>197</sup> Own emphasis. This provision could already be found in the Companies Act 61 of 1973 91A(4)(a), still referring to the transfer of ownership and membership.

<sup>198</sup> See *Strate Rules* 7.3.3.

crediting of the transferee's Securities Account or Central Securities Account".<sup>199</sup> In addition, both the definitions of the "subregister" and the "SDA register" describe these records as the "register of *ownership*".<sup>200</sup>

The Financial Markets Act, likewise, does not paint a picture of clarity. In contrast to the Companies Act and the CSD Rules, however, the Financial Markets Act omits any reference to "ownership" in connection with the transfer of securities and instead refers simply to "[t]he transfer of uncertificated securities or of an interest in uncertificated securities on the uncertificated securities register".<sup>201</sup> This transfer takes place through a debiting and crediting of securities accounts or central securities accounts.<sup>202</sup>

The legislative provisions introduce the mechanism of account entries. In the context of registration, account entries are not novel. The legislation, however, indicates that they also pertain to ownership. This is where unfamiliar territory is entered. These legislative provisions firstly raise the question whether these concepts can be distinguished at all,<sup>203</sup> and secondly, if they can be separated, how a transfer of ownership takes place against the backdrop of the requirement of account entries.

Regarding the first question, it has been set out above,<sup>204</sup> that ownership continues to vest in the ultimate investor. Not only is this model consistent with the legislative provisions, it is also path dependent. Suggestions that the person entered on the uncertificated securities register is automatically the owner of securities are consequently rejected.<sup>205</sup>

The emphasis will therefore fall on the second question. According to Vermaas, the effect of the legislative provisions is that the transfer of shares no longer takes

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<sup>199</sup> 7.3.3.2.

<sup>200</sup> 1.2 (own emphasis).

<sup>201</sup> Financial Markets Act 19 of 2012 s 38(1)(a). Also see Custody and Administration of Securities Act 85 of 1992 s 5.

<sup>202</sup> Financial Markets Act 19 of 2012 s 38(1)(a). Also see Custody and Administration of Securities Act 85 of 1992 s 5.

<sup>203</sup> See for example the argument by Rachlitz (2013) *Stell LR* 410, that registration and ownership cannot be separated in the context of uncertificated shares.

<sup>204</sup> 13 2 3 4 Ownership and holding.

<sup>205</sup> See for example the proposal by Rachlitz (2013) *Stell LR* at n 202 above. For an overview of the positions, see De la Harpe "SS 49-56" in *Commentary on the Companies Act 2-1036-2-1039*. The author postulates two models: an interpretation in terms of which the registered holder is simultaneously the owner and an "ownership formality interpretation" in terms of which the registered title evidences an ownership interest. He however similarly prefers the second variant.

place by cession.<sup>206</sup> Van Huyssteen et al also indicate that “[t]he dematerialisation of shares and the immobilisation of share certificates have profound implications for the cession of shares in companies listed on the stock exchange”.<sup>207</sup> On the other hand, de la Harpe continually refers to a cession of ownership, but without reconciling the transfer mechanisms with the traditional principles of cession.

In analysing the transfer of shares and securities, it is necessary to take cognisance of the fact that existing legal mechanisms may no longer be apposite. It must therefore be tested whether and how the changed circumstances can be accommodated within the framework of cession and also whether the concept of a cession can be said to apply at all.

### *13 2 5 2 2 Account entries*

Legislation unequivocally determines that a transfer of ownership in uncertificated securities takes effect through the debiting and crediting of the accounts in the uncertificated securities register.<sup>208</sup> That the same book entries also transfer holding (registered title) does not mean that the relevant provisions pertain only to such registered transfers; the wording of the sections leaves little doubt that a transfer of ownership interests is intended to be caught within its net.

The introduction of provisions regulating the making of book-entries represents a harmonisation with international best practice. A model of this kind was proposed by the UNIDROIT Convention on Substantive Rules for Intermediated Securities. South Africa is a member of UNIDROIT and has recognised the principles of the convention in preparation of the Financial Markets Act.<sup>209</sup> The convention is said “to promote uniformity and predictability of laws across Member countries to ensure legal certainty of book entries in securities accounts”.<sup>210</sup> Article 11 (Acquisition and disposition by debit and credit) of the convention reads:

<sup>206</sup> Vermaas (2010) *Acta Juridica* 103, also see text to n 260 below. But cf Blackman et al *Commentary on the Companies Act* commenting on the 1973 Act at 5-173, 5-232-3, who clearly contemplate the possibility that a transfer by way of account entries does not exclude alternative transfer mechanisms such as cession.

<sup>207</sup> LF van Huyssteen, MFB Reynecke & GF Lubbe *Contract: General Principles* 5 ed (2016) 400.

<sup>208</sup> Companies Act 71 of 2008 s 53(2); Financial Markets Act 19 of 2012 s 38(1)(a); *Strate Rules* 7.3.3.1.

<sup>209</sup> See *Reviewing the Regulation of Financial Markets in South Africa: Policy Document Explaining the Financial Markets Bill, 2011* (August 2011) 26-29.

<sup>210</sup> 27.

- “1. Subject to Article 16, intermediated securities are acquired by an account holder by the credit of securities to that account holder’s securities account.
2. *No further step is necessary*, or may be required by the non-Convention law or any other rule of law applicable in an insolvency proceeding, to render the acquisition of intermediated securities effective against third parties.
3. Subject to Articles 15 and 16, intermediated securities are disposed of by an account holder by the debit of securities to that account holder’s securities account.”<sup>211</sup>

It is important to note that the article refers to account holders, who, per definition, are not equal to “owners” in South African law. An account holder is defined as “a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others”.<sup>212</sup> The section therefore pertains to both, holding and ownership. A credit in a securities account is, at once, an entry on the securities register that establishes holding, as well as a mechanism to transfer (beneficial) ownership. Article 9 of the Convention recognises that “the credit of securities to a securities account confers on the account holder ... the right to receive and exercise any rights attached to the securities” only “if the account holder is not an intermediary or is an intermediary acting for its own account”.<sup>213</sup> The provision therefore evidences the same tension between account entries as mechanisms for registration and as formalities for transfer that is also evident from South African law.

Moreover, the Convention, in an attempt to harmonise the laws on securities follows a predominantly functional approach. This stems from the impossibility of accommodating the wide range of substantive, doctrinal rules of different legal systems. The solution, according to Gullifer is therefore one which stipulates a desired result, but not the legal reasoning required to get there.<sup>214</sup> The approach is doctrinally neutral and there is a general understanding that it requires jurisdictions to apply it within their own conceptual context.<sup>215</sup> The South African policy document also recognises that the convention does not purport to be a comprehensive code,

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<sup>211</sup> Own emphasis added.

<sup>212</sup> UNIDROIT Convention on Substantive Rules for Intermediated Securities (2009) art 1.

<sup>213</sup> Art 9(a)(i).

<sup>214</sup> L Gullifer “Ownership of Securities: The Problems Caused by Intermediation” in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 17, 19-20.

<sup>215</sup> 8.

but rather aims to set out key provisions that member states should incorporate into their existing legal framework.<sup>216</sup>

The attributes of South African law that must be acknowledged are the unitary conception of ownership and the resulting distinction between holders of shares and owners thereof, which distinguishes South African law from English law, as well as the fact that it is not customary that ownership is transferred to a holder or custodian of securities, which differentiates the South African legal position from that predominant in US and German law. These differences have to be taken into account in interpreting the operation and effect of book entries.

As a result of the account-entry requirement, the transfer of ownership and registration take place simultaneously and by account entry. This achieves the aim of simultaneous settlement,<sup>217</sup> and represents a significant change from the traditional position, in terms of which ownership transferred by cession without, and therefore significantly earlier, than registration.<sup>218</sup> Despite this conflation, conceptually, a transfer of ownership must still be distinguished from registration. Registration founds holding and it does so in the name of the person registered. Account entries are the final step to effect a transfer of uncertificated shares and the names against which the entries are made entered on the accounts are irrelevant for the transfer. The entry requirement can therefore at most be, that an account entry must be made, not that it has to be made in the name of the owner.<sup>219</sup> Only this construction would lead to an adequate distinction between shareholding and ownership and accommodate the continued recognition of nominees.<sup>220</sup> In this manner the requirement of an account entry can also be reconciled with the fact that the register remains a record that is only *prima facie*, not conclusive proof of ownership.

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<sup>216</sup> *Reviewing the Regulation of Financial Markets in South Africa: Policy Document Explaining the Financial Markets Bill, 2011* (August 2011) 27.

<sup>217</sup> Of “delivery” vs payment; “delivery” being effected by account entries. Also see above, 9 4 2 Clearing and settlement.

<sup>218</sup> In relation to instruments traded on an exchange and paid for via the relevant payment system in central bank money, a cession without account entries would also mean that ownership transfers before payment has been made.

<sup>219</sup> Also see De la Harpe “SS 49-56” in *Commentary on the Companies Act 2-1043*: “this [s 53(2)] should not be read too literally as requiring the holders of the beneficial interests to be recorded as holders of the relevant uncertificated securities in the uncertificated securities register”.

<sup>220</sup> This is also reflected in the *Strate Equities Handbook* version 17 (2014) 69-70: “The Subregister will reflect registered ownership and not Beneficial Ownership as these Securities are generally held in the name of the Client or a Nominee. Where Securities are held in the name of a Nominee, the Nominee’s name, and not the Client’s name will be recorded in the Subregister.”

At first glance, legislation requires a debit *and* a credit entry. Yet, the rules of Strate make it clear that a transferee becomes owner upon the crediting of her account.<sup>221</sup> Where the debit entry is delayed, the decisive factor is the credit entry. Furthermore, the risk that a participant may neglect to make an entry at all is eliminated by the requirement that participants reconcile their balances with the CSD on a daily basis.

Furthermore, the validity of the account entry hinges on an instruction that a participant has received from its client.<sup>222</sup> The Rules state that a participant may only make an entry in accordance with such an instruction. For the account entry to be valid, the instruction does not have to be valid, but the participant must have made the entry in accordance with that instruction. Thus, if a participant makes an entry without an instruction or in a manner contrary to it, the entry is not valid. If, on the other hand, a participant makes an entry based on an instruction tainted by fraud or illegality, the entry is valid, provided the purchaser acted in good faith.<sup>223</sup> This is also the logical result of the warranty of correctness and the indemnity given by a client in respect of an instruction.<sup>224</sup> Where a custodian therefore issues an instruction to transfer without having been instructed by its principal to do so, the resulting transaction will be valid and irreversible. The requirement of account entries is therefore remarkably formalistic, particularly evident from two features: 1. the almost immutable nature of instructions; and 2. the fact that the identity of the transacting parties is irrelevant for the transfer of ownership.

### *13 2 5 2 3 Account entries as a formality for cession*

The traditional foundation for a transfer of ownership in securities in South African law can be found in the mechanism of cession.<sup>225</sup> To reconcile the requirement of account entries with cession, the provisions can be interpreted as establishing account entries as a formality for a valid cession.

An account entry provides evidence of the transfer of uncertificated securities by publicising it to the world at large.<sup>226</sup> This publicity was previously provided by the

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<sup>221</sup> Strate Rules 7.3.3.2.

<sup>222</sup> 6.2.2.6.

<sup>223</sup> See below, 13 2 6 Protection of bona fide purchasers of shares.

<sup>224</sup> Companies Act 71 of 2008 s 55(2)(a) and (b).

<sup>225</sup> 8 3 5 2 The transfer of shares.

<sup>226</sup> See the Financial Markets Act 19 of 2012 s 33(2). Also see above, 13 2 4 Registration.

register entry in conjunction with the delivery of the share certificate. Neither the entry on the register, nor the delivery of the share certificate, however, are traditionally formalities for a valid cession. In *Botha v Fick* the court found that where a right of action is evidenced in a document but exists independently of it, the delivery of the document is not a requirement for a valid cession of the right of action.<sup>227</sup> While both registration and delivery provided some level of publicity, they never constituted legally binding publicity mechanisms comparable to delivery when movables are transferred.

Legislation may prescribe additional requirements or formalities for a valid cession.<sup>228</sup> Account entries signal to the world at large that transacting parties have adjusted their intentions in relation to the ownership of an incorporeal asset. Perhaps, by incorporating a “property-like” principle of publicity, the requirement of account entries gives some recognition to the fact that shares and securities are incorporeal units that are highly mobile and circulate in the market like corporeal things. In addition, account entries may serve to fill a part of the void left by the elimination of certificates.<sup>229</sup>

The interpretation of account entries as an “ownership formality” for cession is also preferred by De la Harpe.<sup>230</sup> He therefore rightly posits, that the requisite entries are a mandatory formality for a transfer of ownership in securities.<sup>231</sup> What he does not examine is whether, in addition to accommodating formalities, the principles of cession continue to be a suitable interpretative framework for the transfer of ownership in securities.

#### *13 2 5 2 4 A cession construction*

Cession, particularly if unburdened by formalities, is a flexible mechanism by which personal rights or ownership of incorporeal assets can be transferred. The cornerstones of cession are: 1. consensus, formed by the corresponding intentions of

<sup>227</sup> *Botha v Fick* 1995 2 SA 750 (A) 764I. Also see above, 8 3 5 2 The transfer of shares and 8 3 5 3 The change in registration and holding.

<sup>228</sup> See for example *Rabinowitz v De Beers Consolidated Mines Ltd* 1958 3 SA 619 (A).

<sup>229</sup> On the functions of certificates in general, see above, 8 1 The functions of the share certificate.

<sup>230</sup> For the reasons, see De la Harpe “SS 49-56” in *Commentary on the Companies Act* 2-1039 – 2-1042. For the alternative interpretive approaches, see 2-1036 – 2-1037, which include the interpretation that the provisions relate only to registered title as well as the interpretation that the legislation envisages a type of dual ownership.

<sup>231</sup> 2-1043.

the transacting parties;<sup>232</sup> 2. the fact that the transfer takes place independently of the *causa*, or underlying obligatory agreement; 3. the certainty or determinability of the parties to the transaction;<sup>233</sup> and 4. the certainty or determinability of the object to be transferred.<sup>234</sup> All of these characteristic features of cession pose some problems in the context of uncertificated securities.

In effect, the latter two characteristics demanding that the parties and the object of cession are certain or sufficiently determinable, are part and parcel of reaching consensus. Consensus requires an actual meeting of the minds. Coinciding intentions are therefore not sufficient – the parties must learn of each other's expressions of will.<sup>235</sup> Expressed in the offer and acceptance paradigm, a meeting of minds only takes place once the offeror becomes aware of the acceptance of the other party. Even if offer and acceptance are not the only method by which a meeting of minds can be achieved, they provide a convenient tool by which the parties' intentions can be ascertained.

It is considerably more difficult to reach consensus where firstly, the contracting parties remain anonymous and do not contract directly; and secondly, where the settlement system and the specific rules aimed at achieving the transfer of securities are designed in such a way that the identity of the parties is irrelevant. German authors have grappled with similar interpretive difficulties because intention is likewise of central importance to the German mechanism of transfer (even if it is a property-based mechanism as opposed to cession or assignment).<sup>236</sup> The German model shows that the intentions of the parties can be formed, communicated and ascertained in a different manner. The following model is inspired by the solutions suggested in German law, while accommodating the differences that exist between German and South African law.

Following the completion of the trade, the seller (or her broker) will send an instruction to her custodian, instructing the custodian 1. to transfer ownership of the incorporeal unit; and 2. to cease holding the share for her. This instruction can be construed as an offer or an expression of the intention of the seller to bring about a

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<sup>232</sup> *Johnson v Incorporated General Insurances Ltd* 1938 1 SA 318 (A) 331G.

<sup>233</sup> S Scott *The Law of Cession* 2 ed (1991) 70.

<sup>234</sup> 70.

<sup>235</sup> *Bloom v The American Swiss Watch Company* 1915 AD 100; Van Huyssteen et al *Contract* 25 [2.26].

<sup>236</sup> See above, 11 5 2 Legal framework.

transfer of rights. Legislation dictates that the instruction must be in a particular form.<sup>237</sup> This must be regarded as a formality with which the offer should comply in order to be valid.<sup>238</sup> The law furthermore requires that an offer be brought to the attention of the other contracting party to enable her to accept it.<sup>239</sup> In securities settlement systems, the instruction is transmitted via a custodian or a chain of custodians to the CSD. In German law, the receipt of the instruction by the CSD is automatically construed as the receipt thereof by the buyer.<sup>240</sup> There is merit in this construction as the CSD upon the receipt of both instructions from the seller and the buyer can commence with the process of clearing. The importance of the seller's instruction is underscored by section 55(2) of the Companies Act. The section provides that "[a] person who gives an instruction to transfer uncertificated securities must- (a) warrant the legality and correctness of that instruction". In addition, that person must indemnify the company, participant or CSD against any claim, direct loss or damage that arises out of a transfer effected on the basis of such an instruction.<sup>241</sup>

The instruction sent by the buyer via his custodians can, on the other hand, not be construed as acceptance of the offer for a number of reasons: 1. It is probable that the instruction is sent at or around the same time as the seller's instruction, after both parties or their custodians are informed of the trade, and therefore before the buyer learns of the offer; and 2. Such an acceptance would not be irrevocable as the process of clearing, aimed at establishing the positions of the contracting parties, has not yet commenced. The CSD Rules set out the point at which instructions become final, that is the point in time at which the instructions become irrevocable and unconditional and the transaction will go forth. This is known as settlement finality. Settlement finality serves mainly to provide a cut-off point for revocability in the case of insolvency of one of the contracting parties.<sup>242</sup> Finality also encourages netting because netted orders cannot be unwound after the point of settlement finality is

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<sup>237</sup> See the definition of "Client Instruction" in *Strate Rules* 1.2.

<sup>238</sup> See Van Huyssteen et al *Contract* 53-54 [3.5], on formalities imposed by law with which an offer should comply.

<sup>239</sup> Van Huyssteen et al *Contract* 53 [3.4].

<sup>240</sup> See above, 12 4 2 Legal framework. German law is similarly concerned with the conclusion of a real agreement, albeit in the context of corporeal movables.

<sup>241</sup> Companies Act 71 of 2008 s 55(2)(b).

<sup>242</sup> See the definition of "Moment of Finality of Instructions" in Rule 1.2 of the *Strate Rules*. Also see *Strate Rules* 7.3.2.

reached.<sup>243</sup> Rules on finality do not determine when a transfer of securities is final in the full legal sense of the word, but they can reveal when offer and an acceptance become unconditional and irrevocable.

During clearing, the respective positions of the parties are established in relation to either securities or funds. Clearing serves an important function by identifying the object to be transferred. Personal rights as incorporeals are by their nature not easy to identify. Share certificates contained a certificate number as a unique designator. This designator has fallen away.<sup>244</sup> Furthermore, it is probable that shares are held collectively by custodians on behalf of investors. In England and Germany the object to be transferred is said to be certain once the fraction of the bulk is specified. Although the abstract nature of the personal rights are determinable before this point, the scope of the rights is not, because per legislation, the co-ownership interest of collectively held securities must be determined as a proportion of the total number or value of securities held and administered by a custodian at the level of the uncertificated securities register.<sup>245</sup> The object of the cession can therefore only be said to be determined or determinable when reservation takes place.<sup>246</sup>

Following settlement, the CSD makes the relevant entries in its books, following which it sends an authenticated instruction to the participants advising them that the transaction has been completed. The authenticated instruction represents the point in time at which acceptance is communicated to the offeror through his custodian(s). Were it not for the formality of account entries, this would appear to be the point in time at which the parties reach consensus.

While above model is a theoretical possibility, it is nonetheless difficult to reconcile the commercial and legislative mechanisms with the principles of cession. The formalistic nature of the account-entry formality has been remarked on above. Its implications are that, not only is an agreement to cede independent of the underlying obligatory agreement, but in fact no such underlying agreement would be required at all.<sup>247</sup> In the same vein, the corresponding intentions of the parties to transfer and

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<sup>243</sup> E Johansson *Property Rights in Investment Securities and the Doctrine of Specificity* (2009) 24.

<sup>244</sup> ISIN numbers are assigned by the JSE but they only identify a particular issue, not individual shares that make up the issue.

<sup>245</sup> This was the conclusion reached above, 13 2 3 4 Ownership and holding.

<sup>246</sup> See above, 13 2 5 2 Legal framework.

<sup>247</sup> Also see De la Harpe "SS 49-56" in *Commentary on the Companies Act 2-1043–2-1044*.

to receive transfer have become redundant.<sup>248</sup> Account entries are conclusive for the transfer of ownership regardless of the underlying intentions of the parties and as long as account entries have been made in accordance with an instruction, the transfer is valid even without intention.<sup>249</sup>

Furthermore, the process of matching orders by algorithms is based on the premise that buying and selling positions are certain even without the identity of the parties being discernible. In contrast to a cession, the process of clearing and settlement that culminates in account entries therefore does not hinge on the identity of the parties.

On the other hand, it remains of utmost importance to be able to identify the subject matter of the transfer. It must be recognised, however, that collectively held securities are not identifiable in the same way as corporeal movables. This has ignited significant debate, particularly in English law.<sup>250</sup> It is suggested that the position in terms of South African law is that firstly, the co-ownership interest is determined with reference to the uncertificated securities register, not the lower-tier registers as maintained by custodians.<sup>251</sup> Secondly, the interest constitutes a pro-rata interest of all securities of the same type held in an account that forms part of the uncertificated securities register.<sup>252</sup> Thirdly, the pro-rata interest is an undivided fraction of the entire pool of securities of the same type as recorded in the uncertificated securities register.<sup>253</sup> Lastly, the fluctuating nature of the pool makes it difficult to determine the fraction. Yet, it can be argued that at the point of reservation this interest is sufficiently identifiable in relation to the pool as a whole to enable transfer.

Against the background of this analysis, it must be concluded that there are indications that the principles of cession would be stretched too far in accommodating the transfer of ownership in securities held through tiered accounts. It would require a fictional construction of consensus imputed to the transacting parties through a complex web of representatives and a reliance on the identity of transacting parties

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<sup>248</sup> 2-1043 – 2-1044.

<sup>249</sup> See text to nn 221-223 above. For the limited role of intention, see below text to nn 253-255.

<sup>250</sup> See on English law, 10 2 Intermediation – a legal perspective and on German law, 12 4 2 Legal framework.

<sup>251</sup> See above, 13 2 3 4 Ownership and holding.

<sup>252</sup> See s 37(3) of the Financial Markets Act 19 of 2012.

<sup>253</sup> S 37(3).

that is not supported by the commercial realities. Furthermore, account entries do not reflect the identities of the transacting parties and individual transaction become untraceable where netting takes place. This may stretch the notions of intention and consensus too far. In addition, it is doubtful whether the concept of cession still has a useful analytical role to play. The aims of a cession construction are threefold: It reveals *how* a transfer is to take place; it indicates *when* ownership transfers and it determines *who* ownership is transferred to. The *how* and *when* are now simply dictated by the account-entry requirement. The value of the account entry lies in the fact that it enables a determination of the *point in time* at which ownership is transferred without having to refer to the rules on cession. What the account entry alone cannot do, however, is disclose *who* the ownership has been transferred to. An account entry does not provide sufficient context to the transaction. Yet, it must be doubted whether the analytical framework of cession can be of much assistance in this regard. The *who*-question must rather be determined with reference to the chain of instructions, intermediaries and agency relationships. A cession analysis as undertaken above, adds no value to the determination of these three states. The clear and formalistic nature of the provisions in the legislation that determine that ownership passes by account entries, makes it unnecessary to perform a cession analysis.

### *13 2 5 2 5 Some problematic aspects of the transfer of securities by account entry*

A transfer of ownership takes place by account entries. It is best to describe this transfer mechanism as a statutory transfer rather than couching it in the familiar terms of cession. The mandatory nature of the account entries raises some challenges.

In the first place, not every account entry corresponds to an intention to transfer ownership. At times, the intention may simply be to transfer registered holding from one nominee to another or from an “own name” holding to a nominee. The account entry, viewed in isolation, will not indicate that a transfer of ownership has not taken place. This scenario indicates that intention continues to be relevant. The rules and directives of Strate also highlight the importance of intention by distinguishing “account transfers” from ownership transfers.<sup>254</sup> The term “account transfers” catches

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<sup>254</sup> Strate Directive SC.2 Operational Market Windows – Off-market – Equity Securities – JSE and A2X *Special Gazette* No S10-2017 of 05-10-2017.

those account entries that involve no change in (beneficial) ownership.<sup>255</sup> Such transfers are processed through the system, but pursuant to special procedures that allow the transfers to be distinguishable. The same is true for portfolio movements.<sup>256</sup>

It is also conceivable that no entries are made on the level of the uncertificated securities register despite the parties' intentions to transfer ownership, because the nominee that has held the securities for the transferor continues to hold them for the transferee. This scenario raises the question whether such a transaction can be valid without account entries being made. It has been set out that the account entry has a dual purpose; it records holding and transfers ownership. Where the entry is not required to achieve the former, it might still be necessary to bring about the latter. The legislative provisions are couched in mandatory terms and indicate that account entries are required for every transfer of ownership. Entries recorded on the accounts of lower-tier intermediaries are therefore insufficient.

The relevant legislative instruments set out a clear rule for the transfer of securities by crediting them to an account. On the basis of a strict interpretation of the relevant provisions, the question whether a transfer of ownership can still take place by cession without account entries, must be to the negative. The inconsistencies in the wording of the legislative provisions have been pointed out above.<sup>257</sup> Whereas section 53(1) of the Companies Act refers only to a "transfer ... in an uncertificated securities register",<sup>258</sup> s 53(2) specifically refers to a "transfer of ownership". Vermaas similarly points out that the legislation is silent on lower-tier transfers.<sup>259</sup> She seems to suggest, however, that the Act concerns itself with a transfer of "legal", as opposed to "beneficial" ownership.<sup>260</sup> This would mean that transfers in the lower tiers are effective even without an entry on the uncertificated securities register. The stronger worded s 53(2) as read with the rules of *Strate* suggests otherwise. The rules of *Strate*, however, provide that *Strate* may "effect Transfer to a person to whom the right to any Securities has been transmitted by operation of law or by *agreement*, or

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<sup>255</sup> 5.3.

<sup>256</sup> 7.3.

<sup>257</sup> See the text to nn 196-201 above.

<sup>258</sup> Similar, s 52 of the Companies Act 71 of 2008 and s 38 of the Financial Markets Act 19 of 2012.

<sup>259</sup> Vermaas (2010) *Acta Juridica* 103-104.

<sup>260</sup> 109: "The transfer that takes place on settlement date (DvP) on the participant level is transfer of legal title (ownership) in terms of the Act."

pursuant to a court order” (own emphasis in italics).<sup>261</sup> Corresponding provisions in the Companies Act<sup>262</sup> and Financial Markets Act<sup>263</sup> provide only for the power of Strate to effect a transfer pursuant to a transmission by “operation of law”. The “operation of law” requirement is uncontroversial; it encompasses, for example, the transfer of securities passed by inheritance, during the course of insolvency or pursuant to a corporate action. More unusual is the reference to transfers by agreement. Section 53(6) of the Companies Act evidences a clear departure from s 91A(5)(c) of its predecessor, which still included the power of a participant to effect a transfer of a right transmitted by agreement. The Strate rules do not reflect this change. The rules may be intended to simply catch off-market transactions. Off-market transactions are those where parties intend to transfer ownership in securities, but they reach an agreement to transfer privately and without the facilitation of an exchange. Strate provides that such transactions must be processed through the electronic settlement system by mandating that transacting parties report such transactions to their participants.<sup>264</sup> In addition, a participant that settles both legs of a transaction must report this to Strate.<sup>265</sup> Settlement must therefore take place through Strate and provision is made for payments to be effected via the payment system.<sup>266</sup> Where the parties have not reported an off-market transaction or have failed to do so timeously, it is doubtful, however, whether Strate has the power to effect such a transfer.

Whereas Strate therefore almost certainly does not have this power, the question arises whether the courts have the power to recognise as valid, cessions of rights entered into without the requisite account entries having been made or to unwind transactions by ordering that the register should be rectified. The requirement that ownership passes by account entry is very formalistic. This trait will be identified in Part 3 as a defining feature of the “law of accounts”. Agreement is reached by a series of specific communications and culminates in entry. This formalism can be

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<sup>261</sup> Strate *Rules* 7.3.3.5. Also see Companies Act s 53(6), which however refers only to an order of court, not an agreement.

<sup>262</sup> Companies Act 71 of 2008 s 53(6).

<sup>263</sup> S 38(1)(c).

<sup>264</sup> Strate Directive SC.2 Operational Market Windows – Off-market – Equity Securities – JSE and A2X *Special Gazette* No S10-2017 of 05-10-2017 3.3. Also see JSE Limited *Equities Rules* (26 January 2018) 6.30, 6.40, 6.10.2 and 6.10.3.

<sup>265</sup> Strate Directive SC.2 Operational Market Windows – Off-market – Equity Securities – JSE and A2X *Special Gazette* No S10-2017 of 05-10-2017 3.11.

<sup>266</sup> 3.18.

explained with reference to the impossibility of unwinding transactions on fast-paced securities markets. Furthermore, netting of transactions makes unwinding impossible. Ownership transfers must therefore, subject to only few exceptions, be final. This strengthens transactional security. From this perspective, the power of courts to unwind completed transfers must be limited. This is reflected in s 53(5) of the Companies Act, in terms of which “[a] court may not order the name of a transferee contemplated in this section to be removed from an uncertificated securities register, unless that person was a party to or had knowledge of a fraud or illegality ...”<sup>267</sup> While a court may still order a rectification of the register,<sup>268</sup> its powers are circumscribed.<sup>269</sup>

Section 53(1)(b)(ii) of the Companies Act provides that a participant or CSD may also transfer uncertificated securities upon receipt of a court order. While this provision may simply be aimed at giving the CSD or participants the power to recognise court orders pertaining to the rectification of a register, it raises the possibility that courts may recognise cessions of rights effected without account entries. The rules and principles governing cession may play its part in this determination. These cases must be distinguished from those described above where a recorded transfer is disputed. They involve at most, the recognition of transfers not previously recorded by account entry<sup>270</sup> and therefore necessitate no unwinding of transactions. The same policy grounds that limit the power of courts to reverse transfers therefore do not apply here. At the same time, other grounds indicate that, as a general rule account entries are required for valid ownership transfers and the discretion of courts to find otherwise should be restrained. These include the strong mandatory language of the legislative provisions requiring account entries,<sup>271</sup> the objective of achieving simultaneous settlement and payment of transactions and the undermining of the publicity and transparency function of the

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<sup>267</sup> The reference to the “name of the transferee ... [on] an uncertificated securities register”, is confusing because it blurs the distinction between holding and ownership.

<sup>268</sup> Although the Companies Act 71 of 2008 does not expressly provide for rectification, such an order may be made in terms of the common law or s 161 of the Act.

<sup>269</sup> Also see De la Harpe “SS 49-56” in *Commentary on the Companies Act 2-1025* n 2 (n 104).

<sup>270</sup> Note, however, that Strate Directive SC.2 Operational Market Windows – Off-market – Equity Securities – JSE and A2X *Special Gazette* No S10-2017 of 05-10-2017 requires sellers and purchasers of securities, as well as their participants, to report off-market transactions – see 3.3, 3.4 and 3.11. This should reduce the incidence of transactions not processed through the system.

<sup>271</sup> Also see De la Harpe “SS 49-56” in *Commentary on the Companies Act 2-1068*.

account entries.<sup>272</sup> It must be noted that, even if a court can recognise transmissions without entry, the default rule remains that an entry must be made. Thus, before such an entry is made, following a court order to that effect, a transfer has not been completed. Decisive for determining the timing of the transfer therefore appears to be the account entry, as also set out above. It appears, therefore, that such a court order does not have retrospective effect.

In addition to the scenarios sketched above, the netting of transactions may cause problems. In terms of s 35(2)(y) of the Financial Markets Act, depository rules “must provide for netting arrangements if transactions in one or more categories of securities settled through the central securities depository settle on a net basis”. Accordingly, the Strate Rules provide for multilateral securities and cash netting on participant level.<sup>273</sup> Netting significantly reduces the number of account entries and makes it impossible to correlate account entries and specific transactions. If the account entry requirement is interpreted strictly to require individual account entries for every single transaction, netting becomes impossible.<sup>274</sup> The legislation does not provide a clear solution to this conundrum. De la Harpe therefore finds that “netting of aggregate trades would only effect a transfer of the ownership interest in respect of the net number of securities between the approved nominee ‘A’ and approved nominee ‘B’ and would not give effect to the multiple transfers of beneficial ownership interests at the investor level”.<sup>275</sup>

On the other hand it was concluded above that, taking into account the dual purpose of account entries, the entry requirement in relation to transfers of ownership is only procedural.<sup>276</sup> It requires that entries be made, but without regulating that they be made in the name of the (beneficial) owners. Account entries determine how and when transfers of ownership takes place, but they do not reveal or regulate the consequences and substantive aspects of such transfers, including the identity of owners. The mere fact of entry on an uncertificated securities register is constitutive for a transfer of ownership, while the actual content of such an entry is merely evidentiary for determining the right of ownership. From this perspective, to conclude

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<sup>272</sup> 2-1072.

<sup>273</sup> *Strate Rules* 7.5. Also see JSE *Equities Rules* 10.30.1.4: “All transactions in equities securities must be settled ... on a net basis per member, per trade type and per equity security”.

<sup>274</sup> 2-1052.

<sup>275</sup> De la Harpe “SS 49-56” in *Commentary on the Companies Act* 2-1053.

<sup>276</sup> This is consistent with the nature of a “law of accounts”, which will be considered below, 17 2 A law of accounts.

that netted account entries can represent several transactions, does not require such a great leap. For every transaction in pooled securities held through nominees, whether netted or not, the substantive aspects of ownership, including the identities of the transacting parties will be obscured at the level of the uncertificated securities register and will have to be investigated by looking into underlying accounts and client mandates.<sup>277</sup>

### 13 2 6 Protection of bona fide purchasers of shares

Through cession, a transferor cannot confer on the transferee more rights than he himself has. This is the core maxim in South African law that governs both the transfer of incorporeal assets by cession as well as the transfer of corporeal things by the mechanisms provided by the law of things. South African law knows no doctrine of good faith acquisition. The South African approach is said to prioritise the interests of the owner, balanced only by the application of the doctrine of estoppel.<sup>278</sup> If a transfer of ownership in securities is construed to be a statutory transfer mechanism rather than in the nature of cession, any deviation from this maxim can be understood to be an inherent part of the statutory transfer mechanism rather than being construed as an exception to the principles of cession.

Section 53(4) of the Companies Act provides:<sup>279</sup>

“A transfer of ownership [of uncertificated securities] in accordance with this section occurs despite any fraud, illegality or insolvency that may-

(a) affect the relevant uncertificated securities; or

(b) have resulted in the transfer being effected,

but a transferee who was a party to or had knowledge of the fraud or illegality, or had knowledge of the insolvency, as the case may be, may not rely on this subsection.”

This provision introduces the concept of good faith acquisition of shares and other securities to the South African legal landscape. It signifies a shift from the dominance of ownership towards greater transactional security. The change is in line with international developments and gives greater recognition to the characterisation of shares and securities as incorporeal units that are designed to circulate in the

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<sup>277</sup> Also see text to nn 219-220.

<sup>278</sup> In general, see above, 8 4 5 Estoppel and the protection of bona fide purchasers in South African law.

<sup>279</sup> Also see Financial Markets Act 19 of 2012 s 38(3), ss 41 and 46; *Strate Rules* 7.3.3.3.

market. The provision in the first place provides for a higher level of certainty of transfer. While the usefulness of this rule may be debatable from a buyer-centered transaction cost perspective,<sup>280</sup> a constant stream of transaction reversals would certainly hamper the efficient operation of any settlement system. At the same time, the provision balances the ideal of transactional security with the interests of the owner by disallowing parties who act in bad faith from relying on the subsection. This is a necessary and important qualification. A court may therefore not order the unwinding of the transfer unless the buyer acted in bad faith.<sup>281</sup>

In addition, the Companies Act provides detailed rules for determining who carries any losses and is liable for damages that may result from unlawful acts. A person who interferes in the uncertificated securities register by changing either the names of shareholders, the number of securities held or the description thereof, is liable to the person who suffered direct loss.<sup>282</sup> Secondly, a person who instructs that uncertificated securities be transferred,<sup>283</sup> warrants the legality and correctness of the instruction and indemnifies the issuer and participant or CSD from any damage or loss that may flow from effecting a transfer pursuant to such an instruction.<sup>284</sup> Lastly, the participants and CSD must indemnify the issuer or any other person for direct loss or damage caused by effecting a transfer without an instruction, in accordance with an instruction that was not properly sent and authenticated or in a manner inconsistent with a properly authenticated instruction.<sup>285</sup>

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<sup>280</sup> See above, 8 4 3 Negotiability and the protection of bona fide purchasers in US law, n 405.

<sup>281</sup> Companies Act 71 of 2008 s 53(5).

<sup>282</sup> S 55(1).

<sup>283</sup> S 55(2)(a).

<sup>284</sup> S 55(2)(b).

<sup>285</sup> S 55(3).

## Chapter 14: Concluding remarks

The first electronic settlement of shares in South Africa took place in 1999.<sup>1</sup> In England, the change to electronic transfer and holding systems was similarly late; all transactions were processed with the aid of physical certificates until 1996.<sup>2</sup> By comparison, in Germany, the need to eliminate the movement of paper arose considerably earlier in the 1930's,<sup>3</sup> followed by the US in the 1970's.<sup>4</sup> Complexes of factors, including economic and political developments, have caused this variation in timing. Also integral were the legal design and the doctrinal tools available to effect a transfer of shares and securities. These included share certificates and registers, but with different legal characterisation and functions attached to them in different legal systems.<sup>5</sup> In addition to influencing the timing of the change, the conceptual foundations of securities therefore also determined the direction of change. In South Africa and England, certificates never embodied the rights that flow from shares; they were documents of evidence only.<sup>6</sup> This explains why South Africa and England have opted for the dematerialisation of shares, while Germany and the US embarked on the route of immobilisation.

Thus, the fact that shares have always been conceptualised in South African law as personal rights, abstract and intangible in nature has firstly, made it less pressing to eliminate the movement of certificates; secondly, has led to the complete abandonment of certificates in the form of a dematerialisation of securities; and thirdly, affects the way in which systems, structures and mechanisms are conceived and legally characterised in a dematerialised environment.

The overarching theme of this thesis is an analysis of the legal nature of shares. Inseparable from such an enquiry is an investigation into the legal nature of transfers of shares as well as into the legal nature of holdings of shares. To chart the progression from paper-based to electronic systems illustrates the influence of legal doctrine. It also makes it possible to identify where legal doctrinal rules have been modified or are in need of modification. The assertion that the law develops in a path-

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<sup>1</sup> *Strate Equities Handbook* (2014) 16.

<sup>2</sup> E Micheler *Property in Securities: A Comparative Study* (2007) 85.

<sup>3</sup> See above, 8 3 4 4 Deposit and 12 1 Introduction.

<sup>4</sup> See above, 8 3 3 4 Deposit and bailment.

<sup>5</sup> See above, 8 1 The functions of the share certificate and 8 2 Registration.

<sup>6</sup> See above, 8 1 The functions of the share certificate.

dependent fashion is therefore not a suggestion that the law is static and that doctrine is immutable. It indicates, rather, that when the law changes, it does so within the context of an existing legal framework.<sup>7</sup>

Part 2 illustrates both the path-dependent and dynamic nature of legal change. It appears from the comparative analysis that the question of the legal nature of securities holdings is largely resolved and evidences significant path-dependence, particularly in English, German and South African law. The legal holding of shares and securities in English law proceeded from the historical origin of the trust and there is agreement amongst leading authors that the principles of trust law continue to apply in the context of dematerialised shares.<sup>8</sup> German law continues to apply a modified form of deposit to securities<sup>9</sup> and it has been argued above, that the principles of the law of agency, as modified and supplemented by legislation, continue to shape the holding of securities in South Africa.<sup>10</sup> In the US, a new holding system was introduced by a fundamental reform of article 8 of the UCC. It introduces a new conceptual basis constructed on the notion of “security entitlements”.<sup>11</sup> That this development is also path-dependent is evident from the election of immobilisation instead of dematerialisation, which reflects the concepts of negotiability and bailment.

The legal nature of transfer mechanisms is far more difficult to canvas. The prevalence of account entries, in combination with electronic instructions and communications that shape the landscape of securities transfers, is difficult to reconcile with existing doctrinal concepts. Writing on English law, leading authors are at odds about the continued application of an assignment-, or novation-based analysis of securities transfers.<sup>12</sup> In German law, property-based transfer mechanisms have similarly come under fire for being based on mere fictions of tangibility and intention.<sup>13</sup> One of the principal objectives of the reform of US law was an overhaul of the transfer mechanisms from negotiation-based delivery mechanisms to transfers by book entries. Although delivery continues to survive in transfers of

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<sup>7</sup> On legal path dependence in the context of securities and the advantages of path-dependent legal development, see Micheler *Property in Securities* 225-230.

<sup>8</sup> See above, 10 2 Intermediation – a legal perspective.

<sup>9</sup> See above, 12 3 Intermediation – a legal perspective.

<sup>10</sup> See above, 13 2 3 3 Agency and mandate.

<sup>11</sup> See above, 11 3 Intermediation – a legal perspective.

<sup>12</sup> See above, 10 5 Equity and trusts, text to nn 105-107.

<sup>13</sup> See above, 12 4 2 Legal framework, text to n 86.

direct holding, it has been completely replaced by account entries where indirect holding passes from one person to another.<sup>14</sup> In South Africa, shares have traditionally passed from transferor to transferee by cession based solely on consensus and without delivery of the share certificate or registration of the transfer.<sup>15</sup> The introduction of account-entry transfers has thrown a cession-based analysis into jeopardy. It challenges the formality-free nature of cessions. In addition, if the rules of cession are to apply, it necessitates that consensus be inferred from the actions or communications of intermediaries and imputed to the transferring parties. Theoretically, such a cession construction is possible, but would be based on a legal fiction of consensus. Until there is clarity on the powers of courts to pronounce on transfers of securities and the legal doctrinal tools they will utilise to do so, cession must, however, be seen as an alternative analytical tool.

An examination of transfer mechanisms therefore shows that legal concepts can be modified and can even be replaced. Micheler posits that such changes cause legal systems to functionally converge.<sup>16</sup> A similar convergence can be observed in the context of certainty of transfers. The jurisdictions surveyed evidence a clear development towards transactional security by protecting buyers of securities that have acted in good faith during the acquisition process. As transfer mechanisms are embedded in a wider legal system, systems do not doctrinally converge, however. Property- and contract rules, rules on deposit, agency, bailment or trusts all shape the way in which securities are held, how transfers take place and the consequences of such transfers. Modified rules and mechanisms couched in functional terms must therefore be placed in their proper context. A functional approach, furthermore, is not synonymous with a lack of conceptual underpinning. The idea, expressed in the notion of a “law of accounts”, that a number of formalistic mechanisms are superimposed on a conceptual basis and are in constant dialogue with legal concepts, will be developed further in Part 3.

It remains imperative to reflect on the conceptual basis of legal rules, whether it is functional or doctrinal. This process can reveal continuity and discontinuity in law, can aid an understanding of why the law develops in certain ways and can show how discontinuity plays out within existing legal frameworks.

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<sup>14</sup> See above, 11 5 2 Legal framework.

<sup>15</sup> See above, 8 3 5 2 The transfer of shares.

<sup>16</sup> Micheler *Property in Securities* 233, 236, 238.

### Part 3

Synthesis: The legal nature and characterisation of shares

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## Chapter 15: Introduction and a prospect of the discussion

### 15 1 Context

The preceding chapters have outlined not only the dual nature of shares within the internal sphere, but also the complex net of relationships within which transactions in securities take place in the external sphere. These relationships and foremost the phenomenon of systemic intermediation, compel us to reconsider the legal foundations on which the holding and transfer of shares are premised. Part 2 has shown that such an evaluation cannot take place in a conceptual vacuum. The same can be said of a determination of the legal nature of shares.

The law finds it useful and necessary to classify and compartmentalise the many relationships that may arise in any given context. Issuer relationships are commonly labelled to fall within the purview of company law; in contradistinction, relationships between investors and third parties are said to be governed by private law rules.<sup>1</sup> Such a distinction may seem useful at times, at least on a practical level for determining the set of rules that must be applied, but is nearly impossible on a more abstract, theoretical level. The content and nature of the rights that make up an issuer-investor or issuer-intermediary relationship must and do inform a private law analysis of the nature of shares.

Much of Part 1 was aimed at illustrating the dual nature of shares as a set of personal relationships as well as an asset or incorporeal object. These “internal” aspects of shares, it will be illustrated in this part, are indispensable for determining the effect of shares in the “external” sphere.

The objective of Part 2 was to describe and analyse the commercial and legal rules and mechanisms that must be applied when shares are transacted with. Some of these rules can be found in company law, others in financial markets legislation and yet others are premised on private law concepts. While it is usually the nature of a right that determines transfer rules and mechanisms, a reverse enquiry is possible and can reveal something about the legal nature of a right. At the same time, Part 2 has illustrated that transfer rules have been modified by phenomena such as systemic intermediation, the electronic environment and the introduction of book-

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<sup>1</sup> M Haentjens “Between Property Law and Contract Law: The Case of Securities” in S van Erp, A Salomons & B Akkermans (eds) *The Future of European Property Law* (2012) 165 167.

entry systems. The developments regarding transfer rules may therefore also require a revision of notions regarding the conceptual underpinning of shares. Even if the focus of Part 2 is necessarily transaction-driven, it has value for an enquiry into the legal nature of shares.

If the legal nature of a right or object is examined, the analysis is one that takes place within the realm of private law. Private law is characterised by a pervasive classification, namely that between *iura in rem* (commonly referred to as property rights) and *iura in personam* (commonly referred to as obligations). This distinction continues to exert its influence on both civilian and common law legal systems.<sup>2</sup> While a description of rules and mechanisms in Parts 1 and 2 is not aimed at analysing the legal nature of shares, inevitably terminology has been used that points in one direction or another, or, as is frequently the case with shares, in all directions at once. This chapter aims to direct the focus more specifically to the legal nature of shares, particularly the tension between shares as property and shares as obligations.

A share is defined in the South African Companies Act as “one of the units into which the proprietary interest in a profit company is divided.”<sup>3</sup> This definition, although widely used and accepted,<sup>4</sup> reveals very little about the legal nature of a share. The reference to a “proprietary interest” certainly does not refer to an interest of the shareholder in the assets of the company,<sup>5</sup> and even the assertion that shareholders are owners of the company, if not its assets, has proved to be precarious.<sup>6</sup> Describing shares as property may serve two purposes: First, it aims to distinguish shares from debts or debt instruments by asserting that shareholders have more than a mere claim against the company, but rather an interest in the company.<sup>7</sup> Any references to “property” in a company law context must be understood in this sense.<sup>8</sup> Secondly, the use of the term “proprietary” implies a

<sup>2</sup> But, on the common law and taxonomy, see below, 17 4 1 Drawing the boundary between property and obligations, particularly the text to n 80 to n 84.

<sup>3</sup> Companies Act 71 of 2008 s 1; The Companies Act 61 of 1973 simply defined a share as “a share in the share capital of that company”.

<sup>4</sup> A similar definition can for example be found in the US Model Business Corporation Act 1.40 (22).

<sup>5</sup> See above, 4 2 The entity theory.

<sup>6</sup> See above, 4 3 The nexus theory.

<sup>7</sup> PL Davies & S Worthington *Gower and Davies' Principles of Modern Company Law* 9 ed (2012) 860-861 [23-2].

<sup>8</sup> The proprietary undertones also appear from section 35 of the Companies Act 71 of 2008. In determining the “[l]egal nature of company shares”, the section determines that “[a] share issued by a

classification of shares as property-as-opposed-to-obligations within a private law context. The property-as-opposed-to-obligations analysis has been extended beyond shares to interests in shares where these are said to be separate assets. Whether and to what extent the second implication is accurate, both in relation to shares and interests in shares, will be examined in this Part.

## 15 2 Why the issue of property arises

Before the legal nature of shares can be considered in any detail, it is useful to ascertain why the “property question” arises in the context of shares in the first place. The issue of property in relation to shares arises in an “internal” and “external” context. Internally, as between the company and its shareholders and investors, the concept of “property” raises the issue of property rights in the assets of the company as well as ownership of the company. A closer look at the internal realm reveals what shares are not – they are not an interest in company assets and they do not confer on its holders ownership of the company. These issues have been adequately canvassed in Part 1. These developments, flowing, at least in the common law realm, from decisions such as *Bligh v Brent*<sup>9</sup> and *Salomon v A Salomon and Co Ltd*,<sup>10</sup> had two important implications: First, they resulted in the re-classification of shares as choses in action;<sup>11</sup> and secondly, they established shares as autonomous units. On the one hand, great emphasis is therefore placed on the personal rights that make up shares; on the other hand, the picture of the share as “a separate right of property”<sup>12</sup> emerged.

It is undisputed that shares are obligations. This classification is uniform across all jurisdictions surveyed. At the same time, scholars and courts in these jurisdictions recognise the unique characteristics of shares. In Germany, the rights of which shares are comprised are recognised to be more than mere claims and are classified

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company is movable property, transferable in any manner provided for or recognised by this Act or other legislation”. Blackman argues that shares are only described as “movable property” so that shares in a company that holds immovable property are not characterised as immovable themselves. See MS Blackman, RD Jooste, CK Everingham, JL Yeats, FHI Cassim & R De La Harpe *Commentary on the Companies Act (2002)* (RS 9 2012) 5-168. The origin of the section can be traced back to decisions such as *Bligh v Brent* 1837 2 Y & C Ex 268. Also see RD Jooste “Capitalisation of Profit Companies (ss 35-48)” in JL Yeats (ed) *Commentary on the Companies Act of 2008* (OS 2018) 2-274 - 2-276.

<sup>9</sup> 1837 2 Y & C Ex 268.

<sup>10</sup> [1897] AC 22.

<sup>11</sup> See above, 8 3 2 2 Choses in action.

<sup>12</sup> *Bradbury v English Sewing Cotton Company Ltd* 1923 AC 744 767.

as “Mitgliedschaftsrechte” instead.<sup>13</sup> In the common law, shares are classified as choses in action, but according to Davies and Worthington, give its holder “rights in the company” as opposed to merely “rights against the company”.<sup>14</sup> Pennington also recognises the “peculiar nature” of the rights of which a share is composed.<sup>15</sup> He concludes his attempt at defining shares by describing them as “a collection of rights and obligations relating to an interest in a company of an economic and proprietary character, but not constituting a debt”.<sup>16</sup> Likewise, in South Africa, shares are variably described as personal rights and rights of action. Malan, however, emphasises that they “involve[s] more than a claim for repayment of a loan.”<sup>17</sup> He argues these personal rights create more than “a legally recognized relationship between a creditor and a debtor entitling the former to a performance by the latter”.<sup>18</sup> In other words, a share is not simply a debt. The exceptional nature of the personal rights that make up shares creates some of the difficulties experienced by courts and scholars alike in demarcating the legal nature of shares.

Another element that creates tensions between obligatory and proprietary legal concepts is the classification of shares as incorporeal units. The law struggles with incorporeals because, in many ways, they behave like corporeal objects of property, but lack the element of corporeality. Conceived of as independent assets, many scholars describe shares as “property”. The dual or “exceptional” nature of securities, therefore frequently leads to conclusions like the one drawn by Khimji:

“As between the holder and the issuer, the legal relationship is contractual or personal as securities represent obligations owed by the latter to the former. ... As between the holder and the world in general, the relationship is proprietary or real as securities are assets subject to property rights.”<sup>19</sup>

Writing on English law, Gower formulated a passage that has been cited frequently in South African cases and textbooks:

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<sup>13</sup> See above, 6.3 The obligatory realms of shares and some conclusions, the text to nn 81-86.

<sup>14</sup> See n 7 above.

<sup>15</sup> R Pennington *Pennington's Company Law* 6 ed (1990) 57.

<sup>16</sup> R Pennington “Can Shares in Companies be Defined?” (1989) 10 *Company Lawyer* 140 144.

<sup>17</sup> FR Malan *Collective Securities Depositories and the Transfer of Securities* (1984) 147.

<sup>18</sup> 192.

<sup>19</sup> MF Khimji “The *Securities Transfer Act* – The Radical Reconceptualization of Property Rights in Investment Securities” (2007) 45 *Alberta LR* 137 147.

“One thing at least is clear: shares are recognised in law, as well as in fact, as objects of property which are bought, sold, mortgaged and bequeathed. They are indeed the typical items of property of the modern commercial era and particularly suited to its demands because of their exceptional liquidity. To deny that they are “owned” would be as unreal as to deny, on the basis of feudal theory, that land is owned”.<sup>20</sup>

Shares are classified as property rather than obligations, Worthington argues, because shares are transferable and their rights are enforceable against third parties to meet the demands of modern commerce.<sup>21</sup> It is therefore commerce, not legal doctrine that shapes and has shaped the nature of shares as items of intangible property. In the context of shares and securities, functional and pragmatic arguments abound. Some of these will be analysed in more detail below. Worthington further observes that the idea of shares as property, despite generally accepted by courts, seems to continue to trouble textbook writers.<sup>22</sup> Nonetheless, she finds that “it would seem that this aspect of shares is now well settled”.<sup>23</sup> Some of these troubles may be traced back to the perceived conceptual void of functional arguments.

The above passages reveal firstly, that authors use the concept of property in different senses. The idea of property and the various guises that it may assume are considered below. Secondly, the external context necessitates the classification of shares as “property”. Shares are considered to behave as “property” because, as incorporeal units, they are easily alienated, can be vindicated and attract proprietary remedies in a range of situations. In addition, the use of “property terminology” in the context of shares is rife, including concepts such as “ownership”, “possession” and “pledge”.

In some jurisdictions, most notably Germany and the United States, the issue of property also surfaces because of the conflation of the share with the share certificate. The reification of the share has led to the adoption of proprietary mechanisms, for example in transferring shares, which makes it difficult to conceptualise shares outside of this proprietary realm.

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<sup>20</sup> Davies & Worthington *Modern Company Law* 862 [23-3].

<sup>21</sup> S Worthington “Shares and Shareholders: Property, Power and Entitlement” (2001) 22 *Company Lawyer* 258 260.

<sup>22</sup> 258, 261.

<sup>23</sup> 258.

One of the most pertinent reasons why the property issue arises in the context of shares must be sought in the theoretical legal framework within which concepts such as property and obligations, specifically contract, operate. Both property and contract lie at the heart of private law. Both institutions perform an important enabling function.<sup>24</sup> They stimulate economic activity and allocate resources. The institutions of property law and contract, however, provide different frameworks of rules to accomplish this task. Both sets of rules aim to increase legal certainty by providing convenient frameworks for ascertaining legal outcomes. Yet, it is frequently difficult to determine with precision where the one ends and the other starts. In addition, Merrill and Smith note, there has been a lot of “repackaging and relabeling” as of late.<sup>25</sup> Apart from the ambiguity this suggests about the boundaries between property and contract, such practices highlight that the distinction is legally relevant.<sup>26</sup> Contract law provides default rules rather than mandatory ones and parties can generally vary these rules to tailor their contracts to their liking. Contract law therefore offers a convenient and flexible framework for structuring legal relationships. Property, however, is an equally powerful concept. Its rules have force beyond the holder of the property. The concept of property is perceived to give its holders greater legal protection than contract law. The normative implications of property are said to advance far beyond those of contract law.<sup>27</sup> In certain respects, it is therefore favourable to classify certain objects or relations as property. Most notable is insolvency – during insolvency, property-owners enjoy considerably stronger protection than parties to a contract.<sup>28</sup>

The classification question in the context of shares is certainly not novel. In the 1770 English case of *Nightingale v Devisme*,<sup>29</sup> Lord Mansfield, to name just one example, rejected the classification of shares as money, finding instead that they are “new species of property”.<sup>30</sup> The property-contract debate in relation to shares has resurfaced with a vengeance following the introduction of systemic intermediation.

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<sup>24</sup> FB Cross & RA Prentice *Law and Corporate Finance* (2007) 1.

<sup>25</sup> TW Merrill & HE Smith “The Property/Contract Interface” (2001) 101 *Columbia LR* 773 775.

<sup>26</sup> 775.

<sup>27</sup> RB Grantham “The Doctrinal Basis of the Rights of Company Shareholders” (1998) 57 *Cambridge LJ* 554 583.

<sup>28</sup> On the importance of the distinction between property and personal rights in the context of insolvency, see especially RM Goode “Ownership and Obligation in Commercial Transactions” (1987) *LQR* 433.

<sup>29</sup> 98 ER 361, (1770) 5 Burrow 2589 (KB).

<sup>30</sup> 363.

The changed holding structures raise the question as to the nature of an investor's rights in dematerialised or immobilised shares held through intermediaries. An answer to this question becomes particularly acute should an intermediary become insolvent.

### **15 3 A prospect of the discussion**

A consideration of the legal nature of shares is not an easy task. For one, it raises issues that go to the core of the taxonomy of private law, which finds itself in a state of flux. A re-ordering of private law cannot be the aim of this thesis. Yet, it is necessary to reflect on the conceptual legal basis of shares. An analysis of the literature shows that this conceptual basis can be found in the legal categories of property and obligations. Alternatively, developments in financial and capital markets have brought to the fore notions of functionally construed concepts and a procedurally oriented "law of accounts".

The answer to the question whether shares are property depends on whom you ask. If you ask property theorists, the answer will more likely than not be yes. In fact, many property scholars treat shares as property in such a routine fashion, that one may well expect the response that the question is redundant. Part of the problem in answering the question is that property itself is an elusive concept. I will therefore include a brief description of the different meanings of property. This account exemplifies how contested the boundary between property and contract is.

If you pose the same question to scholars specifically considering the matter from the vantage point of shares, the answer may well be very different. The question, even if considered by some to be settled, has given rise to extensive debate, which has produced a variety of carefully crafted opinions taking into account the particular environment of shares and securities. Some of these perspectives from English-, US- and German law will be examined to establish how other legal systems deal with shares through the prism of private law. The selected literature does not provide a comprehensive account of all the arguments and opinions that have been advanced by academic commentators regarding the legal nature of shares and securities. Views have been selected firstly, on the basis of their impact and reception in secondary literature and secondly, to reflect the breadth of the debate and that

exemplify different approaches. Included are responses that highlight the proprietary nature of shares; those that assert that shares are obligations; yet others that argue that shares are either conceptually located somewhere between the law of property and the law of obligations or are conceptually unique; as well as views that focus on the procedural, rather than the conceptual aspects of shares. Naturally, it must be understood that these propositions are made within the particular legislative- and wider legal context sketched in Parts 1 and 2. South Africa has not seen much academic debate on this question. While the term “property” is at times encountered in company law texts on shares, the authors neither explain what conception of property they have in mind, nor do they substantiate why shares can be considered to be property. The courts have avoided a description of shares as “property”, yet the cases evidence a tension between obligatory and proprietary aspects of shares. In addition, many cases illustrate the use of proprietary language and remedies in the context of shares.

Drawing on the range of perspectives from comparative law some of the dominant themes that emerge from the literature will be highlighted. These include, in the first place, an examination of functionalism, which is an alternative approach to conceptualising securities uncoupled from traditional doctrinal concepts. The functional approach focuses on market practices and translates these into new concepts. Closely related to functionalism is the notion of a “law of accounts”. A law of accounts is also transaction-based, but, in contrast to functionalism, it focuses almost exclusively on the procedural aspects of transactions. It will be shown that a law of accounts today permeates our legal framework on securities transactions by providing convenient rules by which securities can be said to pass from one person to another – much like the rules on negotiable instruments were once construed to operate. Unlike functionalism, the law of accounts does not propose an alternative conceptual explanation for the legal nature of shares and securities.

In addition, systemic intermediation requires a re-conceptualisation of the dynamic amalgamation of relationships that underlie a holding of shares. The way in which intermediary holding is construed is therefore examined next. Two theoretical models of intermediation are proposed: the proposition that intermediaries derive their entitlement from the core right held by investors and therefore from a burdening of investors’ rights, as opposed to the construction in terms of which investors derive

their rights from intermediaries and therefore hold rights against the rights of their intermediaries. These models will be used to answer the question, also addressed in Part 2, whether and to what extent securities as assets are transformed by systemic intermediation and whether new assets are created in the process. To conclude the analysis of models of intermediation, the idea of management rights will be considered.

While themes such as functionalism, a “law of accounts” and theoretical models of intermediation all feature in the literature, traditional concepts such as property and obligations continue to be prominent. Even the functional approach uses them as an anchor when asserting that shares are *sui generis* in the sense of being located somewhere between the doctrinal categories of property and obligations. Against the backdrop of functionalism and the new or renewed emphasis on the procedural aspects of securities transactions, the legal nature of shares from the angle of traditional doctrinal categories and reasoning is considered. This includes an examination of the property-obligations boundary and the tensions inherent therein, a critical analysis of the contributions that the literature on shares and securities makes to this debate and culminates in the proposal of an explanatory model. This model can be used to distinguish between the internal and external spheres of shares, while at the same time illustrating how the characterisation of shares in the internal sphere (considered in Part 1) has an impact on the question whether shares can have an absolute, “proprietary” effect in the external sphere.

Finally, the discussion will conclude with a brief prospect of future developments by considering the impact that new disruptive technologies may have on the legal nature of shares and securities.

## Chapter 16: The legal nature of shares: selected views

### 16 1 Perspectives from English law

#### 16 1 1 Joanna Benjamin

Benjamin asserts that property rights exist, not only in relation to shares, but specifically also in relation to what she terms interests in shares. This much can be gathered from the sub-title of her book. She rejects the corporeality element of property and, looking back at Roman law and early English commentaries,<sup>1</sup> outlines that, not only did the Romans recognise the existence of incorporeal things,<sup>2</sup> but also that a real action can arise in relation to such intangibles.<sup>3</sup>

Benjamin further argues that in the context of intangible assets, a real action operates only against third parties.<sup>4</sup> As between the debtor and creditor, the obligation persists and only personal rights can be asserted.<sup>5</sup> Benjamin then specifies that property rights in intangibles are rights under a trust.<sup>6</sup> Consequently, she argues that the rights of a trust beneficiary are personal in relation to the trustee and proprietary against the creditors of the trustee and other third parties.<sup>7</sup>

At the core of Benjamin's proposition lies a rejection of the physical model of property. She traces the origins of English law back to actions, which dominated English law until the nineteenth century, and argues that English law has never reached a level of abstraction by which substantive law, such as property rules, were induced from procedural actions.<sup>8</sup> These empirical and pragmatic tendencies of English courts and jurists explain why property rights in relation to obligations can be relative:

“Personal and proprietary status is not unchangeably inherent in the asset, but depends upon whom one is suing. In other words, property is a function of particular actions, not of particular assets. Because the *in personam/in rem* distinction applies to actions (and the

<sup>1</sup> She specifically considers the works of Bracton and Blackstone; see J Benjamin *Interests in Securities: A Proprietary Analysis of the International Securities Markets* (2000) ch 13.

<sup>2</sup> See on the Gaian tripartite distinction, below n 118.

<sup>3</sup> Benjamin *Interests in Securities* 304-305 [13.06]-[13.09].

<sup>4</sup> 305 [13.10].

<sup>5</sup> 305 [13.10].

<sup>6</sup> 306 [13.11].

<sup>7</sup> 306 [13.12].

<sup>8</sup> 315 [13.48].

rights that are extrapolated from actions) and not to assets, it follows that both tangible and intangible assets may be subject to both personal and property rights.”<sup>9</sup>

She cautions that if one proceeds from drawing a distinction between real and personal rights and subsequently categorises assets accordingly, personal or proprietary status becomes a “quality of certain assets”.<sup>10</sup> Thus, obligations will be personal in all respects.<sup>11</sup> This, she finds, is the trap into which civil lawyers have fallen.

Benjamin concludes that the traditional framework of English property law is capable of meeting the demands of a radically changed environment:

“The impression that they are not, and that the law of property is the law of tangible things, involves conflating legal rights of property with the tangible things to which they relate, and further conflating things with tangible things.”<sup>12</sup>

#### 16 1 2 Arianna Pretto-Sakmann

Central to Pretto-Sakmann’s thesis is the importance of drawing and maintaining a clear boundary between the law of property and the law of obligations. For this purpose she rejects the wide notion of property as wealth. She engages in an outward-looking inquiry to personal property to determine first, the outward boundaries of personal property and second, whether shares can be said to fall within it. Pretto-Sakmann’s focus therefore lies with “property-as-opposed-to-obligations”.<sup>13</sup> Her approach relies heavily on a taxonomy influenced by the work of Peter Birks, often said to be more closely related to civilian rational science than common law empiricism.<sup>14</sup> She starts her enquiry by examining the traditional boundary, namely the limitation of rights *in rem* to things which have a physical existence. She enlarges the category to include all things that are in some way locatable in space. In other words, she includes a dimension of spatiality to replace the requirement of corporeality.<sup>15</sup> Nonetheless she concludes that, even on this

<sup>9</sup> 316 [13.51]-[13.52].

<sup>10</sup> 317 [13.53].

<sup>11</sup> 317 [13.53].

<sup>12</sup> 318-319 [13.60].

<sup>13</sup> A Pretto-Sakmann *Boundaries of Personal Property: Shares and Sub-Shares* (2005) 16.

<sup>14</sup> See the general criticism against civilian rational thinking by Benjamin *Interests in Securities* 315-316.

<sup>15</sup> To develop her argument, she draws on the notion of “ideational things” developed by J Harris *Property and Justice* (1996) and considers developments in intellectual property law, arguing that

basis, shares, as bundles of personal rights exercisable either against an issuer (in the case of certificated shares) or against an intermediary (where shares exist in dematerialised form), are not spatially locatable in this way and therefore cannot fall within the boundary of property.<sup>16</sup> Pretto-Sakmann then proceeds by exploring alternative ways in which the boundary between property and obligations could be drawn, namely on the basis of alienability or vindicability. Both alternatives, she finds, must fail. While shares are both clearly alienable and vindicable, they share these characteristics not only with rights *in rem*, but also with rights *in personam*. Obligations, such as contractual rights have become as alienable as movable goods.<sup>17</sup> In addition, not all rights *in rem* are alienable.<sup>18</sup> In the light of these findings, Pretto-Sakmann explains that alienability is frequently associated with property because of the mistaken focus on benefit instead of burden.<sup>19</sup> What distinguishes property from obligations, she argues is the “behaviour of the burden” i.e. for rights *in rem*, the burden follows a thing; for rights *in personam*, the liability fixes itself onto a person.<sup>20</sup> The criterion of vindicability, she finds, is often said to hold much promise as “obligations are typically asserted rather than vindicated”.<sup>21</sup> Pretto-Sakmann identifies vindicability as the core of Benjamin’s thesis.<sup>22</sup> Her criticism of Benjamin’s propositions cannot be elaborated upon here<sup>23</sup> and it must suffice to point out that Pretto-Sakmann argues that contractual obligations can be vindicated in a manner comparable to property by protecting them from unlawful interference by third parties. This, she finds, “makes a contract a vindicable thing”, but not property in the narrow sense.<sup>24</sup> Pretto-Sakmann therefore concludes that “[w]hen the law of property

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patented ideas or designs are “ideational entities” that “materialize in all things which manifest the same idea”. See Pretto-Sakmann *Boundaries of Personal Property* 103-106.

<sup>16</sup> Pretto-Sakmann *Boundaries of Personal Property* 106.

<sup>17</sup> 158-163.

<sup>18</sup> 163-165.

<sup>19</sup> 165.

<sup>20</sup> 166.

<sup>21</sup> 218.

<sup>22</sup> She also identifies alienability and vindicability as the main drivers of the classification of shares and securities as property in the works of AO Austen-Peters *Custody of Investments: Law and Practice* (2000) and S Worthington “Shares and Shareholders: Property, Power and Entitlement” (2001) 22 *Company Lawyer* 258. The former will not be discussed for the author does not develop theoretical arguments for his assertion that shares are property. The latter has been quoted above, 15 2 Why the issue of property arises, n 21.

<sup>23</sup> Pretto-Sakmann *Boundaries of Personal Property* 202-207.

<sup>24</sup> 206.

is contrasted with the law of obligations, there is no way of drawing the boundary in a way which allows shares to stay within it [the law of property]”.<sup>25</sup>

### 16 1 3 Eva Micheler

Eva Micheler uses her civil law background to consider securities from a comparative perspective. The comparative exercise is today dominated by a functional approach.<sup>26</sup> While the legal systems that are the subject of her comparison utilise vastly different legal mechanisms and concepts, Micheler also considers the functional effect of the legal rules. The functional, comparative perspective shapes her conclusions.

She identifies that both in English and German law, the rules on securities, driven by the functions these instruments are expected to perform in a commercial setup, behave in unexpected ways. Micheler identifies shares as rights that are specifically created to circulate freely in financial markets.<sup>27</sup> She draws on an article written by Ewart,<sup>28</sup> who describes negotiable instruments and other choses in action as “ambulatory rights”, because their defining feature is not mere transferability, but “ambulatory intent”, that is they are intended to circulate and, propped by estoppel, do so in favour of innocent purchasers.<sup>29</sup> In addition, Micheler considers the “Wertrechte” (negotiable rights) debate in German scholarship, which similarly recognises that certain rights not embodied in paper instruments, are nonetheless negotiable.<sup>30</sup> She therefore classifies securities as “circulating rights”.<sup>31</sup> Micheler finds that English registered, paper-based shares can be considered to be “quasi-negotiable”, made so by a contract-based novation analysis of their transfer in conjunction with the application of the rules on estoppel.<sup>32</sup> In addition, the centrality of the trust concept in the context of shares is said to point towards a classification

<sup>25</sup> 13.

<sup>26</sup> On functional comparison, see K Zweigert & H Kötz *Einführung in die Rechtsvergleichung* 3 ed (1996); R Michaels “The Functional Method of Comparative Law” in R Zimmermann & M Reimann (eds) *The Oxford Handbook of Comparative Law* (2006).

<sup>27</sup> E Micheler “Farewell Quasi-Negotiability? Legal Title and Transfer of Shares in a Paperless World” (2002) *J Bus L* 358 365.

<sup>28</sup> JS Ewart “Negotiability and Estoppel” (1900) 16 *LQR* 135.

<sup>29</sup> 143, 155, 159.

<sup>30</sup> See Micheler (2002) *J Bus L* 365. Also see the debate on “Wertrechte” below, 16 3 1 Securities as “Wertrechte”.

<sup>31</sup> E Micheler “The Legal Nature of Securities: Inspirations from Comparative Law” in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 131 131.

<sup>32</sup> See Micheler (2002) *J Bus L*; Micheler “Legal Nature of Securities” in *Intermediated Securities* 134-135.

outside the common boundaries of obligations.<sup>33</sup> These rules provide the foundation for property rights in securities, usually recognised simply as intangible choses in action and therefore as obligations. She therefore concludes that securities occupy a special position between property and obligations.<sup>34</sup> They can be grasped completely neither through the prism of property nor through the looking glass of obligations.<sup>35</sup> Micheler applies this analysis to both German and English law. While she finds that English law traditionally classifies shares as obligations and German law assigns them to the law of things, both legal systems need to make exceptions, to accommodate the special features of securities, including their fungibility, liquidity and the need for clear and efficient transfer rules.<sup>36</sup> Therefore, securities in both systems evidence features of both property and obligations and functionally, if not doctrinally, achieve surprisingly similar results.<sup>37</sup> “The rules governing securities”, Micheler finds “are designed to facilitate this purpose [circulation] and to make the circulation of them cost efficient”.<sup>38</sup>

Dematerialisation and immobilisation have significantly changed the environment within which shares are held and traded. A company is no longer involved in the transfer process – neither does it receive transfer documents nor does it verify their accuracy.<sup>39</sup> Hence, it becomes untenable to describe the transfer process as a novation.<sup>40</sup> In addition, the rules on estoppel, even if not abolished, have become partly redundant.<sup>41</sup> Nonetheless, Micheler finds that “*quasi-negotiability*” continues to be desirable, in fact more so than ever.<sup>42</sup> She explains that such *quasi-negotiable* status does not hinge on the application of novation- or estoppel-rules. Instead, she justifies the classification of securities as circulating rights with reference to the functions they are expected to perform. In particular, “[t]hese instruments [securities] are created with a view to circulate in secondary securities markets”.<sup>43</sup> It is primarily

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<sup>33</sup> E Micheler *Wertpapierrecht zwischen Schuld- und Sachenrecht: Zu einer kapitalmarktrechtlichen Theorie des Wertpapierrechts. Effekten nach österreichischem, deutschem, englischem und russischem Recht* (2004) 383.

<sup>34</sup> 382-383.

<sup>35</sup> 383.

<sup>36</sup> 383-384.

<sup>37</sup> 384.

<sup>38</sup> Micheler “Legal Nature of Securities” in *Intermediated Securities* 131.

<sup>39</sup> Micheler (2002) *J Bus L* 362.

<sup>40</sup> 363.

<sup>41</sup> Micheler (2002) *J Bus L* 376. Also see, 10 6 Protection of bona fide purchasers of shares.

<sup>42</sup> Micheler (2002) *J Bus L* 378.

<sup>43</sup> Micheler “Legal Nature of Securities” in *Intermediated Securities* 145.

this purpose that explains the special transfer rules,<sup>44</sup> regardless of whether they are certificated or not.<sup>45</sup> Specifically on the question of property-rights in pooled, intermediated securities, Micheler writes:

“The mechanism [pooling and intermediation] is intended to create property rights for the benefit of investors. The law should recognise this”.<sup>46</sup>

Micheler therefore elevates the purposes for which securities have been conceived and the functions they are expected to perform within a commercial setting to a legal justification for introducing a category positioned somewhere between the known categories of property and obligations.

## 16 2 Perspectives from US law

### 16 2 1 Rogers and Mooney

The analysis in Part 2 has shown that securities under US law were not always negotiable. Rather, the law only gradually migrated towards negotiability and bailment. It is this development that placed securities within the reach of property. The question of property versus obligations must still be understood in this context today. As Rogers notes:

“Had that practice [the reification of intangible rights] not developed, there would have been no need for a body of law like Article 8; questions about transfer of ownership of securities would have remained part of the general contract law of assignment or part of the law of membership in corporation”.<sup>47</sup>

Securities were therefore regularly referred to as forms of property. Negotiability, even if it technically-speaking does not transform personal rights to real rights, reifies them to such an extent that they may be dealt with as property in the same sense as tangible objects.<sup>48</sup> That shares and securities constituted property has therefore been undisputed for many years, even if this “property-status” derives from the conflation of the rights with the certificate. More recently the focus has been directed to security entitlements; but not so much to the question whether they can constitute

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<sup>44</sup> 145.

<sup>45</sup> 148.

<sup>46</sup> 149.

<sup>47</sup> JS Rogers “Policy Perspectives on Revised U.C.C Article 8” (1996) 48 *UCLA LR* 1431 1453.

<sup>48</sup> See, 8 3 3 2 Negotiation, assignment and the transfer of shares.

property in the more traditional sense of this concept, but rather asking what kind of property they may be.<sup>49</sup> No effort is therefore dedicated to the threshold question of whether securities are property in a sense that distinguishes them from obligations.

The concept of “property” is used to refer to both the security entitlement as well as the “object” to which it relates. In this sense the concept does not reveal much more than that “property” constitutes assets. Rogers describes the property that is the security entitlement not as “a claim to a specific identifiable thing”, but nonetheless as being “located” at a custodian.<sup>50</sup> He puts the term “located” in inverted commas, probably for the element of tangibility that it bears and for lack of a better term. On the issue of “locatability”, Mooney adds that under the new approach locating property is frequently neither “useful nor necessary”.<sup>51</sup> The importance of these statements lies not therein that they convey that property, even if not related to a tangible object, is nevertheless connected to an object external to itself. Rather the opposite – the object decreases in importance while the rules about how the object is held take centre stage.<sup>52</sup> Where mention is made of the “property” of the intermediary to which a security entitlement relates, such property consists, in the usual course, of security entitlements that an intermediary holds against his own custodian. This use of the concept of property is unsuitable for drawing clear boundaries between traditional private law categories.

Indeed, such a doctrinal exercise is not the aim of article 8 of the UCC, which demarcates its scope in more functional terms. In fact, Mooney viewed, with scepticism, “the analytical traps and slippery slopes of conclusory doctrinal reasoning”.<sup>53</sup> Much of the legal scholarship advocating for a new approach was therefore focused on overcoming the straightjacket of property. Mooney, before the 1994 revision of article 8, wrote that where securities “are cut from the familiar fabric of property law ... we shall see, traditional legal garments fit poorly on the frame of

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<sup>49</sup> Rogers (1996) *UCLA LR* 1468 refers to the “attributes of that property interest”.

<sup>50</sup> 1456.

<sup>51</sup> CW Mooney “Law and Systems for Intermediated Securities and the Relationship of Private Property Law to Securities Clearance and Settlement: United States, Japan, and the UNIDROIT Draft Convention” in Institute for Monetary and Economic Studies, Bank of Japan *Discussion Paper Series 2008-E-7* (2008) 9.

<sup>52</sup> JS Rogers “The Revision of Canadian Law on Securities Holdings through Intermediaries: Who, What, When, Where, How and Why?” (2007) 45 *Can Bus LJ* 49 55. The “objects” covered by article 8 UCC are intentionally defined broadly, being “financial assets”, see 11 5 2 Legal framework.

<sup>53</sup> Mooney “Law and Systems for Intermediated Securities” in *Discussion Paper Series* 5.

current practice”.<sup>54</sup> Mooney therefore finds that any construct based on property law is “fundamentally flawed”,<sup>55</sup> and Rogers explains:

“In this setting ... the movement from a paper to an electronic environment has not simply been a matter of changing predicates of unchanging legal objects; the significant objects themselves have changed. In the traditional securities holding system, the key relationship for commercial law was that between the investor and the issuer, and that relationship could be analysed by application of property concepts to a physical embodiment of the underlying rights. In the modern indirect holding system, it remains just as true that for most purposes the key relationship is that between the investor and the issuer, but for purposes of the commercial law rules concerning the mechanisms of settlement the key relationship is that between an investor and its securities intermediary. That relationship is neither represented by any physical or metaphysical object, nor capable of analysis in terms drawn from the property law of physical objects.”<sup>56</sup>

“Property”, where the term is used in the context of revised article 8, is therefore hardly reminiscent of its doctrinal namesake, nor is it meant to “invoke the entire panoply of attributes of ‘property’”.<sup>57</sup> Abandoning the traditional private law category of property does not imply, however, that securities should henceforth be reclassified in traditional terms. Rather, it is illustrative of the perceived need for entirely new concepts.

In the particular context of the US legal system, the rejection of the property concept goes hand in hand with eschewing negotiability.<sup>58</sup> Negotiability, Mooney and Rogers argue, is inseparable from the reification of abstract rights and therefore from old property mechanisms.<sup>59</sup> An application of the negotiability principle presupposes firstly, that the object that is being transferred can be identified;<sup>60</sup> and secondly, that

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<sup>54</sup> CW Mooney “Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries” (1990) 12 *Cardozo LR* 305 307.

<sup>55</sup> 310.

<sup>56</sup> JS Rogers “An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision” (1995) 31 *Idaho LR* 689 697-698.

<sup>57</sup> Mooney “Law and Systems for Intermediated Securities” in *Discussion Paper Series* 8.

<sup>58</sup> Schroeder, on the other hand, argues that the approach is rather one of “super-negotiability” in that purchasers almost take free from adverse claims; see JL Schroeder “Is Article 8 Finally Ready this Time? The Radical Reform of Secured Lending on Wall Street” (1994) *Columbia Bus LR* 291 355-356.

<sup>59</sup> Rogers (1995) *Idaho LR* 695; JS Rogers “Negotiability, Property and Identity” (1991) 12 *Cardozo LR* 480; Mooney (1990) *Cardozo LR*.

<sup>60</sup> See especially Rogers (1991) *Cardozo LR* 484-486. Also see Mooney (1990) *Cardozo LR* 370.

the object that the transferor gets is the same one that the transferor had.<sup>61</sup> Both assumptions require significant conceptual stretching where shares lose their corporeality. The problem that the negotiability principles addresses, namely whether a transferor takes the object of the transfer free from adverse property claims, must be rephrased in functional terms.<sup>62</sup>

The new conceptual framework for an intermediated environment, developed initially by Mooney as a model of upper-tier priority, became known as a “security entitlement” in the revised article 8 of the UCC. As Mooney describes it, “[t]he interest of an ownership claimant through an intermediary is best characterised as a bundle of rights against the intermediary. The ‘property’ involved is the claimant’s interest in its account with its intermediary, not the fungible bulk that may or may not underlie that account”.<sup>63</sup> It necessarily follows that the use of the property concept does not simultaneously signify that the rights are also *in rem*; in fact the essence of the concept of security entitlement is that it consists of a package of rights *in rem* and *in personam*. Instead of leaving transfer mechanisms, adverse acquisition, priority and insolvency questions to the law of property, article 8 sets out a number of rights in functional terms. Some of these rights can be enforced only against the relevant intermediary; others persist against third parties, such as intermediary creditors.<sup>64</sup> According to Rogers, this bundle of rights may be described as a property right, but with the caveat that it is in no way connected to the traditional rules on transfers of property.<sup>65</sup> Commonly, a security entitlement is therefore pronounced a *sui generis* right or relationship that refuses to fit neatly into any one of the traditional private law categories.<sup>66</sup>

<sup>61</sup> See especially Rogers (1995) *Idaho LR* 695-696. Rogers therefore also argues that securities cannot be said to be transferred; also see Rogers (1991) *Cardozo LR* 505-507.

<sup>62</sup> Rogers (1995) *Idaho LR* 695-696.

<sup>63</sup> Mooney (1990) *Cardozo LR* 310-311.

<sup>64</sup> For a more detailed description of the package of rights, see 11 5 2 Legal framework. Also see Rogers (1996) *UCLA LR* 1450-1451.

<sup>65</sup> Rogers (1991) *Cardozo LR* 507; Rogers (2007) *Can Bus LJ* 61. Also see UCC § 8-503 *Official Comment 2*: “the incidents of this property interest are established by the rules of Article 8, not by common law property concepts”. For a brief summary of the essential features of the property interest derived from article 8, see M Dubovec *The Law of Securities, Commodities and Bank Accounts: The Rights of Account Holders* (2014) 61.

<sup>66</sup> Mooney (1990) *Cardozo LR* 413; Rogers (1996) *UCLA LR* 1496. In another contribution, Mooney points out, that modern technology has “made possible the creation of new kinds of property, products and relationships” – see CW Mooney “Property, Credit, and Regulation Meet Information Technology: Clearance and Settlement Systems in the Securities Markets” (1992) 55 *Law and Contemporary Problems* 131 134. Also see UCC *Prefatory Note – 1994 Revision* III B: “The technique used in Revised Article 8 is to acknowledge explicitly that the relationship between a securities intermediary

## 16 2 2 Joseph Sommer

Joseph Sommer's finds that the property versus contracts debate is sterile and elects to focus on a "law of accounts".<sup>67</sup> It must be stated from the outset, that his theory, like that of Mooney and Rogers catches, quite intentionally, only intermediated securities. In fact, the law of accounts is premised on intermediation, particularly tiered intermediation.<sup>68</sup>

Sommer argues that accounts are entirely made up of communications. These communications, however, do not merely convey a promise, they are "the very performance promised in the message".<sup>69</sup> Authenticated messages, therefore constitute the communication and create or attribute rights.<sup>70</sup> Authenticated records, such as account entries, only provide evidence of the rights so created or attributed.<sup>71</sup> Sommer specifies, however, that communication accounts only for the structure of a resulting relationship, in other words how rights are created, extinguished or attributed.<sup>72</sup> Communication does not determine the content of relationships; this is the dominion of substantive law.<sup>73</sup> A law of accounts is therefore procedural. The communication is bilateral, meaning that it only links adjacent parties.<sup>74</sup> It therefore performs an important function in reducing complex structures through compartmentalisation.<sup>75</sup> From this he concludes that security entitlements are "dyadic relations" founded in communications.<sup>76</sup> Although we often find it "intuitively attractive" to conceive of them as things, Sommer contends that when security entitlements are transferred, in effect nothing is transferred.<sup>77</sup> Security

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and its entitlement holders is sui generis, and to state the applicable commercial rules directly, rather than by inference from a categorization of the relationship based on legal concepts of a different era".

<sup>67</sup> JH Sommer "International Securities Holding and Transfer Law" (2001) 18 *Ariz J Int & Com L* 685 696.

<sup>68</sup> JH Sommer "A Law of Financial Accounts: Modern Payment and Securities Transfer Law" (1998) 53 *Bus L* 1181 1200-1201.

<sup>69</sup> Sommer (2001) *Ariz J Int & Com L* 697.

<sup>70</sup> 697.

<sup>71</sup> 697.

<sup>72</sup> 698.

<sup>73</sup> 698.

<sup>74</sup> 700.

<sup>75</sup> 700.

<sup>76</sup> 706.

<sup>77</sup> 706.

entitlements are therefore “just a series of bilateral relationships that affect the relationship among end-parties”.<sup>78</sup>

While we therefore wish to view securities in accounts as something more real than a claim or right to sue, they are in effect “lawsuits in embryo”.<sup>79</sup> Sommer explains that the law at times encourages the impression that securities in accounts are real in a possessory sense.<sup>80</sup> This, he argues, serves the purpose of reducing the great complexity of securities holding systems. The orderly functioning of a complex system requires not only good and clear law, but also “simple user rules”.<sup>81</sup> Thus, “[t]he users are under the illusion that they are dealing with ... ‘securities,’ not intermediated choses of action”.<sup>82</sup>

The law of accounts, Sommer continues, is characterised by two “engineering design principles”, namely privity and nominalism.<sup>83</sup> Communication is bilateral and functions to reduce complexity due to the application of the legal doctrine of privity. Privity, every student of contract law will know, binds parties to a contract and limits the reach of the contract to those parties. Thus, a contract is generally said not to have implications for third parties. While a myriad of parties are involved in securities holding and transfers, privity “orders this complexity into simple pairwise relationships”.<sup>84</sup> Privity in the particular context of financial markets, Sommer finds, is both structural and causal. It is structural because it significantly reduces the number of relations and also enables parties to avoid relationships.<sup>85</sup> Privity is causal, Sommer writes because it “does to account relationships what negotiability does to property relations. The doctrine of privity cuts off adverse claims, and abolishes the relevant history of the account”.<sup>86</sup> Ordinary privity therefore keeps non-transacting parties out of the holding chain.<sup>87</sup> In addition, the law of financial accounts knows vertical privity, which ensures that each holding tier can be conceived of separately,

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<sup>78</sup> 706. Sommer contrasts with this a transfer by assignment, but states that this does not affect intermediaries; see n 42.

<sup>79</sup> Sommer (1998) *Bus L* 1192-1193.

<sup>80</sup> He for example refers to the statement contained in article 8 UCC that security entitlements are property; see 1193.

<sup>81</sup> 1197.

<sup>82</sup> 1197.

<sup>83</sup> JH Sommer “Commentary: Where is the Economic Analysis of Payment Law?” (2008) 83 *Chi-Kent LR* 751 754.

<sup>84</sup> 754.

<sup>85</sup> 755.

<sup>86</sup> 755.

<sup>87</sup> Sommer (1998) *Bus L* 1205.

thereby cutting off claims to higher tiers.<sup>88</sup> Privity, unlike communication, also exceeds the dyadic relation between two parties; Sommer describes it as a triad, namely “two parties and a system of law”.<sup>89</sup> Privity has exceptions of course; insolvency may be one of them, creditor’s rights another.<sup>90</sup> Adverse claims are another exception; they may, however, be brought only in exceptional circumstances.<sup>91</sup> An adverse claim, Sommer finds, is not only an exception to the privity principle, but also to the communicative nature of accounts, because it inevitably involves assertions external to the parties.<sup>92</sup> However, the need for privity is stronger in financial markets than elsewhere.<sup>93</sup> This is reflected by the need, for example to insulate an intermediary relation from the intermediary’s creditors; in this context absolute privity is maintained.

Sommer sees the second element of negotiability mirrored in the principle of nominalism. By nominalism he means super-formalism. Authentic communications result in an attribution of rights to certain persons based solely on the data content of- and the rule-framework that governs the communication.<sup>94</sup>

While Sommer does not dwell on the property-contract question, he recognises that security entitlements are simply rights to sue, but also finds that they exhibit some proprietary characteristics.<sup>95</sup> One of them is the duty that rests upon intermediaries to maintain sufficient assets.<sup>96</sup> Another is that property binds third parties. Such a claim, he therefore finds, “straddles the distinction between property and contract”.<sup>97</sup> For this reason we frequently conceive of accounts as contractual between the parties and as proprietary against third parties.<sup>98</sup> What Sommer therefore has in mind when he describes accounts as proprietary is very similar to what Mooney and Rogers perceive of as “property”, namely some type of third-party effect.

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<sup>88</sup> 1204.

<sup>89</sup> 1205.

<sup>90</sup> Sommer (2008) *Chi-Kent LR* 756.

<sup>91</sup> Sommer (1998) *Bus L* 1211.

<sup>92</sup> Sommer (2001) *Ariz J Int & Com L* 704.

<sup>93</sup> 756.

<sup>94</sup> Sommer (2009) *Chi-Kent LR* 757. In negotiability, this function is achieved through possession and the delivery of possession.

<sup>95</sup> Sommer (1998) *Bus L* 1201; Sommer (2001) *Ariz J Int & Com L* 696.

<sup>96</sup> Sommer (2001) *Ariz J Int & Com L* 696.

<sup>97</sup> 696.

<sup>98</sup> 696.

Furthermore, Sommer's suitcase analogy must be noted.<sup>99</sup> Sommer suggests that the underlying rights, in other words shares, are the contents of a suitcase. The account, and with it the rules and laws that govern its existence and operation, are the suitcase. When shares are held or transferred the contents of the suitcase are of little consequence. The features of the suitcase – its weight, volume, shape – matter. To Sommer the law of securities transfer and holding is the suitcase. An account, like the paper before it, is therefore simply a vehicle by which assets are held and conveyed.

The law of accounts applies not only to indirectly held securities; it is at the same time an attempt to distil general principles that apply to all rights held in or through accounts, including money. Rights in a financial setting, Sommer points out, have oscillated between being “embodied” and “account-based”.<sup>100</sup> The next shift, he predicted in 2000, may well be back to “embodied-rights” if we can devise of the technology to link a unique electronic token to an unassailable electronic register.<sup>101</sup>

16 2 3 Jeanne Schroeder

The continued reference of American scholars to “proprietary interests” while at the same time avoiding the recognition of property as a system may be traced back to Hohfeld, legal realism and the bundle of sticks theory. In this sense, the debate on property rights in securities is therefore representative of the general status of property in US law. Schroeder is highly critical of this “supposed disaggregation of property” advanced by theorists who believe that “modern property is not a unitary right, but merely a bundle of sticks”.<sup>102</sup> She similarly rejects Hohfeld's dismissal of the legal object in property.<sup>103</sup> This, she writes, is a denial of the “objective aspect of property”, which erases any unique and identifiable characteristics of property.<sup>104</sup> Schroeder argues that “objects” of property exist, but she finds that the UCC

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<sup>99</sup> 689.

<sup>100</sup> JH Sommer “Against Cyberlaw” (2000) 15 *Berkeley Tech LJ* 1145 1172.

<sup>101</sup> 1172-1173.

<sup>102</sup> JL Schroeder “Death and Transfiguration: The Myth that the U.C.C. Killed ‘Property’” (1996) 69 *Temple LR* 1281 1282.

<sup>103</sup> Schroeder does not explicitly reject Hohfeld's system of jural conceptions in terms of which legal relations always exist between legal subjects, not between subjects and objects. She rather criticises the second part of Hohfeld's theory in which he rejected the view that some legal relations can also relate to an object; see 1285-1286.

<sup>104</sup> 1283.

recognises,<sup>105</sup> that such objects can be legal creations; thus intangibles can be objects of property rights.<sup>106</sup> The crux of Schroeder's argument is therefore the rejection of the "physical metaphor" of property. This, she writes is a conflation of the "symbolic" with the "real".<sup>107</sup> Something that is "real" has either a physical existence or it exists outside of, or prior to, the law.<sup>108</sup> The law, however, is purely symbolic.<sup>109</sup> Property cannot exist without the law mediating between a subject or subjects and an object.<sup>110</sup> Conceived of as a legal concept, property is therefore symbolic; a mere fiction.<sup>111</sup> Property nonetheless has reality. Schroeder argues that the fiction of property has utility in that property gives "structure and meaning to our lives".<sup>112</sup> Property insinuates a level of authenticity and permanence that cannot be provided by the symbolic alone – for this reason we identify the "real" i.e. the object of property, with the "symbolic", the law of property.<sup>113</sup> Schroeder sets out to dispel the physical metaphor, but she denies that the recognition of property as symbolic rather than real leads to its disintegration. Repudiating that property is "real" does not mean that it does not have reality.<sup>114</sup> As a symbolic creature, property "has reality in that it performs a coherent function in our legal and economic practices".<sup>115</sup> Despite being symbolic, property has an "objective existence ... in the sense that it is played out in our actual, concrete, intersubjective economic and legal practices".<sup>116</sup>

The physical metaphor was readily apparent from the treatment of shares as negotiable instruments where the certificate as the "real" element was conflated with the "symbolic" notion of property.<sup>117</sup> Commenting on the revised Article 8, Schroeder finds that the drafting was premised on precepts of legal realism in that the process duly recognised the interaction between law and practice.<sup>118</sup> Article 8 takes, what

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<sup>105</sup> In this contribution, Schroeder analyses property in the broader context of the UCC, not specifically in relation to Article 8.

<sup>106</sup> 1287.

<sup>107</sup> Schroeder (1996) *Temple LR* 1287 bases her argument on the philosophy of Hegel and the psychoanalysis of Lacan. Also see JL Schroeder "Chix Nix Bundle-O-Stix: A Feminist Critique of the Disaggregation of Property" (1994) *Michigan LR* 239 252-255.

<sup>108</sup> Schroeder (1996) *Temple LR* 1287.

<sup>109</sup> 1287.

<sup>110</sup> 1288.

<sup>111</sup> 1288.

<sup>112</sup> 1288.

<sup>113</sup> 1288.

<sup>114</sup> 1289.

<sup>115</sup> 1289.

<sup>116</sup> 1339.

<sup>117</sup> See Schroeder (1994) *Columbia Bus LR* 291 303-305, 311.

<sup>118</sup> 351-352.

she terms a “transactional approach” by firstly identifying the transactions common in financial markets and as a second step prescribing legal effects that fit market practices.<sup>119</sup> Article 8 should be understood against this background. It does not represent an attempt at characterisation and therefore eludes any categorisation according to the traditional paradigms of property and obligations. Yet, a rejection of the traditional property paradigm does not equal an elimination of property rights in securities. Schroeder clearly identifies property aspects of securities, such as possession (in the sense of control and the right to exclude), enjoyment (in that all benefits must be passed down by intermediaries), and alienation.<sup>120</sup> Market practices dictate that these proprietary aspects are not always absolute. In addition, not all elements of security entitlements are proprietary in the first place; thus the *sui generis* nature of security entitlements.<sup>121</sup>

Schroeder may reject the legal realists’ approach to the unbundling of property, yet she endorses their functional methodology. This is reflected in her description of the “objective existence” of property as well as in her analysis of revised Article 8 as a more precise rendition of market practices and legal effect. Realism is regularly associated with a functional or pragmatic approach to law.<sup>122</sup> In fact, the reform project of Article 8 is a compelling illustration of the lasting impact of realism on American law, or how Singer formulates it: “The slaying of conceptualism has been quite successful”.<sup>123</sup> Realism rejected abstract concepts such as title and property for their vagueness, indeterminacy and contestability.<sup>124</sup> This is the aspect of the realist project that Schroeder rejects. She argues that the UCC, even in rejecting property terminology and the application of traditional property rules and analysis to many issues that arise, still retains an overarching system of property.<sup>125</sup> The realist project also sought to understand legal rules within their particular social, moral, institutional and policy context.<sup>126</sup> This latter aspects is most commonly associated with the functional element of legal realism. Singer identifies another aspect that is also reflected in revised Article 8, namely the aim of realists to make rules more context

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<sup>119</sup> 357.

<sup>120</sup> 367-368.

<sup>121</sup> 369.

<sup>122</sup> See in general, L Kalman *Legal Realism at Yale, 1927 – 1960* (1986); JW Singer “Legal Realism Now” (1988) 76 *California LR* 465 (a review of Kalman’s book).

<sup>123</sup> Singer (1988) *California LR* 475.

<sup>124</sup> 469, 470.

<sup>125</sup> Schroeder (1996) *Temple LR* 1290.

<sup>126</sup> Singer (1988) *California LR* 468, 469.

specific and thus to recognise that certain transactions, in this case the holding and transfer of securities, are unlike others.<sup>127</sup>

To conclude this analysis it must be mentioned that Schroeder points out, that for legal purposes outside the realm of securities holding and transfer, the law regularly reverts to the traditional common law terminology and classification of an entitlement holder as a beneficial owner.<sup>128</sup> This is typically the case in terms of state corporation laws and it indicates that there are spheres where the traditional paradigms do apply.

### 16 3 Perspectives from German law

#### 16 3 1 Securities as “Wertrechte”

Parallel to the development of global certificates and collective custody, German law saw the emergence of securities, notably government bonds, being issued without certificates. Through legislative intervention these uncertificated instruments were made equal to other certificated securities in that the framework of the law of things was made to apply to them as well. This practice contradicts the materialisation theory, which holds that the provisions of the law of things can only apply to securities if they have a real tangible existence and thus the certificate takes prevalence over the rights embodied therein.<sup>129</sup> The uncertificated rights were termed “Wertrechte” (securitised rights), a term thought to have been coined by Opitz.<sup>130</sup> Not only has this development elicited deliberations about the theoretical justification for placing securitised rights under the umbrella of the law of things, but it has also prompted critical voices to question whether the continued certification of securities is still appropriate. These two debates will briefly be considered in turn.

A central register for government bonds and other securities issued by the state and therefore a book-entry system for such securities is not novel – it has existed in Germany at least since 1891.<sup>131</sup> Brink shows that the transfer of such book-entry

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<sup>127</sup> 471.

<sup>128</sup> Schroeder (1994) *Columbia Bus LR* 371.

<sup>129</sup> See, 8 3 4 2 “Wertpapiere” and the materialisation of intangible rights, especially the text to nn 248-257.

<sup>130</sup> See G Opitz “Wertrechte und Wertpapiere” in G Opitz *Fünfzig depotrechtliche Abhandlungen* (1954) 426 (original publication in 1941).

<sup>131</sup> For the historical development see U Brink *Rechtsbeziehungen und Rechtsübertragung im nationalen und internationalen Effektenverkehr* (1976) 29-33.

securities was effected on the basis of the law of obligations.<sup>132</sup> Good faith purchases were therefore largely impossible.<sup>133</sup> It was only on the 31<sup>st</sup> of December 1940 that the rules regarding the deposit and administration of collectively administered book-entry securities and securities held in collective deposit were equated.<sup>134</sup> The legal significance of this step was that book-entry securities were removed from the sphere of obligations and were henceforth subjected to the rules of the law of things.<sup>135</sup> Book-entry securities continue to exist in this form in Germany and their issue is recorded in a public, central register that is said to be comparable to the deeds register.<sup>136</sup> Such securities are known as “Schuldbuchforderungen” and the creditor’s rights recorded in this manner by book-entry are referred to as securitised rights.

Opitz recognised that, dogmatically, it is the physical manifestation that transforms a claim, creditor’s right or membership right into a right that may be alienated and vindicated in accordance with the rules of the law of things. Even if the certificate therefore has a merely servient function, the claim is inextricably linked to the paper.<sup>137</sup> According to Opitz, the elimination of the certificate nonetheless did not result in the theoretical reconceptualisation of such securities from proprietary- to obligatory instruments.<sup>138</sup> He found the reason in the German trust (“Treuhand”), which rests on a proprietary basis.<sup>139</sup> A securitised right therefore only comes into

<sup>132</sup> Brink *Effektengiroverkehr* 31-33.

<sup>133</sup> Brink *Effektengiroverkehr* 31-33; D Einsele *Wertpapierrecht als Schuldrecht: Funktionsverlust von Effektenurkunden im internationalen Rechtsverkehr* (1995) 17-18.

<sup>134</sup> See, Verordnung über die Behandlung von Anleihen des Deutschen Reichs im Bank- und Börsenverkehr vom 31. Dezember 1940. Also see Brink *Effektengiroverkehr* 33; Einsele *Wertpapierrecht als Schuldrecht* 18.

<sup>135</sup> G Opitz *Depotgesetz: Gesetz über die Verwahrung und Anschaffung von Wertpapieren vom 4. Februar 1937* 2 ed (1955) 447-448, § 42 [12]; Brink *Effektengiroverkehr* 34; Einsele *Wertpapierrecht als Schuldrecht* 18.

<sup>136</sup> K Peters “Bucheffecten – eine Alternative zum Wertpapier? Möglichkeiten einer Weiterentwicklung des Effektenwesens” (1976) 35 *WM* 890 892.

<sup>137</sup> Opitz “Wertrechte und Wertpapiere” in Opitz *Fünfzig depotrechtliche Abhandlungen* 426.

<sup>138</sup> 430.

<sup>139</sup> Opitz “Wertrechte und Wertpapiere” in Opitz *Fünfzig depotrechtliche Abhandlungen* 431. In German law, as in the common law, there is recognition that “[o]ne main problem both in understanding and in conceptualizing trust and *Treuhand* is that contractual and property elements seem strangely intertwined in them”; see S Grundmann “The Evolution of Trust and *Treuhand* in the 20<sup>th</sup> Century” in R Helmholz & R Zimmermann *Itinera Fiduciae: Trust and Treuhand in Historical Perspective* (1998) 469 469. Indeed, Opitz recognises that one would have to test whether and to which extent the “Verwaltungstreuhand” can be placed under the rubric of property; Opitz “Wertrechte und Wertpapiere” in Opitz *Fünfzig depotrechtliche Abhandlungen* 431. Grundman, however, points out that towards the end of the 20<sup>th</sup> century the contractual question took precedence in Germany. While in Anglo-American law beneficial interests are today consistently treated as property, German law follows a more contextual approach in terms of which beneficial interests can at times be

existence if uncertificated rights are deposited with an intermediary who holds them in collective deposit, in other words where the intermediary acts as a trustee.<sup>140</sup> This, Opitz argues, is a special type of trust in terms of which the trustee does not become owner of the rights, but instead fulfils an administrative function which makes him appear as an owner, but actually endows him only with the ability to exercise and enforce rights.<sup>141</sup> On this basis he places securitised rights within the realm of the law of things, even if there is no special legislative provision to this effect.<sup>142</sup> The general legal definition of things, Opitz posits, has therefore been expanded to include not only corporeal objects, but also such objects that can be equated to corporeal objects.<sup>143</sup>

The legal classification of securitised rights has always given rise to debate. The thrust of general opinion agrees that the equal treatment of book-entry securities and collective securities in terms of which securitised rights are attributed a “thingness” usually characteristic of corporeal objects, is based on a legal fiction (“Gleichstellungsfiktion”).<sup>144</sup> In the context of this fiction, Opitz and others suggest a “Verdinglichung” (reification)<sup>145</sup> of obligations.<sup>146</sup> The reification theory is disputed by

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proprietary and at times contractual. More specifically, he writes that “[t]he German Treuhand bestows protection on third party relationships only if specific legislative policies can be found”. See Grundmann “Evolution of Trust and Treuhand” in Helmholz & Zimmermann *Itinera Fiducia* 477-478 as well as S Grundmann “Trust and Treuhand at the End of the 20<sup>th</sup> Century: Key Problems and Shift of Interests” (1999) 47 *Am J Comp L* 401 404. But also see, n 144 below.

<sup>140</sup> Opitz *Depotgesetz* 446, § 42 [12].

<sup>141</sup> Opitz *Depotgesetz* 446, § 42 [12]. Also see W Zöllner “Zurückdrängung des Verkörperungselements bei den Wertpapieren” in L Raiser & F Baur (eds) *Funktionswandel der Privatrechtsinstitutionen: Festschrift für Ludwig Raiser zum 70. Geburtstag* (1974) 249 257.

<sup>142</sup> Opitz *Depotgesetz* 451, § 42 [12C]: “Schließlich hat die gesetzliche Regelung des Schuldbuchgiroverkehrs nichts anderes gebracht als die Bestätigung dessen, was ohnehin schon rechtens war”. But see, n 139 above.

<sup>143</sup> Opitz “Wertrechte und Wertpapiere” in Opitz *Fünfzig depotrechtliche Abhandlungen* 538; Opitz *Depotgesetz* 452, § 42 [12C] also quoting G Dulckheit *Die Verdinglichung obligatorischer Rechte* (1951).

<sup>144</sup> H-P Schwintowski “§ 16 Depotgeschäft” in H-P Schwintowski (ed) *Bankrecht 4 ed* (2014) 772, § 16 [50]; Einsele *Wertpapierrecht als Schuldrecht* 19; H Delorme “Vom Wertpapier zum Wertrecht” (1981) 9 *Die Bank* 431 435; T Heinsius, A Horn & J Than *Depotgesetz* (1975) 662, § 42 [26]; F Fabricius “Zur Theorie des stückelosen Effekten giroverkehrs mit Wertrechten aus Staatsanleihen” (1963) 162 *AcP* 456 465-466; R Büchner *Die treuhandrechtliche Organisation des Effekten giroverkehrs* (1956) 188. Today, the basis for this fiction is however not considered to be a “fiduziarische Treuhand”, as initially argued by Opitz, but rather the “Ermächtigungstreuhand”, in terms of which a right (“Vollrecht”) is not transferred to a trustee, but the trustee is rather endowed with certain administrative powers such as the right to collect benefits. See especially Büchner *Effekten giroverkehr*; Peters (1976) *WM* 893-895; Heinsius et al *Depotgesetz* 659, § 42 [23]; also see below, n 44. Einsele *Wertpapierrecht als Schuldrecht* however petitions for the introduction of a model based on the “fiduziarische Treuhand” similar to the common law trust. This model will not be discussed further, especially considering that it has not had much of an impact on the debate and legal development.

<sup>145</sup> Reification is not intended in this context to mean a conversion from corporeal to incorporeal as is the case when rights are reified in negotiable instruments for example, but rather refers to a

others, most prominently Canaris, who argues that the application of the rules of the law of things as contained in the BGB is not direct, as some of the essential requirements for the application of the relevant provisions are absent, most notably corporeality. The rules must therefore rather be said to apply by analogy.<sup>147</sup> According to Canaris a reification of obligatory rights does not take place as the mere fact that a right is made subject to the rules of the law of things does not imply that such a right is, or becomes real.<sup>148</sup>

The replacement of individual certificates with global certificates held collectively ignited a discussion of whether the theory of securitised rights can and should be extended more broadly to all securities. Authors such as Zöllner, Canaris and Fabricius strongly criticised the institution of the global certificate, arguing that from a practical perspective, the certificates no longer fulfil any of its traditional functions. While the certificate has always had a merely servient function in that the content and value of the rights, not the paper, were decisive, the certificate aided, for example, the transferability of the rights as well as legitimated the performance by the company to the holder thereof.<sup>149</sup> Where securities are immobilised in a global certificate these functions fall away and factually a book entry takes the place of the certificate. In the literature this development is termed the “Funktionsverlust der Urkunde”.<sup>150</sup> Zöllner therefore described the collective or global certificate as a mere “Denkbehelf” or “geistige Krücke”.<sup>151</sup> Canaris labelled the development a “lazy compromise”, dogmatically-speaking, with tradition<sup>152</sup> and Fabricius described it as a

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transformation in terms of which they exhibit characteristic of real rights. But on Opitz’s approach, see Fabricius (1963) *AcP* 464 in n 146 below.

<sup>146</sup> See for example Opitz “Wertrechte und Wertpapiere” in Opitz *Fünfzig depotrechtliche Abhandlungen* 434 “depotrechtlich verdinglicht”. Also see Opitz *Depotgesetz* § 42; Büchner *Effektengiroverkehr* 197,201. Fabricius, on the other hand, sees in Opitz’s theory a “Sachwerdung” (materialisation in terms of which obligations become corporeal things) of obligations rather than their “Verdinglichung”; see Fabricius (1963) *AcP* 464.

<sup>147</sup> Also Einsele *Wertpapierrecht als Schuldrecht* 19-20, who terms this approach a “Rechtsfolgeanordnung” – i.e. merely aimed at a specific legal result; I Koller “Der gutgläubige Erwerb von Sammeldepotanteile an Wertpapieren am Effektengiroverkehr, 1. Teil” (1972) *Der Betrieb* 1857 1494; Brink *Effektengiroverkehr* 35-36.

<sup>148</sup> C-W Canaris “Die Verdinglichung obligatorischer Rechte” in HH Jakobs, B Knobbe-Keuk, E Picker & J Wilhelm (eds) *Festschrift für Werner Flume zum 70. Geburtstag I* (1978) 371 374.

<sup>149</sup> For more detail, see above, 8 1 The functions of the share certificate.

<sup>150</sup> In addition to the sources immediately below, also see more recently M Lehmann *Finanzinstrumente: Vom Wertpapier- und Sachenrecht zum Recht der unkörperlichen Vermögensgegenstände* (2009) 16.

<sup>151</sup> Zöllner “Zurückdrängung” in Raiser & Baur *Festschrift für Ludwig Raiser* 255.

<sup>152</sup> C-W Canaris *Bankvertragsrecht II* 3 ed (1988) § 2042.

“detour”.<sup>153</sup> These scholars therefore advocated for the transformation of collective deposit (“Sammelverwahrung”) to a system of collective administration or management (“Sammelverwaltung”). Against the backdrop of the development of securitised rights in conjunction with the loss of the functional relevance of certificates, it was contended that certification is no longer imperative – neither from a practical nor from a legal perspective.<sup>154</sup> The contribution to this debate of Zöllner in particular, will be considered in more detail immediately below. The more recent works of Micheler and Lehmann will likewise be examined.

Other academic commentators rejected the complete abandonment of certificates on the basis that the expected rationalisation would be negligible considering that the costs of printing and administering global certificates are manageable and that the establishment of a register would in turn attract significant costs.<sup>155</sup> In addition, it was pointed out that a book-entry system requires that the register be administered by a neutral and unbiased third-party.<sup>156</sup> Than cautioned that the blanket introduction of an account-based system may be risky in an international context; thus any change must be underscored by an adequate legislative foundation.<sup>157</sup> In effect the impetus for a dematerialisation of securities must originate in the market which, owing to the insignificant potential for cost-saving and rationalisation, is currently content with the system of dematerialised global certificates which continue to exist alongside dematerialised public debt instruments.

### 16 3 2 Wolfgang Zöllner

Zöllner examined whether the functional aims of certificates can also be attained through book-entries. In doing so he argued for a modification of some of the central tenets of the term “Wertpapiere”<sup>158</sup> and also critically questioned whether, in the absence of any physical token, the continued legal categorisation under the law of

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<sup>153</sup> Fabricius (1963) *AcP* 481.

<sup>154</sup> Zöllner “Zurückdrängung” in Raiser & Baur *Festschrift für Ludwig Raiser* 255.

<sup>155</sup> D Einsele “Wertpapiere im elektronischen Bankgeschäft” (2001) 1 *WM* 7 10; Koller (1972) *Betrieb* 1498.

<sup>156</sup> Einsele (2001) *WM* 10; Koller (1972) *Betrieb* 1499; S Kümpel “Ablösung der ‘Wertrechte’ durch (Dauer)Globalurkunden? Zu den Reformvorschlägen für das Wertpapierrecht” (1982) 27 *WM* 730 733-735.

<sup>157</sup> J Than “Wertpapierrecht ohne Wertpapiere” in N Horn, H-J Lwowski & G Nobbe (eds) *Bankrecht – Schwerpunkte und Perspektiven: Festschrift für Herbert Schimansky* (1999) 821 835-836.

<sup>158</sup> Zöllner “Zurückdrängung” in Raiser & Baur *Festschrift für Ludwig Raiser* 268-271; 285.

things could be said to be appropriate.<sup>159</sup> A detailed exposition of the first aspect would be too lengthy without adding much substance to the core question under consideration here, namely the impact of a (possible) dematerialisation on the property-obligations dichotomy. In considering the objective of “transactional security” (“Verkehrsschutz”),<sup>160</sup> he found that, correctly construed in the modern context, “transactional security”, as a type of protection of legitimate expectations, is founded on trust.<sup>161</sup> Possessory constructs, on the other hand, have become irrelevant.<sup>162</sup> A statutory solution should therefore abandon contemplations founded in the law of things.<sup>163</sup> Any legal order, Zöllner argued, may determine the scope of “transactional security” independently of the existence-, or movement of corporeal things.<sup>164</sup> He therefore advocated for a model of transactional security tailored specifically to the demands of uncertificated, dematerialised securities.<sup>165</sup> To enable the easy and efficient transfer of securities, it makes no difference, according to Zöllner, whether the root of the transfer is a certificate held in collective deposit or an obligation recorded in a register.<sup>166</sup> Even the co-ownership interest put forward in the Depotgesetz, he argued, comes within the grasp of the law of obligations if viewed from the angle of accounting.<sup>167</sup> Zöllner is careful to point out that he sees no blurring of the boundaries between the law of things and the law of obligations.<sup>168</sup> His suggestions have rather been interpreted as an appeal to recognise uncertificated instruments as being *sui generis* in nature.<sup>169</sup>

### 16 3 3 Eva Micheler

The broad outlines of the approach taken by Micheler have been sketched above.<sup>170</sup> It must be noted that her argument applies equally to German law. Micheler

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<sup>159</sup> 258-259.

<sup>160</sup> On transactional security, see above, 8 4 2 “Verkehrsschutz” and the protection of bona fide purchasers in German law.

<sup>161</sup> Zöllner “Zurückdrängung” in Raiser & Baur *Festschrift für Ludwig Raiser* 267.

<sup>162</sup> 267.

<sup>163</sup> 267.

<sup>164</sup> 282-283.

<sup>165</sup> 284.

<sup>166</sup> 259-260.

<sup>167</sup> Zöllner “Zurückdrängung” in Raiser & Baur *Festschrift für Ludwig Raiser* 260. Also see I Koller “Wertpapierrecht” in Bundesministerium der Justiz (ed) *Gutachten und Vorschläge zur Überarbeitung des Schuldrechts II* (1981) 1427 1493.

<sup>168</sup> Zöllner “Zurückdrängung” in Raiser & Baur *Festschrift für Ludwig Raiser* 260.

<sup>169</sup> Koller “Wertpapierrecht” in *Gutachten* 1494.

<sup>170</sup> See above, 16 1 3 Eva Micheler.

meticulously shows how the German law on “Wertpapiere” follows the law of things, but transcends its requirements in important ways. She therefore argues that the existing transfer rules for “Wertpapiere” should be applied to dematerialised instruments in totality by analogy and not through the intervention of assumptions of the possession of physical certificates.<sup>171</sup> Her approach differs from Zöllner’s in that she does not argue for a system of unique rules “outside” the traditional categories of property and obligations, but posits that traditional property rules and mechanisms continue to apply, but by analogy, not through the “gate” of corporeality. Micheler herself categorises her solution as *de lege lata* – a solution that falls back on the law in its existing form and does not require development of the law *de lege ferenda*.<sup>172</sup> Her solution has often been criticised for its lack of doctrinal justification.<sup>173</sup>

#### 16 3 4 Matthias Lehmann

Lehmann similarly identifies the momentous change that financial markets have experienced over the past decades; changes which have not left securities unscathed. The first part of Lehmann’s critique aims to demonstrate that the existing law on securities (“Wertpapierrecht”) is antiquated. It does not take into account that certificates have lost their function,<sup>174</sup> ignores the increasing internationalisation of the trade in securities<sup>175</sup> and provides an inadequate framework for the creation of new financial instruments.<sup>176</sup> The first part of his solution jettisons the existing category of “Wertpapiere” and suggests the creation of a new category of “financial instruments” (“Effekten”/“Finanzinstrumente”).<sup>177</sup> Lehmann’s proposal therefore goes a step further than the suggestions of Zöllner and others to abandon physical certificates in conjunction with a modification of the definitional- and terminological margins of “Wertpapiere”. He designs a system in terms of which all instruments traded on financial markets are grouped together. Dogmatically, the resulting “law of financial instruments” is not located “between” or even “outside” the existing categories of subjective rights. Rather, Lehmann strongly criticises the existing law of

<sup>171</sup> Micheler *Wertpapierrecht zwischen Schuld- und Sachenrecht* 184.

<sup>172</sup> 181.

<sup>173</sup> See for example Lehmann *Finanzinstrumente* 182; S Meppen *Das Inhaberpapier: Von der Verbriefung zum unverbrieften Wertrecht?* (2014) 186.

<sup>174</sup> Lehmann *Finanzinstrumente* ch 2 § 3.

<sup>175</sup> Ch 2 § 4.

<sup>176</sup> Ch 2 § 5.

<sup>177</sup> 3; 8-9.

things for its preoccupation with corporeality.<sup>178</sup> The consequential rejection of all incorporeal assets from the category of things, Lehmann argues, results in the ill fit of the modern German securities deposit- and trading systems with the law of things.<sup>179</sup> Lehmann therefore remains loyal to the “law of things”, but suggests that it be reformed to a “law of property” in the wide sense to accommodate the inclusion of incorporeal assets such as the instruments that populate his newly created category. This is the second part of his solution. The solution represents his attempt to avoid the trap into which Micheler, in his opinion, fell: Corporeality is a prerequisite for the application of the German law of things. To overcome the problems connected to the materialisation of “Wertpapiere” it is insufficient to abandon certificates and apply the law of things by analogy. A more fundamental criticism of the dogmatic structure of the law of things is called for.<sup>180</sup> In developing his criticism, Lehmann considers the bases for the distinction between the law of obligations and the law of things. For reasons that cannot be elaborated in any detail, he finds that the distinction can be drawn neither on the basis of content (personal vs real rights) nor effect (relative vs absolute rights).<sup>181</sup> The dichotomy, he argues, must be understood against the backdrop of the social functions of the two areas of the law, namely the movement of goods and the allocation of goods.<sup>182</sup> The distinction is contained in the idea that the law of obligations should regulate the passing of scarce resources, in the form of contractual ordering for example, and the law of things should allocate them.<sup>183</sup> While the former therefore pertains to a “right to receive” (“Bekommensollen”), the latter extends to an already-existing “have” (“Haben”).<sup>184</sup> The law of things must therefore allocate or determine legal positions clearly and unambiguously.<sup>185</sup> For this reasons its rules are said to be largely mandatory and operate absolutely.<sup>186</sup> Lehmann takes cognisance of the work of Wiegand, who argued that an integral function of the law of things is also circulation and therefore the passing of

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<sup>178</sup> Ch 4 § 9.

<sup>179</sup> 184.

<sup>180</sup> 183.

<sup>181</sup> 220.

<sup>182</sup> 218.

<sup>183</sup> Lehmann *Finanzinstrumente* 218. On this theory also see H Westermann *Sachenrecht 4 ed* (1960) 6-9; F Wieacker & C Wollschläger (ed) *Zivilistische Schriften (1934-1942)* (2000) 360-396. Specifically applied to “Wertpapiere”, see Fabricius (1963) *AcP* 469-475.

<sup>184</sup> Lehmann *Finanzinstrumente* 218-219.

<sup>185</sup> 219.

<sup>186</sup> 219.

resources.<sup>187</sup> Wiegand traced back this function to the law of property in the wide sense (“Vermögensrecht”) and it therefore applies to both the law of things and the law of obligations.<sup>188</sup> This does not mean, however, Lehmann posits, that the allocative function of the law of things should be dismissed. While Lehmann therefore approves of the distinction between the functions of “passing” and “allocation”, he sets out to show that a distinction on this basis has two key implications: Firstly, it shows that a sharp distinction between the law of obligations and the law of things is a fallacy.<sup>189</sup> Secondly, the restriction of the law of things to corporeals is not justified.<sup>190</sup> Incorporeals must be allocated to specific persons as well.<sup>191</sup> In fact, modern developments show that the allocation of incorporeals as items of wealth regularly exceeds that of the allocation of corporeal things.<sup>192</sup> As such the law of things, restricted as it is to corporeal objects, fails to fully fulfil its function of the allocation of resources.<sup>193</sup> Applied to the specific context of securities (“Wertpapiere”), Lehmann establishes the allocation of the securities to specific persons as a central purpose of the law on securities (“Wertpapierrecht”).<sup>194</sup> It shares this purpose with the law of things.<sup>195</sup> Through tracing this congruence of function, Lehmann seeks to, at once, highlight the need for, and justify a modification of the concept of “things”.

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<sup>187</sup> See W Wiegand “Die Entwicklung des Sachenrechts im Verhältnis zum Schuldrecht” (1990) 190 *AcP* 112 119. Also see Lehmann *Finanzinstrumente* 219.

<sup>188</sup> Wiegand (1990) *AcP* 119.

<sup>189</sup> Lehmann *Finanzinstrumente* 220.

<sup>190</sup> 220.

<sup>191</sup> Lehmann *Finanzinstrumente* 220. This is also the view of Westermann *Sachenrecht* 7-8: “In Wirklichkeit sind aber auch die Forderungen und andere Gegenstände genau so einer bestimmten Person zugeordnet. Sie sind auch mögliche Objekte von Zuordnungsgeschäften.” Westermann uses the example of a pledge of a claim. A pledge is a right with relative effect. At the same time it is the object of an allocation with absolute effect. Also see Fabricius (1963) *AcP* 471-473, who denies that allocation and passing of resources provide, on their own, a sufficient basis for drawing the distinction between the law of things and the law of obligations. He comes to the conclusion that, when considering the content of the rights as an additional factor i.e. that real rights establish a direct relationship of a person to an object, claims and other personal rights must be considered to also establish a direct relationship to an object. The object is not the obligation as such, but rather the interest of the creditor in the obligation of the debtor. This, he argues, is a legal object with which the creditor can deal to his liking including the right to exclude, in the same way as he can deal with a corporeal thing. This conclusion implies that the rights to incorporeals, including claims, are also objects that must be directly allocated to a legal subject.

<sup>192</sup> Lehmann *Finanzinstrumente* 220.

<sup>193</sup> 221.

<sup>194</sup> 224.

<sup>195</sup> 226.

## 16 4 Perspectives from South Africa

### 16 4 1 The case law

#### 16 4 1 1 Delineating the legal nature of shares

The dual nature of shares as both personal rights and incorporeal units is evident from South African case law.

In the early case of *McGregor's Trustees v Silberbauer*,<sup>196</sup> the question arose whether the seller had transferred shares to the buyer before becoming insolvent. In deciding the matter, the court equates shares to rights of action transferable by cession.<sup>197</sup> In *Randfontein Estates Ltd v The Master*,<sup>198</sup> the legal question was whether shares held by one person and registered in his name on behalf of another form part of his estate. Shares, it was found, are “simply rights of action – *jura in personam* – entitling their owner to a certain interest in the company, its assets and dividends”.<sup>199</sup> According to the court they “pass from hand to hand, and form the subject of many transactions without the original registration in the books of the company being disturbed”.<sup>200</sup>

Similarly, in *Liquidators Union Share Agency v Hatton*,<sup>201</sup> a share is described as “a *jus in personam*, a right of action, the extent and nature of which and the liability attaching to the ownership of which depend upon statute”.<sup>202</sup> Innes CJ further states that “[t]he common law also, where it is necessary to classify incorporeal rights as movable or immovable regards a *jus in personam* as movable...but that does not alter the juristic nature of such a rights, or its general characteristics”.<sup>203</sup> The nature of a share as a right of action and an incorporeal right was also emphasised by the court in *Jeffrey v Pollak and Freemantle*.<sup>204</sup>

One of the most influential statements on the legal nature of shares comes from a decision by Corbett JA in *Standard Bank of South Africa Ltd v Ocean Commodities*

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<sup>196</sup> 1891 9 SC 36.

<sup>197</sup> 38.

<sup>198</sup> 1909 TS 978.

<sup>199</sup> 981.

<sup>200</sup> 981-982.

<sup>201</sup> 1927 AD 240.

<sup>202</sup> 250.

<sup>203</sup> 252.

<sup>204</sup> 1938 AD 1 at 14.

*Inc.*<sup>205</sup> Corbett JA reasoned that “[a] share in a company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends”.<sup>206</sup> The “bundle of rights” idea runs like a golden thread through case law and literature following on *Ocean Commodities*. In *De Leef Family Trust v Commissioner for Inland Revenue*,<sup>207</sup> the court summarises that “[t]he nature of a share may be elaborated on by stating that it represents a complex of rights and duties of a shareholder”.<sup>208</sup> In *Cooper v Boyes*,<sup>209</sup> the court, after referring to prior cases and the literature, concludes that “it is clear that there is no simple definition of a share”.<sup>210</sup> “The various definitions emphasise a complex of characteristics which are peculiar to it. The gist thereof is that a share represents an interest in a company, which interest consists of a complex of personal rights which may, as an incorporeal movable entity, be negotiated or otherwise disposed of”.<sup>211</sup>

#### 16 4 1 2 Property language, remedies and mechanisms

##### 16 4 1 2 1 Vindication of shares

The *rei vindicatio* is the primary remedy by which ownership is protected in the law of property. It allows an owner to recover his property wherever he may find it. The *rei vindicatio* is a real remedy and is concerned with asserting ownership and restoring physical control over a *res*.<sup>212</sup> It is traditionally applied to the vindication of corporeal objects, both movable and immovable.<sup>213</sup> In the cases of *Oakland Nominees* and *Ocean Commodities* the possibility of vindicating shares was nevertheless contemplated by the court.

In *Oakland Nominees Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd*,<sup>214</sup> shares were misappropriated by a nominee and sold to a third party. The beneficial owner accordingly sought an order to declare him the owner of the shares. The buyer, on the other hand, sought to estop the plaintiff from making any

<sup>205</sup> 1983 1 SA 276 (A).

<sup>206</sup> 288H.

<sup>207</sup> 1993 3 SA 345 (A).

<sup>208</sup> 356G.

<sup>209</sup> 1994 4 SA 521 (C).

<sup>210</sup> 535B.

<sup>211</sup> 535B-C.

<sup>212</sup> AJ van der Walt & GJ Pienaar *Introduction to the Law of Property* 7 ed (2016) 163; ZT Boggenpoel *Property Remedies* (2017) 41.

<sup>213</sup> Van der Walt & Pienaar *Property* 164; Boggenpoel *Property Remedies* 42.

<sup>214</sup> 1976 (1) SA 441 (A).

claim for ownership and registration in the share register.<sup>215</sup> The defence of estoppel has been discussed and will not be analysed here.<sup>216</sup> More interesting is the question whether shares are capable of vindication. The court takes cognisance of the argument on behalf of the appellant (defendant) that shares, consisting entirely of rights *in personam*, are incapable of sustaining a *rei vindicatio*.<sup>217</sup> It was contended that the respondent (plaintiff) was not permitted to reclaim the shares by vindication from a party outside the contractual nexus. This line of argument was rejected by the court as being “at odds with the realities of the situation”,<sup>218</sup> and a “beneficial owner” deprived of ownership of shares was held to be entitled to bring an action for delivery of the shares or share certificates provided that such a claim is not defeated by a successful reliance on an estoppel.<sup>219</sup> The court asks:

“When a beneficial owner of shares finds that they have been stolen or, if you like, that the share certificates registered in the name of his nominee, have been stolen, must he bring an action asserting 'contractual rights *in personam* ' against his nominee? Or does he sue in the name of his nominee? Or must he first obtain, from his nominee, a transfer form signed in his favour? All this would stifle the effectiveness of the practical concept of a beneficial owner.”<sup>220</sup>

In *Standard Bank of South Africa Ltd v Ocean Commodities Inc*,<sup>221</sup> a claim was brought for the “delivery” of shares, which were at the time of institution of the action not in the “possession” of the respondents. The respondents were the beneficial owners of the shares and claimed delivery from their nominees.<sup>222</sup> Corbett JA recognised the conceptual difficulty of reconciling a claim based on a bundle of personal rights with a “true *rei vindicatio*”.<sup>223</sup> Nonetheless, he held that the claim brought by the respondents against the nominee was not merely the enforcement of a contractual right, but constituted delivery of shares. As a result “[t]here is thus much to be said for the view that the cause of action should be classified, or

<sup>215</sup> For a summary of the facts of the case see 450-451.

<sup>216</sup> See above, 8 4 5 Estoppel and the protection of bona fide purchasers in South African law.

<sup>217</sup> *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 (1) SA 441 (A) 461B-F.

<sup>218</sup> 462D.

<sup>219</sup> 462.

<sup>220</sup> 462D-E.

<sup>221</sup> 1983 1 SA 276 (A).

<sup>222</sup> See 277-278.

<sup>223</sup> 290A.

characterized, as one analogous to the *rei vindicatio* in respect of property situated within the jurisdiction”.<sup>224</sup>

Both cases exhibit the conceptual and terminological lacunae that may arise when personal rights also exist as incorporeal assets that circulate and behave in the market in a manner closely aligned to that of corporeal movables. The courts identify the need for a remedy that is functionally equivalent to the *rei vindicatio*, but at the same time acknowledge the lack of comparable tools in the law of obligations, to which shares belong.<sup>225</sup> Hence the great caution with which the courts use terms such as “ownership” and “*rei vindicatio*”, which are said to apply by analogy only. The assertion by the South African Law Reform Commission that the primary remedy at the disposal of the owner is the *rei vindicatio* is therefore misplaced.<sup>226</sup> The remedy applied by the courts, but obscured by the use of proprietary terminology, is as Lubbe points out, simply a declaratory order that is vindicatory in nature in that the beneficiary is declared the creditor of the company and the company is mandated to undertake all formal steps required to put the creditor on the register.<sup>227</sup>

#### 16 4 1 2 2 Quasi-possession and the mandament van spolie

A similar argument was made by the appellant in *Tigon Ltd v Bestyet Investments (Pty) Ltd*,<sup>228</sup> albeit in the context of the *mandament van spolie*. To reiterate the facts briefly: Bestyet was recorded on the register of Tigon as a member (today a shareholder) of a certain number of shares, which it held as a nominee. The ownership and holding of the Tigon shares had come about as a result of a sales transaction in terms of which the seller had sold shares, shareholder’s loan accounts and an interest in one company (EuroPoint Communications) to a second-tier subsidiary of Tigon, payable with shares in Tigon.<sup>229</sup> The Tigon shares were subject

<sup>224</sup> 294.

<sup>225</sup> Also see A Borrowdale “The Transfer of Proprietary Rights in Shares: A South African Distillation out of English Roots” (1985) 18 *CILSA* 36 45, who argues that the protection of ownership must take an “artificial form” because it is premised on the artificial division of ownership into benefit and ability to enforce.

<sup>226</sup> South African Law Reform Commission “Report on the Protection of a Purchaser of Securities” Project 62 (1993) 83.

<sup>227</sup> GF Lubbe “Sessie in securitatem debiti en die komponente van die skuldeisersbelang” (1989) 52 *THRHR* 485 487-498. Also see Borrowdale, who argues that the protection of ownership must take an “artificial form” because it is premised on the artificial division of ownership.

<sup>228</sup> 2001 4 SA 634 (N).

<sup>229</sup> 637F-H.

to a two-year restraint on dealing with the shares.<sup>230</sup> Five days before the expiry of the restraint Tigon notified Bestyet of the cancellation of the agreement of sale on the basis of its being void.<sup>231</sup> Tigon subsequently expunged the shares held by Bestyet from the register. Bestyet sought to have its name restored to the register on the basis of spoliation.<sup>232</sup> Tigon argued that the *mandament van spolie* is not applicable as the rights of a shareholder are personal in nature, not real.<sup>233</sup>

The *mandament van spolie* is a remedy aimed at ensuring that unlawfully deprived possession is restored in a timely manner. It protects factual possession, not property rights,<sup>234</sup> and as such the merits of the dispute are irrelevant.<sup>235</sup> The relief granted by the *mandament* is temporary until the dispute regarding the merits has been resolved. The remedy is said to prevent self-help.<sup>236</sup>

For a successful reliance on the *mandament*, an applicant must prove firstly, that he was in peaceful and undisturbed possession and secondly, that he was unlawfully deprived of such possession. Possession ordinarily requires physical control of a thing coupled with the intention to derive some benefit from such control.<sup>237</sup> South African law, however, recognises the *quasi*-possession of rights.<sup>238</sup> The extension of the remedy to incorporeal assets incapable of being physically controlled therefore attracted considerable debate.<sup>239</sup> In particular the extension of the *mandament* to incorporeals raises the questions as to what kind of rights are capable of being possessed, and, how are they possessed? The courts have repeatedly held that the *mandament van spolie* is not a “catch-all” remedy that extends to the *quasi*-

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<sup>230</sup> 637H.

<sup>231</sup> 637-638.

<sup>232</sup> 639.

<sup>233</sup> 640.

<sup>234</sup> *Bon Quelle (Edms) Bpk v Munisipaliteit van Otavi* 1989 1 SA 508 (A) 513; *Plaatjie v Olivier NO* 1993 2 SA 156 (O) 159F; *Firststrand Ltd t/a Rand Merchant Bank v Scholtz NO* 2008 2 SA 503 (SCA) 509 para 12; ZT Boggenpoel “Applying the Mandament van Spolie in the Case of Incorporeals: Two Recent Examples From Case Law” (2015) *TSAR* 76 76 n 2.

<sup>235</sup> *Plaatjie v Olivier NO* 1993 2 SA 156 (O) 159C; PJ Badenhorst, JM Pienaar & H Mostert *Silberberg and Schoeman’s The Law of Property* 5 ed (2006) 290.

<sup>236</sup> Also see AJ van der Walt “Nog Eens Naidoo v Moodley – ‘n Repliek” (1984) 47 *THRHR* 429, who argues that the *mandament* is aimed not at protecting possession, but at protecting the public order against disturbances of the peace; see n 247 below.

<sup>237</sup> Badenhorst et al *Silberberg & Schoeman’s Property* 276.

<sup>238</sup> *Nino Bonino v De Lange* 1906 TS 120; *Telkom SA Ltd v Xsinet (Pty) Ltd* 2003 5 SA 309 (SCA) 312-313 para 9. D Kleyn “The Protection of Quasi-Possession in South African Law” in E Descheemaeker (ed) *The Consequences of Possession* (2014) 185 190-191 traces this back to the Gaian tripartite division of the law that paved the way for the recognition of *quasi*-possession later received into Canon law and the *ius commune*.

<sup>239</sup> For some of the sources, see nn 246, 247 and 248 below.

possession of all rights. In particular, it is not appropriate where contractual rights are in dispute, particularly where specific performance of a contractual right is claimed.<sup>240</sup> The application of the remedy in the context of incorporeals is therefore often said to be restricted to two groups of cases, those of “servitudinal rights” and cases that exhibit certain “incidents of possession”.<sup>241</sup> Required for both is a close nexus between the use of a right and the possession of a corporeal thing.<sup>242</sup> A servitude, for example, is a right that exists over immovable property. In the second group of cases, services such as the provision of water and electricity relate to the possession of premises. From a review of two more recent cases on *quasi*-possession,<sup>243</sup> Boggenpoel therefore identifies the tendency of courts to focus on the characterisation of the nature of the right.<sup>244</sup> Furthermore it has been held that such *quasi*-possession is effected through the exercise or use of the right.<sup>245</sup>

The extension of the *mandament* did not find favour with all academic authors. While Sonnekus criticises the application of the remedy to incorporeals, which are historically and theoretically incapable of being possessed, he argues that it extends to some cases because they exhibit such an extraordinarily close link between the possession of the right and a corporeal thing, that any deprivation thereof actually amounts to a deprivation of the possession of the corporeal thing.<sup>246</sup> Van der Walt credits the extension of the *mandament* to what he perceives to be its purpose, namely the protection of the public order against disturbances of the peace.<sup>247</sup> Yet,

<sup>240</sup> *Firstrand Ltd t/a Rand Merchant Bank v Scholtz NO* 2008 2 SA 503 (SCA) 510 para 13; *Telkom SA Ltd v Xsinet (Pty) Ltd* 2003 5 SA 309 (SCA) 314 para 14; *Plaatjie v Olivier NO* 1993 2 SA 156 (O) 159; *Zulu v Minister of Works, Kwazulu* 1992 1 181 (D) 188H.

<sup>241</sup> See Kleyn “Quasi-Possession” in *Consequences of Possession*; Badenhorst et al *Silberberg & Schoeman’s Property* 296-297. Also see *Firstrand Ltd t/a Rand Merchant Bank v Scholtz NO* 2008 2 SA 503 (SCA) 510 para 13.

<sup>242</sup> Kleyn “Quasi-Possession” in *Consequences of Possession* 207.

<sup>243</sup> *Van Rhyen No v Fleurbaix Farm (Pty) Ltd* 2013 5 SA 521 (WCC) and *City of Cape Town v Strümpher* 2012 4 SA 207 (SCA).

<sup>244</sup> Boggenpoel (2015) *TSAR* 78, 80, 81, 82. Whether this determination precedes the application of the requirements for the *mandament* or forms part of the first requirement, as Boggenpoel suggests at 81, is probably neither here nor there. Kleyn “Quasi-Possession” in *Consequences of Possession* 204 however enquires whether some of the same results could not have been achieved without investigating the nature of the rights.

<sup>245</sup> *Bon Quelle (Edms) Bpk v Munisipaliteit van Otavi* 1989 1 SA 508 (A) 514H-I; *Telkom SA Ltd v Xsinet (Pty) Ltd* 2003 5 SA 309 (SCA) 312-313 para 9.

<sup>246</sup> JC Sonnekus *Sakereg Vonnisbundel* (1980) 54; JC Sonnekus “Mandament van Spolie – Kragtige Remedie by Kragonderbreking?” (1985) *TSAR* 331 337. But also see Hefer AR in *Bon Quelle (Edms) Bpk v Munisipaliteit van Otavi* 1989 1 SA 508 (A) 516C-E.

<sup>247</sup> Van der Walt (1984) *THRHR* 430; AJ van der Walt “Toepassing van die Mandament van Spolie op Onroerende Sake” (1986) *TSAR* 223 228.

he similarly views the presence of a corporeal thing as the boundary within which the remedy must operate.<sup>248</sup>

*Tigon v Bestyet* was decided against this backdrop. The court is well aware that the remedy cannot be applied to “purely” personal rights. It therefore examines the nature of the rights, finding firstly that the Companies Act designates shares to be “movable property”,<sup>249</sup> and secondly, that “a distinction (not always recognised) may be drawn between the share itself, which is an incorporeal movable entity, and the bundle of personal rights to which it gives rise”.<sup>250</sup> The court further concludes that registration, like holding, pledging, bequeathing and otherwise dealing with and in shares, is an instance of possession.<sup>251</sup> It concludes that expunging shares from a register without following proper procedure cannot be said to leave the rights of shareholder unaffected and therefore amounts to an unlawful deprivation of possession.<sup>252</sup>

The decision often goes unmentioned by recent contributions on *quasi*-possession and the *mandament van spolie*.<sup>253</sup> Both Van der Walt and Sutherland, as well as Larkin and Cassim point out that the court could have resolved the issue with reference to the right to be on the register without having to look into the nature of shares.<sup>254</sup> The main problem, however, that arises from the decision is that the court assumes that principles set out in *Bon Quelle* and other cases falling into the two categories set out above, apply seamlessly to the facts at hand. Even if the court attempts to show that shares transcend purely personal rights, it fails to recognise that the required (if indirect) link to corporeal things, present in the existing body of case law, is clearly missing. This is also the crux of the criticism by Van der Walt and Sutherland.<sup>255</sup> Consequently this case is a further extension of the *mandament*, but

<sup>248</sup> Van der Walt (1986) *TSAR* 223 228-229.; AJ van der Walt “Die Mandament van Spolie en Quasi-Besit” (1989) 52 *THRHR* 444 452-453.

<sup>249</sup> *Tigon Ltd v Bestyet Investments (Pty) Ltd* 2001 4 SA 634 (N) 642F.

<sup>250</sup> 642I-643A.

<sup>251</sup> 643A-B.

<sup>252</sup> 643B, 645D-E

<sup>253</sup> See for example Kleyn “Quasi-Possession” in *Consequences of Possession* and Boggenpoel (2015) *TSAR*. But see the case analysis by AJ van der Walt & PJ Sutherland “Dispossession of Incorporeals or Rights – Is the Mandament van Spolie the Appropriate Remedy?” (2003) 15 *SA Merc LJ* 95. Also see the short note by MP Larkin & FHI Cassim “Company Law (Including Close Corporations)” in *2001 Annual Survey of South African Law* (2001) 506 530.

<sup>254</sup> Van der Walt & Sutherland (2003) *SA Merc LJ* 101-102; Larkin & Cassim “Company Law” in *2001 Annual Survey* 532. Both sources also criticise the distinction drawn by the court between the share itself and the bundle of personal rights to which it gives rise.

<sup>255</sup> Van der Walt & Sutherland (2003) *SA Merc LJ* 98-102.

the court does not provide an adequate theoretical basis on which such an extension can rest. In addition, Van der Walt and Sutherland argue that the extension of the *mandament* is not warranted on policy grounds as the removal of a shareholder's name can hardly be said to trigger the purpose of the *mandament*, namely the protection against self-help and the maintenance of public order.<sup>256</sup> Lastly, the authors show that section 115 of the Companies Act<sup>257</sup> provided adequate relief where a shareholder's name is removed from the register through unilateral action.<sup>258</sup> While the relief granted through ordering the rectification of a register is at times compared to a spoliation order,<sup>259</sup> it is at most functionally equivalent.<sup>260</sup> The extension of the *mandament* to such cases is therefore not only "unnecessary and unwise",<sup>261</sup> but also demonstrates the conceptual difficulty of applying proprietary terms such as "possession" and "spoliation" to obligations.

#### 16 4 1 2 3 *Usufruct over shares*

Another decision that concerned the application of precepts of property law to shares, *Cooper v Boyes*, was received with much more enthusiasm than *Tigon v Bestyiet*.<sup>262</sup> The dispute in *Cooper v Boyes* arose following a testamentary bequest in 1984 in terms of which the testator's son (the plaintiff) was to receive one-half of the estate subject to a usufruct in favour of the testator's wife.<sup>263</sup> Included in the residue of the estate were shares. Unbeknown to the plaintiff, the usufructuary had disposed of some of the shares with the proceeds invested otherwise. The value of the shares had increased in the meantime and upon the death of the usufructuary a dispute

<sup>256</sup> 102-104. Also see above, n 247.

<sup>257</sup> Act 61 of 1973 (the corresponding section in Act 51 of 2008 is s 163(2)(k), but note that in the case of uncertificated shares the mechanisms of registration make a unilateral rectification virtually impossible. Also see s 53(5), which restricts the power of the courts to order rectification.

<sup>258</sup> Van der Walt & Sutherland (2003) *SA Merc LJ* 104-108.

<sup>259</sup> See *Rooibokoord Sitrus (Edms) Bpk v Louw's Creek Sitrus Koöperatiewe Maatskappy Bpk* 1964 3 SA 601 (T) 605A-B: "It may therefore be that the unilateral action of the company in erasing a person's name from the register would constitute taking the law into its own hands and amount to a spoliation, ie a deprivation of possession of the member's rights. There are dicta ... that suggest that that would be a spoliation or at any rate something analogous to it." Also see *Verrin Trust & Finance Corporation (Pty) Ltd v Zeeland House (Pty) Ltd* 1973 4 SA 1 (C) 10D: "It has been described as a summary jurisdiction (see Peer's case, supra at p. 617) and as providing a remedy analogous to a spoliation order".

<sup>260</sup> Van der Walt & Sutherland (2003) *SA Merc LJ* 106.

<sup>261</sup> 109.

<sup>262</sup> But see the critical contribution by E Leos "Quasi-Usufruct and Shares: Some Possible Approaches" (2006) 123 *SALJ* 126.

<sup>263</sup> *Cooper v Boyes* 1994 4 SA 521 (C) 522.

arose regarding the date of valuation of the shares.<sup>264</sup> If the shares had been the subject of a usufruct, ownership would have immediately vested in the ultimate beneficiary subject to the use and enjoyment of another person.<sup>265</sup> On this construction, the increase in value over time would therefore have accrued to the ultimate beneficiary. If the shares had been the subject of a *quasi*-usufruct, ownership would have vested in the usufructuary subject to a guarantee that the usufructuary would return an equivalent amount or quantity. Upon devolvement to the ultimate beneficiary the value would therefore be determined with reference to the time of the passing of the testator not the usufructuary.<sup>266</sup> Hence the question arose whether a usufruct or a quasi-usufruct is created in respect of shares.

From an array of Roman- and Roman-Dutch sources, the general principles of which have been received into South African law,<sup>267</sup> the court finds that a usufruct can be created over any property whether movable or immovable, corporeal or incorporeal. Exceptions are fungibles and consumables; these are subject to a quasi-usufruct considering the impossibility of maintaining the substance of the property.<sup>268</sup> The defendant argued in favour of classifying shares as consumables by virtue of their fluctuating value, the eventuality of liquidation of the company and the possibility of contingencies such as mergers, take-overs or a reduction or variation of share capital.<sup>269</sup> Determining the nature of shares as “a complex of personal rights which may, as an incorporeal movable entity, be negotiated or otherwise disposed of”, the court rejects the notion of shares as consumables.<sup>270</sup> Shares can therefore be subject to an ordinary usufruct.

The principles of the usufruct, by design and evolution, are not fixed on the pivot of corporeality. These cases therefore broach neither the difficult line of corporeality nor of effect. An application of the principles of usufruct therefore does not necessitate a reconsideration of the boundary between the law of property and the law of obligations, whether it is drawn on the basis of content or effect. In effect a court deciding a matter of this sort only has one question to consider: whether

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<sup>264</sup> 522E-H.

<sup>265</sup> 524C.

<sup>266</sup> 524C-D.

<sup>267</sup> 531G-H.

<sup>268</sup> See 523-532.

<sup>269</sup> 532G-H.

<sup>270</sup> 535B-E.

shares are incorporeal objects or property not in the nature of fungibles or consumables.

#### 16 4 2 The views of South African academic commentators

The legal nature of shares regularly receives no more than a cursory mention from most South African authors. Echoing the case law, they mostly agree that shares are personal rights, albeit not purely personal rights.<sup>271</sup> Yet there is no comprehensive and robust breakdown of what this might mean for legal theory or commercial practice. The legal nature of shares is predominantly analysed from the perspective of company law. As a result, there is scarce recognition and discussion of the private law aspects raised by this question. Furthermore, there is very little discussion on the implications that a change from certificated to uncertificated shares has on the legal nature of shares and its pursuant relationships.

Malan describes shares as personal rights, but emphasises that they “involve[s] more than a claim for repayment of a loan.”<sup>272</sup> In other words, a share is not simply a debt. He recognises the tensions inherent in shares and argues that a share is a personal right that is not only “a legally recognized relationship between a creditor and a debtor entitling the former to a performance by the latter”.<sup>273</sup> A share is “also a unit of wealth and as such similar to corporeal property forming part of a man’s estate”.<sup>274</sup> The nature of wealth, he writes, has “changed considerably during the past centuries”.<sup>275</sup> He therefore views critically the law’s continued fixation with corporeal assets as the primary units of wealth.<sup>276</sup> Difficulties with the use of terminology such as “ownership”, “possession” and the “pledge” of shares, according to Malan, can be traced back to the law’s preoccupation with corporeality.<sup>277</sup>

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<sup>271</sup> Shares are frequently described as “proprietary” or as “a form of property” – see M Sigwadi “The registration of securities under the new Companies Act 71 of 2008” in TH Mongalo (ed) *Modern Company Law for a Competitive South African Economy* (2010) 73 76. Also see RA de la Harpe “Securities Registration and Transfer (ss 49-56)” in JL Yeats (ed) *Commentary on the Companies Act of 2008* (OS 2018) 2-506 2-507, who finds that shares are “not ordinary personal rights” and in n 244 (n 3), that they are “bundle[s] of rights ... [that] nevertheless constitute property” and that “beneficial owners should be regarded as having real rights in such property”.

<sup>272</sup> FR Malan *Collective Securities Depositories and the Transfer of Securities* (1984) 147.

<sup>273</sup> 192.

<sup>274</sup> 192-193.

<sup>275</sup> 193.

<sup>276</sup> 193-194.

<sup>277</sup> 194.

According to *Hahlo's*, shares are clearly “objects of property which are bought, sold, mortgaged, bequeathed, even bequeathed by way of a usufruct”.<sup>278</sup> They represent a “proprietary interest in the company, not its assets”<sup>279</sup> and are “made up of various rights”.<sup>280</sup> While these rights are contractual in nature,<sup>281</sup> Hahlo elusively concludes that “the concept of a share serves different functions”.<sup>282</sup>

The characterisation of the rights that make up a share as contractual is described by Van der Walt and Sutherland as “artificial”<sup>283</sup> as they flow from the memorandum of incorporation and the Act, thus being more of a statutory rather than a real contract.<sup>284</sup> Van der Walt and Sutherland also warn that descriptors such as “property”, “ownership” and the availability of the “*rei vindicatio*” to recover shares should be used with caution.<sup>285</sup> They further argue that “the description of shares as moveable property does not take the argument any further as [i]t does not change the shares from being incorporeal personal rights”.<sup>286</sup>

Vermaas states that the transformation from certificated to uncertificated shares has no implications for the legal nature of shares.<sup>287</sup> This finding is based on the fact that the mechanism of registration remains unchanged.<sup>288</sup> At the same time Vermaas recognises that “[t]he basic rules on the legal nature, transfer and pledge provisions of securities were formulated when securities were transferred individually by physical delivery of certificates evidencing or representing them”.<sup>289</sup> In an electronic environment “[t]he legal nature and ‘ownership’ of securities cannot easily be

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<sup>278</sup> JT Pretorius, PA Delpont, M Havenga & M Vermaas (eds) *Hahlo's South African Company Law through the Cases* 6 ed (1999) 148.

<sup>279</sup> 148.

<sup>280</sup> 148.

<sup>281</sup> 150.

<sup>282</sup> 150.

<sup>283</sup> Van der Walt & Sutherland (2003) *SA Merc LJ* 97.

<sup>284</sup> 97.

<sup>285</sup> 100.

<sup>286</sup> 100.

<sup>287</sup> M Vermaas “The Reform of the Law of Uncertificated Securities in South African Companies Law” (2010) *Acta Juridica* 87 90.

<sup>288</sup> Vermaas (2010) *Acta Juridica* 90-91; Opposed to registered shares, it is far more difficult to reconcile the negotiability status of bearer shares with the process of computerisation; See also M Yates & G Montagu *The Law of Global Custody: Legal Risk Management in Securities Investment and Collateral* 4 ed (2013) 19-20.

<sup>289</sup> Vermaas (2010) *Acta Juridica* 93.

defined”.<sup>290</sup> This, according to Vermaas is particularly true for shares in multi-tiered chains of intermediaries.<sup>291</sup>

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<sup>290</sup> 104.  
<sup>291</sup> 104.

## Chapter 17: The legal nature of shares: a theoretical framework

### 17 1 A functional approach

An idea that features prominently in the academic discussions on shares is functionalism. At the core of the functional approach lies the rejection of concepts and categories such as property and obligations “and all the rest of the magic ‘solving words’ of traditional jurisprudence”.<sup>1</sup> Nevertheless, a functional approach is not the antithesis to conceptual reasoning; it must rather be viewed as providing alternative conceptual explanations. The proposition advanced in this thesis is therefore that shares and securities are always premised on a conceptual basis, but that the conceptual basis may have shifted, wholly or in part, from a strictly doctrinal to a more functional approach.

Functionalists take what Schroeder terms a “transactional approach”. They formulate rules about how an object, such as a share, is held, transferred, provided as security or otherwise transacted with. As such they place a strong focus on practical, actual experiences and market practices. Systematisation is, however, not foreign to functionalism. In terms of a functional approach functions, patterns, arrangements and relationships in legal transactions and in markets are collated. Article 8 of the UCC is a good illustration of systematisation on a functional level. The article does not merely collect actual experiences to translate them into disjunctive rules; it organises them into a coherent framework. Conceived as such, a functional approach is not simply a response to market mechanisms, but at the same time shapes those practices. This is also in very broad strokes, the gist of Schroeder’s argument: system remains significant.<sup>2</sup>

The declared preference of functionalism to abandon meaningless concepts and to replace them with redefined or new ones<sup>3</sup> makes a comparison between legal systems premised on functionalism and legal systems based on doctrinal reasoning, difficult if not impossible. The contributions by Mooney, Rogers and Schroeder neatly illustrate this point.<sup>4</sup> The security entitlement is an example of such a new concept

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<sup>1</sup> F Cohen “Transcendental Nonsense and the Functional Approach” (1935) 35 *Columbia LR* 809 820.

<sup>2</sup> See above, 16 2 3 Jeanne Schroeder.

<sup>3</sup> According to Cohen (1935) *Columbia LR* 824 the real value of the functionalist exercise must be sought, not in its negative rejection of traditional concepts, but rather in its positive contribution to the creation and advancement of knowledge.

<sup>4</sup> See above, 16 2 1 Rogers and Mooney and 16 2 3 Jeanne Schroeder.

that has no equivalent in other jurisdictions.<sup>5</sup> Part of the reason is that the security entitlement repackages rights and duties of the issuer-investor, the investor-intermediary and the intermediary-intermediary relationships into a single legal category. Rights and duties inherent in these relationships are mingled and conceptual categories of obligations, property, agency and deposit become indiscernible.

A functional approach can provide important lessons. When reference is made to the *in rem* and *in personam* components of security entitlements, what is meant is their absolute or relative effect. The security entitlement is therefore recognition that absolute and relative rights can exist in relation to one and the same “object”. This is the essence of the *sui generis* concept.<sup>6</sup> A functional approach therefore highlights the need to uncouple property and obligations from absolute and relative effect.

The functional approach manifests that how relationships and transactions play out in the real world should be an important consideration for the law and legal development. As such it must necessarily inform doctrinal reasoning. However, functionalism does not need to be all-encompassing. Functional considerations are equally valuable in a more traditional context. They have utility for re-determining the usefulness of existing doctrinal categories.<sup>7</sup> The lessons of functionalism can be applied even where the functional exercise is not exhaustive. The UNIDROIT Convention on Substantive Rules for Intermediated Securities is an example. It imposes functional rules that are doctrinally neutral and therefore permits the application of uniform rules in the context of highly diverse backgrounds.<sup>8</sup>

The South African model is not a fully functional one as it does not evidence the unmasking of traditional legal concepts and the level of rearrangement and functionally-based systematisation that is necessary for a comprehensive functional framework. The Financial Markets Act, The Companies Act, the Rules of Strate and other legislative instruments rather provide a number of rules, many of them functional, that supplement, suffuse and modify the private law framework.

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<sup>5</sup> In English law, a beneficial interest under a trust can, to some degree, be considered a functional equivalent. This reality is expressed in the widespread use of the term “security interest”. In German and South African law such a functional equivalent does not exist.

<sup>6</sup> See above, 16 2 1 Rogers and Mooney and 16 2 3 Jeanne Schroeder.

<sup>7</sup> See above, 13 2 5 2 Legal framework.

<sup>8</sup> See above, 13 2 5 2 2 Account entries.

Applied to more doctrinally rigid legal systems, a recourse to functional, and other underlying considerations, it is proposed in the model developed below,<sup>9</sup> can help solve conceptual dilemmas. By contending that functional arguments can serve as the basis for a continued application of doctrinal, property-based rules, and perhaps even as the impetus for more fundamental legal changes, Micheler and others endorse such a conception of functionalism.

## 17 2 A law of accounts

An assertion that the law on securities is a law of accounts has at least two separate parts: Firstly, it assumes that there exists a category of “securities” or “financial instruments”. The law of accounts does not concern itself with individual instruments. Secondly, it implies that all the instruments that make up the category are, or should be subject to uniform rules and procedures.

The question whether there is a need for a single legal category is one that features prominently in the work of Lehmann. The question is particularly acute in the German legal context, because the category of “Wertpapiere” is at once incredibly broad,<sup>10</sup> and also restrictive because the *numerus clausus* bars the inclusion of innovative financial instruments.<sup>11</sup> Anglo-American and South African law already have a category of the sort that Lehmann envisages. The category of securities in Anglo-American and South African law is much narrower than the term “Wertpapiere”, which Lehmann finds so problematic, because it does not include most of the traditional negotiable instruments such as promissory notes or bills of exchange. In addition, it has been shown that the category is flexible and open-ended and allows innovative securities to be included.<sup>12</sup>

While these definitions are unsuitable for identifying common substantive characteristics shared by all instruments that are part of the group of “securities” or “financial instruments”, there is clearly a need for regulatory and procedural uniformity of rules. The existence of accounts is the common denominator of a group comprised of otherwise disparate instruments. The notion of accounts-based rights

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<sup>9</sup> 17 4 3 Developing an explanatory model.

<sup>10</sup> See above, 2 2 Shares as securities.

<sup>11</sup> See above, 16 3 4 Matthias Lehmann.

<sup>12</sup> See above, 2 2 Shares as securities.

also suffuses the definition of “securities” in the UNIDROIT Convention and the Hague Securities Convention.<sup>13</sup>

Sommer and Dubovec both strongly emphasise the procedural nature of the law of accounts.<sup>14</sup> The law of accounts relates not to the substantive content of the relationships and the rights and duties that flow from such relationships, but rather creates rules and procedures for how these rights and duties are created, transferred and extinguished. The law of accounts, to put in Sommer’s terms, is the suitcase for conveying the underlying rights.<sup>15</sup>

In Sommer’s estimation a law of accounts is free from doctrinal overtones. In terms of the UCC, rights are attributed to a certain person through a series of messages and communications that culminate in an account entry. The communication attributes (or creates) the rights; the account-entry evidences it. South Africa also has a law of accounts. It is contained in the instructions, confirmations and other communications sent by participants in the settlement system<sup>16</sup> as well as in the provisions requiring account entries for a transfer of securities. The account entry therefore at once formalises relationships, lists financial transactions and sums economic positions. Based as it is on accounting functions, a “law of accounts” cannot, however, regulate the consequences of account entries.<sup>17</sup> The law must do this. A “law of accounts” primarily refers to the “transfer” function. Transfer, it has been stated at the outset of this thesis,<sup>18</sup> is a complex cluster of procedural mechanisms and legal rules. What a “law of accounts” clearly evidences is a relative increase in the importance of the procedural aspects of transfer. A transfer can be sufficiently described and carried out using commercial language and mechanisms. To analyse a transfer using legal doctrinal terminology may not be necessary in a great preponderance of day-to-day transactions. Nonetheless, a “law of accounts” is only one leg; the other leg is legal concepts, whether determined in a functional or doctrinal manner.

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<sup>13</sup> See above, 2 2 Shares as securities.

<sup>14</sup> See above, 16 2 2 Joseph Sommer. Also see M Dubovec *The Law of Securities, Commodities and Bank Accounts: The Rights of Account Holders* (2014).

<sup>15</sup> See above, 16 2 2 Joseph Sommer.

<sup>16</sup> See above, 13 2 5 1 Commercial mechanisms.

<sup>17</sup> Dubovec *Law of Securities, Commodities and Bank Accounts* 14.

<sup>18</sup> See above, 1 1 Context.

A law of accounts is useful, therefore, because it provides commercial practice with mechanisms for transactions in securities that can firstly be applied to all securities<sup>19</sup> and that are secondly clear, efficient and capable of application regardless of doctrinal background. In addition, the notion of a law of accounts creates scope for the development of pragmatic and transaction-specific legal rules that can supplement or even alter traditional private-law rules.

Sommer rightly points out that a law of accounts is characterised by formalism and draws parallels to the law of negotiable instruments.<sup>20</sup> The law of negotiable instruments is the epitome of formalism.<sup>21</sup> The new formalism shares with negotiable instruments its two basic precepts: 1. It sets a simple (mechanical) transfer mechanism; and 2. It lays down a rule for the acquisition of title in good faith. These two aspects are mechanical because they make transfer and title acquisition determinable with reference to objectively ascertainable acts or facts without having to consider the subjective intentions of the transacting parties. The law of negotiable instruments focuses on “transfer”; the same focus can be observed in the law of accounts. This explains why in the context of transfer mechanisms of shares and securities, an increase in formalism and a decrease in conceptual reasoning can be observed.<sup>22</sup> On the other hand, the law of negotiable instruments had implications beyond transfer: It also shaped how such obligations were held (through bailment or deposit) or enforced (through possession). In one respect, however, the new law of accounts differs from the old law on negotiable instruments; it does not reify the obligation. For this reason the new formalism may have a smaller impact beyond the mechanisms of transfer and title acquisition. Thus, by steering clear of reification or tokenisation, the law of accounts leaves room for conceptual analysis.

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<sup>19</sup> Indeed, Dubovec argues that a “law of accounts” can highlight common features of securities, money and commodities. On some of the shared features of these accounts-based rights, see Dubovec *Law of Securities, Commodities and Bank Accounts* 222-232.

<sup>20</sup> See above, 16 2 2 Joseph Sommer. True negotiability hinges on tangibility, of course, and does not extend to incorporeals. The law of accounts shows, however, that similar principles can be put forth in statute.

<sup>21</sup> See for example G Gilmore “Formalism and the Law of Negotiable Instruments” (1979) 13 *Creighton LR* 441 445-446, who described negotiable instruments as belonging to an area of the law in which “form – and formalism – completely triumphed over substance, leaving nothing of any interest to be said”.

<sup>22</sup> See Part 2, especially 13 2 5 Electronic settlement and transfer.

## 17 3 Models of Intermediation

### 17 3 1 Introductory remarks

The possibility of employing a person to intermediate the personal relationship between an issuing company and an investor, whether intermediation is “simple” or “systemic”, has an important implication: Functionally, it results in a splitting of the ability to enforce performance from the entitlement to receive the benefits of such performance.<sup>23</sup> Conceptually this splitting is explained in different ways.<sup>24</sup> The rise of intermediary relationships raises a number of questions in the context of the legal characterisation of shares and securities: Does intermediation transform the asset held by an investor? Does it lead to the creation of an entirely new asset in the hands of the investor? If yes, what is the legal nature of the transformed or newly created asset? The legal nature of intermediary relationships has been considered from a more practical angle in Part 2. Two theoretical approaches have been selected to supplement this discussion; the theory of a burdening or “splitting-off” of personal rights and the idea of rights against rights.

### 17 3 2 The burdening of a personal right

The idea that a personal right consists of a number of distinct components or entitlements originates in German legal theory.<sup>25</sup> The core of the right is the beneficial interest that the creditor has in the performance of the debtor.<sup>26</sup> Included in the personal right is the entitlement to demand and collect performance,<sup>27</sup> the entitlement or capacity to dispose of the right to performance<sup>28</sup> as well as the right to institute legal action.<sup>29</sup> So construed a personal right or claim consists of a bundle of

<sup>23</sup> See above, 8 5 Taking stock.

<sup>24</sup> See above, 8 5 Taking stock.

<sup>25</sup> See for example K Larenz *Allgemeiner Teil des deutschen Bürgerlichen Rechts* 7 ed (1989) 200-201 §12 II; M Wolf & J Neuner *Allgemeiner Teil des Bürgerlichen Rechts* (2012) 207-208 § 19 IV.

<sup>26</sup> Larenz *Allgemeiner Teil* 201 § 12 II; Lubbe (1989) *THRHR* 497.

<sup>27</sup> S Enchelmaier *Übertragung und Belastung unkörperlicher Gegenstände im deutschen und Englischen Privatrecht* (2014) 29.

<sup>28</sup> GF Lubbe “Sessie in securitatem debiti en die komponente van die skuldeisersbelang” (1989) 52 *THRHR* 485 497.

<sup>29</sup> In general, see Larenz *Allgemeiner Teil* 201 § 12 II and in the South African context S Scott *The Law of Cession* 2 ed (1991) 22.

entitlements (not to be confused with the “bundle of rights” that are shares).<sup>30</sup> An “owner” of a personal right can therefore surrender entitlements piece by piece.<sup>31</sup>

Lubbe shows at the hand of security cessions that a construction of personal rights or claims as bundles of entitlements that can be split off is reconcilable with South African law.<sup>32</sup> He further recognises that the intermediation of shares by nominees evidences a comparable split.<sup>33</sup>

When shares and securities are intermediated the entitlement to demand performance is split-off from the personal right and relinquished to the intermediary. The intermediary, not the investor, can therefore demand performance from the issuer. This constitutes a burdening of the personal right.<sup>34</sup> A burdening is therefore the splitting-off of distinctive entitlements from a personal right. A burdening must be distinguished from an outright transfer. An outright transfer comprises the entire personal right. A burdening also involves a transfer, but only a partial one.<sup>35</sup> The mechanisms for an outright transfer and the transfer of a burden differ. Shares are a particularly good illustration of this point. In the context of shares the ability to enforce rights can be distinguished from the right or entitlement to benefit from such rights.<sup>36</sup> A share itself, constituting the core right, is transferred from a seller to a buyer thereof in accordance with the transfer mechanisms set out in Part 2. The ability to enforce the right against the issuer flows from a contractual relationship between the owner of the shares and a nominee in terms of a contract of mandate. The burdening or splitting-off theory posits that the latter constitutes a “transfer” of the entitlement to demand and enforce performance from the owner or rights-holder to the nominee.

According to von Thur an outright transfer constitutes a translative or quantitative transfer of rights. The loss of the owner of the rights is final and encompasses all entitlements and accessory rights.<sup>37</sup> A partial transfer, on the other hand, is constitutive or qualitative. It includes a transaction in terms of which a lesser right or

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<sup>30</sup> Lubbe (1989) *THRHR* 493.

<sup>31</sup> 493.

<sup>32</sup> Lubbe (1989) *THRHR* 493-496. Also see S Scott “Verpanding van Vorderingsregte: Uiteindelik Sekerheid?” (1987) 50 *THRHR* 175 184-185. In the case of security cessions this construction is today widely accepted.

<sup>33</sup> Lubbe (1989) *THRHR* 497-498.

<sup>34</sup> Enchelmaier *Übertragung und Belastung* 29.

<sup>35</sup> 29.

<sup>36</sup> See above, 8 5 Taking stock.

<sup>37</sup> A von Thur *Der Allgemeine Teil des Deutschen Bürgerlichen Rechts* 2(1) (1914) 59.

entitlement is split off from the content of a personal right and transferred to a different subject.<sup>38</sup> The derivative entitlement is qualitatively different from the right of origin, but can be traced back to entitlements that are part and parcel of the right of origin.<sup>39</sup> It is not a disposal because the right of origin continues to vest in the same person, but rather a burdening of the right of origin.<sup>40</sup> Entitlements can be split-off without compromising the character of the core right.<sup>41</sup>

A burdening of a personal right can take several forms. A personal right is burdened where it is offered as security. Similarly, a direct debit authorisation gives a bank the entitlement to demand payment. Such an authorisation differs from providing a security as collateral in that it is aimed only at the convenience of the “owner” of the personal right and can be revoked at any time.<sup>42</sup> The entitlement of an intermediary to demand performance from the issuer is comparable to the latter example. German law uses the term “Einziehungsermächtigung” to describe such cases where another person is given the power to collect performance.<sup>43</sup> While the theory of the burdening of rights is traditionally not invoked in relation to German bearer shares, it features in the case of dematerialised “Wertrechte”. The prevailing view is that the power of an intermediary to collect the benefits that flow from a holding of shares are based on a “Ermächtigungstreuhand”, which has been described by courts as a “false” administrative trust in terms of which an intermediary or person so authorised acquires not the obligation or claim, but is merely authorised to collect the performance.<sup>44</sup>

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<sup>38</sup> 62.

<sup>39</sup> 62.

<sup>40</sup> 62.

<sup>41</sup> Larenz *Allgemeiner Teil* 201 § 12 II.

<sup>42</sup> Enchelmaier *Übertragung und Belastung* 29. But see S Scott *Scott on Cession; A Treatise on the Law in South Africa* (2018) 83-86, who finds (but not in the particular context of securities) that an authorisation to collect, akin to an “Einziehungsermächtigung” constitutes a *mandatum in rem suam* in terms of South African law and is therefore irrevocable. Scott, however, does not take into account that an agent may act in its own name for an undisclosed principal. In the context of listed shares in particular, beneficial interest disclosures mean that the issuer is aware of the agency-status of a nominee and it is therefore unnecessary to classify the nominee as a mandatary *in rem suam*. Also see above, 8 3 5 4 Agency, representation and mandate.

<sup>43</sup> Enchelmaier *Übertragung und Belastung* 29; Scott *Law of Cession* 160-161.

<sup>44</sup> See BGH, 03.04.2014 – IX ZR 201/13 para 25: “Eine Einziehungsermächtigung ist demgegenüber ein abgespaltenes Gläubigerrecht, das die Verfügungsbefugnis des Ermächtigten über ein fremdes, dem Ermächtigenden verbleibendes Recht durch den Begriff der Einziehung klar umgrenzt.” And para 26: “Die Einziehungsermächtigung beruht auf einer unechten uneigennützigen Verwaltungstreuhand, weil der Ermächtigte ... nicht die Forderung erwirbt, sondern lediglich zu ihrem Einzug befugt ist”.

### 17 3 3 Rights against rights

English law may reach the same result, namely that the benefits of performance and the ability to demand and collect these benefits accrue to different persons. Conceptually and terminologically, it reaches this outcome in a different fashion.

The split is most often construed as resulting from the legal concept of a trust and the contrast between legal and equitable title inherent in trusts.<sup>45</sup> Writing on English law, McFarlane and Stevens suggest an alternative conceptual explanation (but one within the trust construct).<sup>46</sup> They argue that the concept that is central to intermediation in English law is a right to or against a right.<sup>47</sup> Equitable property rights, they write are rights against rights. While the trustee therefore holds the “core right”, the beneficiary has a rights against the trustee’s right.<sup>48</sup> As his right follows the core right, it is capable of having an effect on third parties and is therefore more than a mere personal right.<sup>49</sup>

The contrast to the theory whereby personal rights are burdened is patent. The core right is held by the intermediary, not the investor. In fact, the “underlying right”, which is the share, is “immobilised” at the top of the pyramid. If A (a CREST member and legal owner of a share) holds the right for B, who in turn is the intermediary of investor C, B has a right against the underlying right held by A and this right, in turn, becomes the core right against which C has a right. The underlying right is therefore intact. It is not burdened and no entitlements are split-off. “The key feature of intermediated securities” McFarlane and Stevens write, “is that an investor is given the benefit of a right without holding the right itself”.<sup>50</sup> This is the inverse of the position according to the burdening theory.<sup>51</sup>

The burdening theory is frequently said to create rights *over* rights.<sup>52</sup> Yet, von Thur cautions that, correctly described, these are rights *from* rights.<sup>53</sup> On this construction

<sup>45</sup> See above, 8 3 2 Transfer and holding in English law and 8 5 Taking stock.

<sup>46</sup> B McFarlane & R Stevens “Interests in Securities: Practical Problems and Conceptual Solutions” in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 33.

<sup>47</sup> 37, 58.

<sup>48</sup> 37.

<sup>49</sup> 37.

<sup>50</sup> 34.

<sup>51</sup> Rephrased, the position according to the splitting-off theory is as follows: “The key feature of intermediated securities is that an intermediary is given the entitlement to enforce performance without holding the right itself.”

<sup>52</sup> For example by creating a pledge or lien over a claim.

an intermediary has a right that derives *from* the right of the investor. In terms of the alternative theory in English law, an investor derives his right from the right of the intermediary and therefore has a right *against* it.<sup>54</sup> This is the context within which the direction of disbursement of rights or entitlements has been said to differ.<sup>55</sup> Furthermore, the “underlying right” from which all entitlements or rights flow is “located” at opposite ends of the holding chain.

An investor therefore acquires, McFarlane and Stevens conclude, firstly personal rights against an intermediary or holder of the core right arising from the relationship (likely contractual) between them. These personal rights do not flow from the core right. Secondly, the investor acquires rights against the core right of his intermediary. These are not merely personal in nature.<sup>56</sup>

The notion of a “right against a right” also explains why investors are today thought to hold “interests in securities” instead of “securities”. According to Gullifer, “the ultimate investor’s asset is so far removed from the original securities that it makes no sense to conceptualise it as ‘securities’”.<sup>57</sup>

Mention of “interests in securities” leads to associations with “security entitlements”. In fact, the “rights against rights” theory can similarly explain many of the features of security entitlements. Security entitlements are detached from the “underlying rights” in the same manner as “interests in securities” or “beneficial interests” are disconnected from them.<sup>58</sup> In addition, one security entitlement can become the “object” of another security entitlement one tier down.<sup>59</sup>

#### 17 3 4 Transformation of assets and the creation of new assets and rights

The proposition that systemic intermediation results in the creation of new assets was first advanced in the US and English law followed suit. A security entitlement is considered by many writers to be a separate asset, distinct from underlying securities

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<sup>53</sup> Von Thur *Allgemeine Teil* 66.

<sup>54</sup> Or a right to it if the investor is the only beneficiary, which is however unlikely in the case of pooled securities; see McFarlane & Stevens “Practical Problems and Conceptual Solutions” in *Intermediated Securities* 37-38.

<sup>55</sup> See above, 8 5 Taking stock.

<sup>56</sup> McFarlane & Stevens “Practical Problems and Conceptual Solutions” in *Intermediated Securities* 38.

<sup>57</sup> L Gullifer “Ownership of Securities: The Problems Caused by Intermediation” in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 1 19.

<sup>58</sup> See above, 16 2 1 Rogers and Mooney, the text to n 63.

<sup>59</sup> See, 16 2 1 Rogers and Mooney, text to n 50.

but derived from them. Its value is identical to that of the underlying securities. In English law, beneficial interests in trusts are similarly considered to be rights and assets in their own right and can become the trust property of a sub-trust.<sup>60</sup>

The notion of the creation of separate assets does not find favour with all academic commentators. Khimji argues, and I quote him at length:

“The assumption that underlying securities have a sort of independent existence disconnected from the indirect holder is both unnecessary and mistaken. ... What is disconnected from the indirect holder is any personal relationship with the issuer. This, however, affects investment securities in only one of the capacities in which they operate: as a package of personal rights as against the issuer. The ultimate beneficiary of these personal rights is the investor at the bottom of the chain. It has no bearing, however, on the other capacity in which they operate: as assets subject to property rights.”<sup>61</sup>

It is useful to distinguish the transformation of rights or assets from the creation of new rights or assets and to determine in whose hands the transformed or newly created rights or assets are held.

In the context of both English and US law, the “rights against rights” theory suggests that the underlying rights or asset, the share, is not transformed. Khimji can be said to be in agreement with this postulate. At dispute is rather who holds this untransformed asset. In terms of the “rights against rights” theory the underlying rights are no longer held by an investor, but by an intermediary in the top tier. A new asset is therefore created in the hands of an investor – the security entitlement or the beneficial interest. This is not a single new asset; in fact multiple new assets are created in the hands of investors and intermediaries in the holding chain. This second finding is disputed by Khimji, who maintains that “[t]he asset delivered will be shares ... The asset delivered simply cannot be anything else.”<sup>62</sup> Khimji therefore argues that an investor continues to have a claim against the underlying securities, but as only the securities in an account can be sufficiently identified for purposes of a

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<sup>60</sup> See for example R Goode “Security Entitlements as Collateral and the Conflict of Laws” (1998) 7 *JIBFL* 22 25, who sets out that following a deposit with a securities intermediary, “the subject matter of his [the investor’s] entitlement becomes completely different ... What he acquires in its place is a combination of personal and proprietary rights”.

<sup>61</sup> M Khimji “The Role of Legal Concepts in Commercial Law: Comments on Spink, Rogers and Scavone” (2007) 45 *Can Bus LJ* 94 97.

<sup>62</sup> MF Khimji “The Securities Transfer Act – The Radical Reconceptualization of Property Rights in Investment Securities” (2007) 45 *Alberta LR* 137 151.

proprietary claim, the claim can be exercised only against an intermediary. This analysis, he argues, achieves the same compartmentalisation between tiers of intermediaries and thus the same functional advantage, but without denying that the investor holds or “owns” the underlying securities.<sup>63</sup> According to Khimji systemic intermediation therefore not only leaves the underlying rights intact, but it also does not provide an impetus for the creation of new assets – at least not in the hands of the investor.

If the burdening theory is applied to South African law, the core right, it has been found, retains its essential character despite being burdened. From this perspective, the transformation of the right or asset is negligible. Furthermore, the core right continues to be held by the investor. This conclusion finds support if the principles of agency are brought to bear on the question. The agency analysis shows that in a holding system based on consecutive sub-mandates, “ownership” continues to vest in the investor as the person who stands to benefit economically from the shares and who also carries the economic risks associated with them.<sup>64</sup> Therefore no new asset is created in the hands of the investor.

Intermediation, however, vests an entitlement in an intermediary. Such an entitlement is typically derivative and hinges on the core right. Larenz recognises that it is not always easy to determine whether a burden is merely an entitlement or an independent right.<sup>65</sup> The answer depends on the independent alienability of the entitlement and on the weight and importance that is attached to it.<sup>66</sup> The entitlement to collect performance can be “transferred” from one intermediary to another, but firstly, not without the consent of the holder of the burdened core right and secondly, it cannot exist independently of it. These are indicators that an independent right does not come into existence.

Such a conclusion must not be understood to imply that intermediaries hold no rights. In addition to the entitlement, a number of rights flow from the legal relationship with their client originating in contract and statute. One of these is the right to be remunerated for the services that intermediaries offer in connection with the collection of the performance. These rights are assets in an intermediary’s estate

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<sup>63</sup> 151.

<sup>64</sup> See above, 13 2 3 3 Agency and mandate.

<sup>65</sup> Larenz *Allgemeiner Teil* 201 § 12 II.

<sup>66</sup> 201 § 12 II.

and are likely to qualify as assets for purposes of compiling financial statements. As McFarlane and Stevens point out, these rights or assets do not arise directly from the core right.<sup>67</sup>

### 17 3 5 Management or custodial rights

In an intermediary a myriad of rights and duties come together: those rights and duties that originate from contract, those that flow from statute as well as those that arise from or against the core right, however construed. In fact, a myriad of additional entitlements, powers or rights can be created by contractual arrangement or splitting-off between an investor and a custodian. These can include voting powers or rights, cash management, collateral management, securities lending, foreign exchange services as well as brokerage services.<sup>68</sup> From a commercial perspective there is some utility to bundle all these rights, duties and entitlements together and conceive of them as “management” rights or custodial rights represented by a single account entry. It is certainly recognition of the fact that the powers of modern intermediaries advance far beyond the ability to collect performance.

This raises the question whether a management right in the sense described above can be construed as sufficiently independent to be able to function as an autonomous object of rights? In English law it is abundantly clear that a beneficial interest, which is an essential part of management rights, can be the object of another beneficial interest. The same applies to security entitlements. Sub-agency constructs are similarly possible where the direction of rights or entitlements is bottom-up. In all these constructions, however, the contractual aspects of management rights, such as the level of remuneration for the services offered or cash management arrangements, depend on specific agreement between the parties at each tier of intermediation and cannot be passed on. Management rights can be construed as secondary rights in that they hierarchically derive from another right,<sup>69</sup> but technically only certain portions or strands of management rights are secondary

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<sup>67</sup> See text to n 56 above.

<sup>68</sup> See above, 9 3 3 A brief overview of important intermediaries for a brief discussion of intermediaries.

<sup>69</sup> I use here the concept of secondary rights – a model proposed by Van Erp in the context of property rights and ownership. Primary rights include primarily ownership and therefore presuppose a relation between a person and an object (whether or not this object can be incorporeal depends on how it is defined). Secondary rights are lesser rights in that they derive from primary rights. Van Erp suggests, inconclusively however, that rights to manage another’s property may be secondary property rights. See S van Erp “Fluidity of Ownership and the Tragedy of the Hierarchy” (2015) 4 *EPLJ* 56 62 n 19.

in nature, such as an entitlement to collect performance or even an entitlement to use the core right (in the context of short selling for example). In addition, parties can contractually determine the scope of such rights or entitlements and the degree of independence and authority of the agent. If the question therefore arises in which circumstances such amalgamated management rights can have absolute effect, a bundling together of the different strands of rights or entitlements is not useful. Such an approach results in the mingling of the proprietary and contractual aspects of shares. As Micheler writes:

“In reality, one custodian does not neatly fit into the other. There is no stick and no connection between issuer and investor. We are looking at a series of independent contractual links reflecting the preferences of the custodians concerned.”<sup>70</sup>

If anything, the notion of management rights should drive home the principle that intermediaries as managers or custodians of their clients, in whichever respects and in relation to the entire package of “management rights”, act as fiduciaries. The importance of the fiduciary dimension of the relationship is embedded not only in the concepts of trust, agency or deposit, but it has been statutorily reinforced in the case of securities intermediaries.<sup>71</sup> On Fiduciary duties, Easterbrook and Fischel write:

“These legal duties reflect both the nature of the principal's choice (he is hiring expertise) and an obvious condition (the principal is unwilling to put himself at the mercy of an agent whose effort and achievements are both exceedingly hard to monitor).”<sup>72</sup>

The advantage of a regime of fiduciary duties, whether they derive from contract or statute, is that they compensate for the impossibility of writing “complete” contracts or drafting comprehensive laws.<sup>73</sup> On the other hand, it is important to carefully distinguish between the fiduciary and the contractual elements.<sup>74</sup> The centrality of fiduciary duties to the characterisation of the intermediary-client relationship also explains, in the South African context, why the common law concept of agency continues to be of value – it automatically invokes a comprehensive protective regime of fiduciary rights and duties that safeguards the interests of a mandatory. At the

<sup>70</sup> E Micheler “Custody Chains and Asset Values: Why Crypto-Securities are Worth Contemplating” (2015) 74 *Cambridge LJ* 505 508.

<sup>71</sup> See especially, 13 2 3 3 Agency and mandate.

<sup>72</sup> FH Easterbrook & DR Fischel “Contract and Fiduciary Duty” (1993) 36 *J Law & Econ* 425 426.

<sup>73</sup> Easterbrook & Fischel (1993) 426 make this finding in relation to contracts only, but it can certainly be said to apply equally to the impossibility of drafting legislation that caters for all eventualities.

<sup>74</sup> See M Yates & G Montagu *The Law of Global Custody: Legal Risk Management in Securities Investment and Collateral* 4 ed (2013) 119 [6.44].

same time, the imposition of a comprehensive statutory fiduciary regime necessarily leads to the conclusion that the legal concept at play is, at least in part, a statutory mandate in terms of which the common law rules apply only where the legislation does not put forward a specific rule.

Lastly, the notion of “management rights” emphasises that intermediation must be reconceived from a state of “static” holding often associated with traditional legal concepts such as agency and deposit, to a more dynamic management and administration function.

## 17 4 The idea of property and obligations in law

### 17 4 1 Drawing the boundary between property and obligations

Property is a term that is almost invariably characterised by vagueness and ambiguity. “Property”, Grey asserts, is “a conceptual mirage” and “an emotive phrase in search of meaning”.<sup>75</sup> Part of its elusiveness stems from the practice, widespread among jurists and laymen alike, to use the term to describe either objects of rights or those rights themselves.<sup>76</sup> Associating property with objects, particularly corporeal objects, is common in everyday usage.

An added level of difficulty encountered in finding a suitable and comprehensive definition of property is that its meaning almost invariably depends on context. Where the term is used in specific contexts or legislative instruments, its meaning may vary. Furthermore, in the constitutional context, property is usually given a wide meaning.<sup>77</sup>

In a more restricted sense, the term property is used to denote the rights that can exist in respect of an object or thing. Legally, this use of the term is taken to be the correct one.<sup>78</sup> This description of property is not uncontested. To understand why, the

<sup>75</sup> K Gray “Property in Thin Air” (1991) 50 *Cambridge LJ* 252 305.

<sup>76</sup> CG van der Merwe *The Law of Things* (1987) 5; PJ Badenhorst, JM Pienaar & H Mostert *Silberberg and Schoeman’s The Law of Property* 5 ed (2006) 9; W Swadling “Property: General Principles” in A Burrows (ed) *English Private Law* 3 ed (2013) 174 [4.02].

<sup>77</sup> On the constitutional property concept, see AJ van der Walt *Constitutional Property Law* (2011); AJ van der Walt *Property and Constitution* (2012); EJ Marais “Expanding the Contours of the Constitutional Property Concept” (2016) *TSAR* 576. Also see *Shoprite Checkers (Pty) Ltd v MEC for Economic Development, Eastern Cape* 2015 6 SA 125 (CC); *Agri South Africa v Minister for Minerals and Energy* 2013 4 SA 1 (CC); *National Credit Regulator v Opperman* 2013 2 SA 1 (CC); *First National Bank of SA Ltd t/a Wesbank v CIR*; *First National Bank of SA Ltd t/a Wesbank v Minister of Finance* 2002 4 SA 768 (CC); *Ex Parte Chairperson of the Constitutional Assembly: In Re Certification of the Constitution of the Republic of South Africa*, 1996 1996 4 SA 744 (CC).

<sup>78</sup> See CB Macpherson “The Meaning of Property” in CB Macpherson (ed) *Property: Mainstream and Critical Positions* (1978) 1 3-4.

purpose or utility of defining it in the first place must be kept within sight. Modern private law, especially civilian law, is constructed on the division between property and obligations. A definition of property must therefore be capable of drawing the line between the two disciplines. The same is true of a definition of obligations. The definitional exercise is therefore at once a taxonomical one. Taxonomy or classification not only aims to depict a part of the law in an orderly and abstract fashion. It aims to draw the boundaries between categories; to describe categories through demarcation and differentiation.

A rigorous systematisation of the law is often associated with civilian legal systems. Systematisation plays a prominent role in German law, where it is said to be formative for legal thought and argumentation.<sup>79</sup> South African private law has a dogmatic structure that is comparable to the system of private law in German law, if somewhat less rigorous. The dichotomy between property and obligations therefore features prominently in both legal systems. Taxonomy has also become more prevalent, if not always more popular, in the common law.<sup>80</sup> Such a statement cannot be made without a disclaimer: In the common law, the exercise of mapping the private law<sup>81</sup> is frequently met with disdain. Many argue that in the common law, practical experience of the law is logically prior to theoretical systematisation.<sup>82</sup> Few will disagree, however, that the common law organises and arranges as well; the disputes rather concern the priority of the systematisation exercise and the exclusivity of categories. This is the context within which a statement like the one made by Reid, that – “the border between obligations and property, has little interest – little meaning even – for the student of English law” – must be placed.<sup>83</sup> An analysis of shares belies, at least to some extent, this statement. It is true that the categories in English

<sup>79</sup> R Michaels ‘Systemfragen des Schuldrechts’ in M Schmoeckel, J Rückert & R Zimmermann (eds) *Historisch-kritischer Kommentar zum BGB III* (2007) 1 3 [1].

<sup>80</sup> See for example the work of Peter Birks and Andrew Burrows. Also see E Sherwin “Legal Taxonomy” (2009) 15 *Legal Theory* 25 25-28.

<sup>81</sup> The mapping analogy was offered by P Birks “Equity in the Modern Law: An Exercise in Taxonomy” (1996) 26 *UWA L Rev* 1 7.

<sup>82</sup> See the dictum in the Australian case of *Roxborough v Rothmans of Pall Mall Australia Ltd* (2001) 208 CLR 5 16 544: “To the lawyer whose mind has been moulded by civilian influences, the theory may come first, and the sources of the theory may be the writing of jurists and not the decisions of judges. However, that is not the way in which a system based on case law develops: over time, general principle is derived from judicial decisions upon particular instances, not the other way around.”

<sup>83</sup> K Reid “Obligations and Property: Exploring the Boundary” (1997) *Acta Juridica* 225 225. But see RM Goode “Ownership and Obligation in Commercial Transactions” (1987) *LQR* 433 433: “In common with other legal systems, English law sharply distinguishes property rights from mere personal rights to the delivery or transfer of an asset.” Also see the discussion of real and personal rights in E McKendrick (ed) *Goode on Commercial Law* 4 ed (2010) 28-32.

law are often drawn along different lines – between real and personal property, the latter of which includes choses in possession and choses in action. The breadth of particularly “choses in action” can lead to the assumption that everything is property and makes this distinction particularly unhelpful.<sup>84</sup> In fact, English law traditionally knows no independent category of obligations, but the need does arise to distinguish between property and personal rights. Beyond legal categories, terminology and concepts, the analyses show that, in relation to shares, English law struggles with the same problem, namely whether shares can be property?

A commonly encountered definition of property is that property is that area of the law that concerns itself with rights or relationships between persons in respect of things. So construed, property is therefore two-pronged: (1) it consists of rights and actions of persons (2) with respect to an object or thing.<sup>85</sup> Taken individually, any one of these elements gives rise to a range of questions.

Property, so the thrust of general opinion, relates to real rights as opposed to personal rights, which fall within the domain of the law of obligations.<sup>86</sup> Determining property as relating to real rights only solves part of the definitional conundrum of property. The definition of real rights suffers from much the same ambiguity as the definition of property. A real right is defined as “a claim of a legal subject to a thing as against other persons”.<sup>87</sup> This definition is similarly unusable for distinguishing real rights from personal rights and other patrimonial rights. Scholars therefore make use of a range of theories to illuminate the distinguishing characteristics of real rights.

The “classical theory” is based on the distinction formulated by Grotius,<sup>88</sup> and posits that real rights establish a relationship between a person and an object or thing, whereas personal rights narrate legal relationships between two persons.<sup>89</sup> A

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<sup>84</sup> See JG Sprankling *Understanding Property Law* 3 ed (2012) 9 [1.04].

<sup>85</sup> See for example AJ van der Walt & GJ Pienaar *Introduction to the Law of Property* 7 ed (2016) 8; Swadling “Property” in *English Private Law* 173 [4.01].

<sup>86</sup> See for example Van der Merwe *Things* 35: “The distinction between real and personal rights forms the basis for the division of the law of property into the law of things and the law of obligations”. Also see A Pretto-Saakman *Boundaries of Personal Property: Shares and Sub-shares* (2005) 90: “the law of property can be cleanly separated from the law of obligations by distinguishing rights *in rem* from rights *in personam*”.

<sup>87</sup> Badenhorst et al *Silberberg & Schoeman’s Property* 47.

<sup>88</sup> For a brief overview of the historical development, see AJ van der Walt “Personal Rights and Limited Real Rights: An Historical Overview and Analysis of Contemporary Problems Related to the Registrability of Rights” (1992) 55 *THRHR* 170 182-186.

<sup>89</sup> Badenhorst et al *Silberberg & Schoeman’s Property* 50; Van der Walt (1992) *THRHR* 184; Van der Merwe *Things* 36-37. Also see the definition of property by W Blackstone *The Commentaries on the*

distinction drawn along these lines still enjoys much support among South African scholars and has featured repeatedly in case law. In *Absa Bank Ltd v Keet*<sup>90</sup> it was held that:

“[r]eal rights are primarily concerned with the relationship between a person and a thing, and personal rights are concerned with a relationship between two persons”<sup>91</sup>

A comparison on this basis has been found to compare criteria that do not match – an object on the side of property and a personal relationship in the context of obligations.<sup>92</sup> The theory has further been criticised for ignoring that all rights, even real rights, are in essence relationships between persons in respect of things.<sup>93</sup> Van der Walt is of the opinion, however, that this criticism should not detract from the fact that the theory contains an element of truth. Real rights, when compared to personal rights, evidence a direct bond between a person and a thing; an equivalent bond is absent in the case of personal rights.<sup>94</sup> That real rights additionally concern subject-subject relationships does not negate the truth of this assertion.<sup>95</sup>

Other scholars draw the distinction between real and personal rights on the basis of their effect. What distinguishes real rights from other rights, they argue, is their ability to bind third parties.<sup>96</sup> This is the basic premise of the “personalist theory” employed to distinguish real rights from personal rights by identifying the person or persons against whom the rights can be enforced.<sup>97</sup> A real right is said to be able to bind the world at large. This is so because the exigibility of the right is determined by the location of the object or thing.<sup>98</sup> Personal rights, on the other hand, are relative, not absolute, as they can be enforced against parties to the obligation and thus

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*Laws of England II* 4 ed (1876 edn by RM Kerr) 1: “that sole and despotic dominion which one man claims over the external things of the world”.

<sup>90</sup> 2015 4 SA 474 (SCA).

<sup>91</sup> *Absa Bank Ltd v Keet* 2015 4 SA 474 (SCA) 481D-E. Also see *Off-Beat Holiday Club v Sanbonani Holiday Spa Shareblock Ltd* 2016 6 SA 181 (SCA) 201-202; *National Stadium South Africa (Pty) Ltd v Firstrand Bank Ltd* 2011 2 SA 157 (SCA) para 31; *Smith v Farely’s Trustee* 1904 TS 949 958. Also see a recent contribution by JC Sonnekus “Vervalbeding as Beperkende Voorwaarde by Koop van Grond, Verjaring en Regsdwalings oor Kenmerke van Saaklike Regte” (2018) *TSAR* 134.

<sup>92</sup> Reid (1997) *Acta Juridica* 225.

<sup>93</sup> Van der Merwe *Things* 37; Reid (1997) *Acta Juridica* 226-227.

<sup>94</sup> Van der Walt (1992) *THRHR* 185. But see below, n 132.

<sup>95</sup> 185-186.

<sup>96</sup> Swadling “Property” in *English Private Law* 174-175.

<sup>97</sup> On the personalist theory, see Badenhorst et al *Silberberg & Schoeman’s Property* 51-54; Van der Merwe *Things* 36; Van der Walt (1992) *THRHR* 186.

<sup>98</sup> P Birks “Definition and Division: A Meditation on Institutes” in P Birks (ed) *The Classification of Obligations* (1997) 1 9.

against specific persons only.<sup>99</sup> The same idea is expressed, from the perspective of the law of obligations, in the notion of a *vinculum iuris* – a legal bond between parties, traditionally thought to be of a purely personal nature.

Critical voices point out that not all real rights have absolute effect.<sup>100</sup> It is also contended that the personalist theory compares apples to oranges. While the description of a right as absolute is based on effect, observing that a right is relative between subjects alludes to the content of the relationship.<sup>101</sup> Van der Walt points out that:

“[T]he personalist theory does illustrate at least one aspect of the difference between the two rights in the sense that the object of a personal right (a performance) involves a specific person who must perform, while the object of a real right does not involve any person”.<sup>102</sup>

Many academics do not deny, however, that real rights relate to both, the element of absoluteness and the existence of an object external to the right.<sup>103</sup> In *Absa Bank v Keet*, the court continued:

“The person who is entitled to a real right over a thing can, by way of vindicatory action, claim that thing from any individual who interferes with his right. If, however, the right is not absolute, but a relative right to a thing, so that it can only be enforced against a determined individual or a class of individuals, then it is a personal right”.<sup>104</sup>

The two theories are therefore increasingly combined. Proponents of the classical theory do not deny that real rights are absolute and those who advocate for the personalist theory recognise that real rights relate to objects or things. The difference then becomes merely one of the order in which these criteria are applied. The result is that the different criteria have been fused into inseparable categories – real rights are always absolute; personal rights are always relative.

A method to further taper the definition of property is by narrowly tailoring the second element of the definition of property, namely “things”. Where “things” are for

<sup>99</sup> Van der Merwe *Things* 36.

<sup>100</sup> Van der Merwe *Things* 36; Van der Walt (1992) *THRHR* 186.

<sup>101</sup> Michaels “Systemfragen” in *HKK III* 75 [66]. Also see JC Sonnekus “Saaklike Regte of Vorderingsregte? – Tradisionele Toetse en ‘n Petitio Principii” (1991) *TSAR* 173 176.

<sup>102</sup> Van der Walt (1992) *THRHR* 187.

<sup>103</sup> Lubbe, for example, combines elements of both theories; see G Lubbe “A Doctrine in Search of a Theory: Reflections on the So-Called Doctrine of Notice in South African Law” (1997) *Acta Juridica* 246.

<sup>104</sup> *Absa Bank Ltd v Keet* 2015 4 SA 474 (SCA) 481E.

example, defined widely to include any patrimonial objects, the definition is one of property as wealth. This is the widest meaning of the term. Property in the first sense can include any asset that has a monetary value and can become part of a person's estate.<sup>105</sup> This idea of property as wealth has immensely increased in importance. Such a definition of property is, however, said to be imprecise and of limited use in defining property as distinguished from other legal concepts, most notably obligations.

What constitutes “things” or objects of property rights is a fiercely debated matter among property scholars. In Roman law the category of “things” included both corporeal and incorporeal objects.<sup>106</sup> Jurists writing on Roman-Dutch law followed the same approach.<sup>107</sup> The exclusion of incorporeal objects from the definition of things is of more recent origin and can be traced back to Pandectist theories.<sup>108</sup> Accordingly, many South African authors continue to emphasise the corporeality element of things. Van der Merwe limits the concept of things to corporeal objects.<sup>109</sup> He thus consistently refers to the body of rules as the “law of things” instead of property law.<sup>110</sup> Similarly, in Germany, things for purposes of the application of the rules of the law of things (“Sachenrecht”) are always corporeal as determined by § 90 BGB. The implication of this approach is as follows: If one applies the classical theory, the distinction between property and obligations is drawn, not merely on the basis that property relates to an object, but based on the assertion that such an object can only be corporeal. Corporeality becomes the key to enter the realm of property.

Adherence to the physical model can differ in scope. Those that observe the physicalist conception of property strictly, deny the existence of incorporeals.<sup>111</sup> Others recognise not only the existence, but also the importance of incorporeals, but like the authors of Silberberg & Schoeman, suggest that “the characteristic of corporeality should be maintained for purposes of the concept of a thing. Inherent in the rejection of the characteristic of corporeality is the danger that the definition of a

<sup>105</sup> Van der Merwe *Things* 5; Badenhorst et al *Silberberg & Schoeman's Property* 9.

<sup>106</sup> Gaius *Institutiones* 1.8; Justinian *Institutes* 2.2.pr. Also see below, n 118.

<sup>107</sup> For an overview, see Badenhorst et al *Silberberg & Schoeman's Property* 13.

<sup>108</sup> Badenhorst et al *Silberberg & Schoeman's Property* 13; Michaels “Systemfragen” in *HKK III* 37-43 [33]-[37].

<sup>109</sup> Van der Merwe *Things* 13; CG van der Merwe “Things” in WA Joubert & JA Faris *LAWSA* 27 2 ed (2014) para 19.

<sup>110</sup> Van der Merwe *Things* 5.

<sup>111</sup> For an overview, see S Scott “Vorderingsregte as Onliggaamlike Sake – Waarom Nie?” (2010) 73 *THRHR* 629 630.

thing may become too vague to have scientific value”.<sup>112</sup> Van der Walt and Pienaar similarly identify corporeality as one of the characteristics of the narrow definition of a thing.<sup>113</sup> Yet, they prefer to include within the ambit of property “everything which can form part of a person’s estate”.<sup>114</sup> Accordingly, they argue that almost any asset can be an object for purposes of property, but they do recognise that assets such as shares do not fit the traditional, narrower ambit of property.<sup>115</sup> The wider meaning of property in terms of the Constitution, Van der Walt and Pienaar argue, should be reflected in the common law.<sup>116</sup>

#### 17 4 2 The boundary in the context of shares

The physical model has become unfashionable in a sense. Many a theorist has set out to demonstrate the fallacy of the physicalist conception of property or to show how it can be overcome. Shares are an apt case study in this regard. What even a cursory examination of the debates surrounding shares also shows, however, is how pervasive the physical model, or its ghost, still is – not only in South Africa, but also beyond.

Of all the treatises on shares considered above, Pretto-Sakmann’s is the only one that endorses the physical model as necessary and appropriate in drawing the boundary between property and obligations.<sup>117</sup> On the other hand, a variety of arguments have been crafted to show why incorporeals, and therefore shares, fall within the ambit of property. Benjamin rests her rejection of the physical model on a historical basis and invokes the Gaian tripartite division of the law to do so.<sup>118</sup> Schroeder draws on philosophy to show why the corporeality requirement must be

<sup>112</sup> Badenhorst et al *Silberberg & Schoeman’s Property* 18-19. Also, Van der Merwe “Things” in *LAWSA* 27 para 17.

<sup>113</sup> Van der Walt & Pienaar *Property* 14.

<sup>114</sup> 12, 25.

<sup>115</sup> 26.

<sup>116</sup> 26.

<sup>117</sup> See above, 16 1 2 Arianna Pretto-Sakmann.

<sup>118</sup> See above, 16 1 1 Joanna Benjamin. According to Gaius, the law (*ius*) consisted of persons, things and actions (Gaius *Institutiones* 1.8; Justinian *Institutes* 1.2.12). Things included both corporeals and incorporeals (Gaius *Institutiones* 2.12; Justinian *Institutes* 2.2.pr). Obligations were therefore incorporeal things (Gaius *Institutiones* 2.14; Justinian *Institutes* 2.2.pr), but they were enforceable by the *actio in personam*, being an action directed at or against a specific person, not the *actio in rem*. The strict property-obligations dichotomy propounded by German jurists was therefore based on the Roman *actiones*, not the *res* and was achieved by equating the obligation and the *actio in personam*. Also see Michaels “Systemfragen” in *HKK III* 35 [32].

rejected<sup>119</sup> and Lehmann proposes that the boundary should be based on the respective functions of property and obligations.<sup>120</sup>

The physical model is paradigmatic of reification in law. The trouble with shares is that they are traditionally subjected to a “double-reification”; firstly the reification of the share in the share certificate and secondly, the reification of property as corporeal objects. In law, reification functions on various levels. One of them is the association of certain legal rights with “thinghood”.<sup>121</sup> This is the root of Schroeder’s criticism.<sup>122</sup> Reification also exerts significant influence on a theoretical level by creating a fertile environment for treating the law “as an immutable object instead of a fluid construction”.<sup>123</sup> The latter effect is particularly evident from an analysis of the idea of property in law.

At the core of shares is the relationship between an issuer of shares and an investor. This is the basis on which shares are classified as obligations. The debate about the contractual nature of the share<sup>124</sup> is an issue of the inward classification of the category of obligations and reveals nothing about the outward classification of obligations as distinguished from property. A recurring finding in the discussions on the classification of shares is that shares transcend the personal relationship. Shares can be alienated or vindicated. They share this fate with many obligations, primarily contracts, as Pretto-Sakmann points out.<sup>125</sup> They differ from ordinary contracts because transferability is an inherent part of their design.

Shares go beyond the personal relationship, said to be characteristic of obligations, in other respects as well, exhibiting characteristics that are said to be typical of property, but not of obligations. One such example is the third-party, absolute effect that shares must have to operate in modern, fast-paced markets. Shares, even if intermediated, must be shielded from the creditors of an intermediary. Furthermore, there is a perceived need to protect *bona fide* purchasers of shares.

<sup>119</sup> See above, 16 2 3 Jeanne Schroeder.

<sup>120</sup> See above, 16 3 4 Matthias Lehmann.

<sup>121</sup> D Litowitz “Reification in Law and Legal Theory” (2000) 9 *Sout Cal Interdisc LJ* 401 402.

<sup>122</sup> See above, 16 2 3 Jeanne Schroeder.

<sup>123</sup> Litowitz (2000) *Southern California Interdisciplinary LJ* 402-403. Also see, M Smith & N Leslie *The Law of Assignment* 2 ed (2013) 15 [2.12].

<sup>124</sup> See above, 6 3 The obligatory realms of shares and some conclusions.

<sup>125</sup> See above, 16 1 2 Arianna Pretto-Sakmann. In the South African context, also see the dictum in *Isaacman v Miller* 1922 TPD 56 61: “There is no doubt that a contract like all rights of action is property; it can be alienated, mortgaged and inherited.”

The narrative of shares is therefore one in terms of which obligations can be enforced, if not “against the world at large”, at least against a part of the world.

One solution to the conundrum is a complete rejection of the physical model, as undertaken by Benjamin, with the effect that shares, but also almost all obligations, are property.<sup>126</sup> English law, precisely because of the absence of an independent category of obligations, is more likely to lean toward such a conclusion. Yet, the physicalist conception of property is also dismissed by Lehmann in the context of German law<sup>127</sup> and by Schroeder writing on US law.<sup>128</sup> While Lehmann focuses on finding a different set of criteria for determining the boundary between the law of property and the law of obligations, Benjamin and Schroeder dismiss the physical model of property without offering alternative theoretical explanations. Their propositions are, however, particularly relevant for showing that part of the problem with the distinction between property and obligations is the fact that the former are always deemed to have absolute effect and the latter are always relative. There is a need to separate these criteria.

An appreciation of the importance of uncoupling “real” from “absolute” and “personal” from “relative” points towards another solution – one that describes shares as *sui generis*.<sup>129</sup> This description not only conveys that shares are located somewhere between property and obligations, but also that they are “unique” in the sense of being a class of their own. Yet shares illustrate certain problems that increasingly arise in a wider context where obligations become fungible, commoditised or ambulatory.

A third solution may be to advocate for an application of certain property mechanisms and remedies based on analogy. Micheler suggests this model in the context of German law.<sup>130</sup> The “analogy” idea also features in South African case law.<sup>131</sup> The problem with this solution is that it is, dogmatically speaking, an easy, but lazy compromise. It avoids having to reconsider or even meddle with established classifications and boundaries, it lacks explanatory force and, as South African case law shows, it often obscures the true state of affairs.

<sup>126</sup> See above, 16 1 1 Joanna Benjamin.

<sup>127</sup> See above, 16 3 4 Matthias Lehmann.

<sup>128</sup> See above, 16 2 3 Jeanne Schroeder.

<sup>129</sup> See above, 16 1 3 Eva Micheler; 16 2 1 Rogers and Mooney; 16 3 2 Wolfgang Zöllner.

<sup>130</sup> See above, 16 3 3 Eva Micheler.

<sup>131</sup> See especially the cases discussed above at 16 4 1 2 1 Vindication of shares.

### 17 4 3 Developing an explanatory model

All these solutions fail, from a theoretical perspective, to show why and in which circumstances shares and obligations can be said to have absolute effect. What is needed is an explanatory and predictive model. Finding a workable model for drawing the boundary between the law of property and the law of obligations by proceeding from the premise of property is marred by uncertainty and disagreement. It is useful therefore to approach the matter from the angle of the law of obligations. Instead of asking what is property as distinguished from obligations the enquiry becomes what sets obligations apart?

It is today widely accepted that an obligation relates to an object as well, found in the performance of the debtor.<sup>132</sup> What distinguishes obligations from property is not so much the presence or absence of an object, an object is present in both, but rather the presence or absence of a *vinculum iuris*, a personal bond. An obligation creates a relationship between a person and an object (the performance) as well as a relationship between a debtor and a creditor.<sup>133</sup> Beyond the subject-object dimension, rights to property in the traditional sense are enforceable between persons as well.<sup>134</sup> Property law nonetheless lacks the personal relationship that characterises the law of obligations.<sup>135</sup> From this perspective it becomes unnecessary to resort to the corporeality of the object as a distinguishing characteristic.

Michaels, writing on German law, differentiates between an internal and an external sphere of obligations.<sup>136</sup> The internal sphere encompasses the personal bond that characterises obligations. Property lacks this internal sphere. In the internal sphere rights are always relative.

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<sup>132</sup> See for example LF van Huyssteen, MFB Reynecke & GF Lubbe *Contract: General Principles* 5 ed (2016) 3 [1.9]; Sonnekus (1991) *TSAR* 179; WA Joubert "Die Betekenis van die Subjektiewe Reg en die Betekenis van 'n Realistiese Begrip Daarvan vir die Privaatreg" (1958) 21 *THRHR* 12 98.

<sup>133</sup> Michaels "Systemfragen" in *HKK III* 76 [67] writes: "Zusätzlich zum absoluten Character der Zuordnung der Forderung existiert noch die spezielle Verbindung zwischen Gläubiger und Schuldner, die beim dinglichen Recht kein Gegenstück hat, weil die Sache selbst nicht als verpflichtet angesehen werden kann." Also see Van der Walt (1992) *THRHR* quoted above, n 102; Van Huyssteen et al *Contract* 3 [1.9].

<sup>134</sup> See the criticism in the text to n 93 above.

<sup>135</sup> Benjamin *Interests in Securities* 305 [13.09]. Also see the statement by Van der Walt quoted in the text to n 102 above.

<sup>136</sup> Michaels "Systemfragen" in *HKK III* 75-76 [66]-[67].

The external dimension describes the subject-subject dimension of obligations, and also of property.<sup>137</sup> Property rights are said to be absolute and operative against the whole world in the external sphere because the right follows the object or thing, not the person. Every obligation also has external effect in the sense that it is protected against interference by parties external to the personal relationship.

The nature and scope of the external effect of an obligation is determined by its characterisation in the internal sphere. The content of a personal right can be directed at an object or a thing (defined widely to include corporeals and incorporeals) or can simply constitute an act.<sup>138</sup> In developing this idea Michaels lends from Gaius, who distinguished between those obligations that are aimed at the delivery of an object or thing (*obligatio dandi*) and those obligations that are aimed at a specific action (*obligatio faciendi*).<sup>139</sup>

The paradigmatic example of an *obligatio dandi* is the procurement of ownership and therefore the conveyance of a tangible thing or an *in rem* right to such a thing. What distinguishes a tangible thing as an object of property from performance as an object of an obligation, is the fact that in the former case, the object is external to the parties contracting about it so that it can be conveyed from one to the other, whereas in the traditional sense, performance as an object is an integral part of the relationship between the parties; if the relationship dissolves so does performance as an object. The pertinent question is therefore whether the object of an obligation assumes such nature that it can be said to become an object external to the personal relationship between the parties.

Penner proceeds from the assumption that property is a right to things. In characterising things he develops the “separability thesis” in terms of which a thing encompasses everything that is separable from ourselves, our person and our personality rich relationships.<sup>140</sup> The primary element that determines whether an

<sup>137</sup> Van der Walt (1992) *THRHR* 188 writes: “Every ‘subjective right’ (including both real and personal rights) has two aspects: a relationship between the subject and the object of the right (called the subject-object relationship), and a relationship between the subject of the right and all other parties (called the subject-subject relationship).”

<sup>138</sup> 76 [67].

<sup>139</sup> Gaius *Institutiones* IV.2. Michaels “Systemfragen” in *HKK III* 76 [67], 35 [32] also refers to the distinction, formulated by Brecher, between “persönlichen und gegenstandsbezogenen Forderungen”; see F Brecher “Vertragsübergang, Betriebsnachfolge und Arbeitsverhältnis” in *Festschrift für Schmidt-Rimpler zum 70. Geburtstag* (1957) 181.

<sup>140</sup> See JE Penner *The Idea of Property in Law* (1997) ch 5. The argument advanced here differs from Penner’s, however, because the aim is not to show which objects can be things for the purposes of property law, but rather to show obligations can be “objects” of other obligations.

object is separable, according to Penner, is the level of personality inherent in a relationship.<sup>141</sup> As a secondary factor he identifies certainty or definability of the value of the object.<sup>142</sup>

That separability relates to an object of certain, or independently determinable value is also reflected in the original notion of an *obligatio dandi*, which was also known as a *certa obligatio* because it has an objectively ascertainable and perceptible value, so that the value of the obligation “is co-extensive with the value of the object of the act”.<sup>143</sup>

Dooyeweerd emphasises that a subject-object relationship is an essential component of every subjective right and finds, in turn, that an object can be anything that is susceptible to economic value.<sup>144</sup> He describes a legal object as being “primarily a juridical objectification of an economic interest”.<sup>145</sup> Implicit in this argument is also an element of a lack of personality.

Two elements are therefore of central importance: personality and certainty of value. This development of the notion of what can constitute an object for purposes of an obligation gives a new dimension to the concept of an *obligatio dandi*. An obligation (obligation x) can be described as object-related if it connects to a performance that becomes “separable” from its subject-subject relationship that characterises this obligation (obligation y) in the internal sphere. This is achieved if an obligation (obligation y) becomes relatively impersonal. It is useful, therefore, to plot an obligation (obligation y) on a continuum from the purely personal to the impersonal. In such cases, the content of obligation x is directed at an object, which is obligation y. This enquiry is an interim step, however, because it can merely reveal how an obligation (obligation x) may behave in the external sphere. It can neither determine conclusively that an obligation will have an effect in the external sphere, nor what the scope of this effect is. Therefore, if an obligation relates to an object or thing (obligation y) in the sense delineated above, it is an indication that the obligation (obligation x) may have absolute effect in the external sphere.

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<sup>141</sup> 115, 117, 118.

<sup>142</sup> 117-118.

<sup>143</sup> R Sohm *The Institutes of Roman Law* (1892) 285 [62] (translation by GC Ledlie of the 4 ed of the German).

<sup>144</sup> HJ Dooyeweerd “Grondproblemen in de Leer der Rechtspersoonlikheid” (1937) 98 *Themis* 367 404-405.

<sup>145</sup> 406 (own translation). Also see 408.

The purpose of this analysis is not primarily to determine whether obligations can be transferred. It is today widely accepted that obligations can be alienated and can also be conveyed by other means such as by inheritance or a mortgage. In addition, it is inaccurate to argue that a personal right is subject to the rules of property law because it is transferable; rather, it is transferable because it evidences certain characteristics that make it comparable to “property” or objects of property.<sup>146</sup> This analysis is, therefore, rather aimed at determining whether and to what degree obligations can have third-party, absolute effect akin to the *erga omnes* effect of property rights.

Before proceeding with an analysis of the external dimension of obligations, it is apt to illustrate the internal dimension, and in particular the propensity of shares to serve as objects external to a transaction or obligation involving shares. Shares, it was illustrated in Part 1, exhibit many features that plot them on the impersonal, object-related end of the continuum: In the first place, shares consist of a number of distinct rights.<sup>147</sup> And although it is true that these rights can only be performed and enforced between an issuer and an investor or shareholder, the law regulating companies, particularly listed companies, has developed in such a way that the identity of shareholders plays only a subordinate role from the perspective of an issuing company. Thus, a listed company no longer has the power to reject a transfer. In addition, it was shown that shares are more than a numerical percentage of the company’s share capital; they are units of capital in their own right.<sup>148</sup> This strengthens the characterisation of shares as objects by highlighting, that shares have a value that, although it can be subject to significant fluctuation, is still objectively determinable with reference to market values. It also underscores the conclusion that the meaning of “objects” transcends the physical paradigm by detaching the value of shares from the value of share capital and from the value of the assets held by the company. This conclusion is reiterated by the entity theory.<sup>149</sup> Macpherson, therefore, who analyses changes in the concept of property in relation to the development of capitalism, finds that, fuelled by “the rise of the modern corporation, and the predominance of corporate property”, “property is again being

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<sup>146</sup> Also see Penner *Idea of Property* 113.

<sup>147</sup> See above, Chapter 5: Rights, obligations and classes of shares.

<sup>148</sup> See above, Chapter 3: The concept of capital.

<sup>149</sup> See above, 4.2 The entity theory.

seen as a right to a revenue or an income, rather than as rights in specific material things".<sup>150</sup>

Shares, as obligations, may act as objects of other obligations. As between an issuer and a shareholder or investor, there exists a personal relationship that dictates, amongst other factors, how shares are created, how and to whom performance must be made and who is entitled to enforce performance. As between the parties in the internal sphere, shares are complex, multifaceted obligations.<sup>151</sup> Whenever shares are transacted with they may act as objects of the obligations so entered into, whether it be a contract of sale, a contract of mandate, a real security transaction or a usufruct.

Every obligation has an external effect. In the case of obligations that are not object-related and that evidence a high level of person-relatedness in the internal sphere, the external effect encompasses a right against interference by persons that are not party to the relationship.<sup>152</sup> This finds expression, for example, in the general duty not to intentionally induce one of the contracting parties to breach the contract.<sup>153</sup> The right against interference is not a manifestation of the absolute operation of rights, comparable to the *erga omnes* effect of property law.<sup>154</sup> On the other hand, obligations that display an object-relatedness in the internal sphere can have absolute effect in the external sphere. The relativity of the obligation diminishes and a measure of absoluteness emerges, but only in relation to parties outside the debtor-creditor relationship.

The finding that an obligation is object-related in the internal sphere is only an indicator of absolute effect in the external sphere. There are two factors that determine the scope of their real operation. In the first place, the level of separability of the object from its own internal subject-subject relation and therefore the prominence of its property-like or thing-like features can reveal something about the degree of external effect. In the second place, it is up to the legislator, policy-makers and courts to decide whether and how to flesh out this third-party effect.<sup>155</sup> Such an

<sup>150</sup> CB Macpherson "Capitalism and the Changing Concept of Property" in E Kameneka & RS Neale (eds) *Feudalism, Capitalism and Beyond* (1975) 104 114; Macpherson "Meaning of Property" in McPerson *Property: Mainstream and Critical Positions* 8.

<sup>151</sup> See, 6 3 The obligatory realms of shares and some conclusions.

<sup>152</sup> Van der Walt (1992) *THRHR* 188-189.

<sup>153</sup> See generally, *Lumley v Gye* 118 ER 749 (1853) and *Isaacman v Miller* 1922 TPD 56.

<sup>154</sup> Van der Walt (1992) *THRHR* 189.

<sup>155</sup> Michaels "Systemfragen" in *HKK III* 77 [69].

evaluation must be made taking into consideration principles such as autonomy and accountability, which mitigate against third-party effect, and the existence of special relationships such as agency, as well as general economic considerations, which advocate for absolute effect.<sup>156</sup> As part of this evaluation, functional considerations find their rightful place. So must constitutional- or human rights considerations. An enquiry along these lines is indispensable because a finding that rights have absolute effect “binds” parties external to an agreement and must therefore be carefully justified. At the very least, a contemplation of underlying principles and considerations can assist in answering *why* certain objects, whether corporeal or incorporeal, are treated as having third-party effect. Categories such as “property” and “obligations” do not have intrinsic value. The value of systematisation lies in the framework it provides for such an evaluative exercise.<sup>157</sup>

The dual nature of obligations is not a novel idea. It has been developed in the context of cessions to explain how and why personal rights, traditionally thought to be inalienable, have become susceptible to a transfer by cession or assignment.<sup>158</sup> One dimension of obligations, or personal rights, is the relationship between two subjects – the debtor and the creditor. When transferring a personal right, a substitution of creditors takes place in the obligatory realm.<sup>159</sup> This is the primary function undertaken by the law of cession.<sup>160</sup> The other dimension is the notion of an obligation as a patrimonial asset that can be transferred from the estate of the cedent to that of the cessionary.<sup>161</sup> This is the proprietary dimension of personal rights. Scott

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<sup>156</sup> 77-78 [69].

<sup>157</sup> Michaels cautions that systematisation can entice jurists to treat categories such as “property” and “obligations” as having intrinsic value instead of treating them as merely providing a framework for evaluation and argumentation; 3 [1].

<sup>158</sup> Scott *Scott on Cession* 15-16; S Scott *Sessie in die Suid-Afrikaanse Reg* LLD thesis University of South Africa (1977) 111; Scott *Law of Cession* 4; Scott (2010) *THRHR* 633; S Scott “The Comparative Method in Action – Aspects of the Law of Cession (Part 1)” (2001) 33 *De Jure* 211 217-218; GF Lubbe & PM Nienaber “Cession” in WA Joubert & JA Faris *LAWSA* 3 3 ed (2014) para 136. Also see G Lubbe “Assignment” in H MacQueen & R Zimmermann (eds) *European Contract Law: Scots and South African Perspectives* (2006) 307 307. For a brief historical overview of the development of a proprietary conception of cession/assignment, see N Jansen “Assignment of Claims” in N Jansen & R Zimmermann (eds) *Commentaries on European Contract Laws* (2018) [6]-[12].

<sup>159</sup> Scott *Scott on Cession* 16; Scott *Sessie* 111; Scott *Law of Cession* 4; Scott (2010) *THRHR* 633; Scott (2001) *De Jure* 217-218.

<sup>160</sup> Lubbe & Nienaber “Cession” in *LAWSA* 3 para 136.

<sup>161</sup> Scott *Scott on Cession* 16; Scott *Sessie* 111; Scott *Law of Cession* 4; Scott (2010) *THRHR* 633; Scott (2001) *De Jure* 217-218.

rightly points to a number of cases on shares where the dual nature of shares was raised, even recognised, but poorly understood.<sup>162</sup>

That obligations can be accorded limited real operation has been recognised by South African courts in cases governed by the doctrine of notice.<sup>163</sup> In these cases, a third party to whom an asset is transferred in breach of a personal right, such as, for instance a right of pre-emption granted to another, can be obliged to give effect to the right of pre-emption if she had knowledge thereof.<sup>164</sup> The real operation is therefore limited to the party who had actual knowledge.<sup>165</sup> This stands in contrast to a real right, which operates against the world at large because everybody is deemed to have knowledge of the right.<sup>166</sup> Of central importance for real operation, whether in property law or for the operation of the doctrine of notice, is therefore an element of publicity.<sup>167</sup> The finding by the court that the publicity precondition is satisfied where the third party has knowledge of the right of pre-emption illustrates the importance of analysing the underlying justifications for the real operation of rights.

The publicity requirement is particularly instructive in the context of shares because it can also explain why account entries are now required for a valid transfer of securities. Traditionally, a transfer of personal rights by cession is valid without any publicity as can be found in the delivery requirement of movable corporeals.<sup>168</sup> As Van Huyssteen et al postulate, “the belief that the incorporeal nature of the asset does not create a significant risk that third parties may be misled by such transfers, seem to play a part”.<sup>169</sup> This assumption does not hold in the context of listed shares and securities, which are frequently highly mobile and liquid. Thus, a publicity mechanism in the form of a book-entry or register system was introduced. That securities

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<sup>162</sup> Scott *Law of Cession* 5.

<sup>163</sup> See *Associated South African Bakeries (Pty) Ltd v Oryx & Vereingte Bäckereien (Pty) Ltd* 1982 3 SA 893 (A) 910G-H: “Die juiste siening na my mening is dat vanweë die kennisleer aan ‘n persoonlike reg beperkte saaklike werking verleen word.” Also see GF Lubbe & C Murray *Contract: Cases, Materials and Commentary* 3 ed (1988) 5-16 n 3.

<sup>164</sup> Van Huyssteen et al *Contract* 83 [3.55].

<sup>165</sup> *Associated South African Bakeries (Pty) Ltd v Oryx & Vereingte Bäckereien (Pty) Ltd* 1982 3 SA 893 (A) 910H.

<sup>166</sup> 910H.

<sup>167</sup> Lubbe & Murray *Contract* 16 n 3.

<sup>168</sup> Van Huyssteen et al *Contract* 440 [12.15].

<sup>169</sup> 440 [12.15].

ownership, transfer and holding is deemed to be sufficiently public, also explains why these rights may have limited real operation.<sup>170</sup>

South African courts are correct insofar as they highlight the dual nature of shares as personal rights and incorporeal objects. The lacuna in their analysis is a proper appraisal of how and why the finding that shares are incorporeals induces third-party effects. The model developed, can assist courts and legislators to determine, categorise and explain the third-party effect of shares and other obligations. In the first step it is useful to picture obligations on a continuum from person-related to object-related. Secondly, the nature of the object deserves scrutiny; and thirdly, underlying principles and considerations must be contemplated, examined and where necessary, weighed up.<sup>171</sup>

Does it matter whether shares are property? Property and its boundaries – an even cursory glance of the literature shows – remain highly contested. Even the idea of the dual nature of obligations can lead to different conclusions on the property-obligations dilemma. Based on his model, Michaels concludes that all matters that fall within the external sphere must correctly be classified as belonging to the law of property. So construed, cession or assignment would fall under the law of property not the law of obligations.<sup>172</sup> Scott, also in the context of cession, takes note of the divergent constructions, but concludes that cession necessarily relates to both the law of property and the law of obligations.<sup>173</sup> Canaris, on the other hand, distinguishes between a “reification of obligations” (“Verdinglichung obligatorischer Rechte”)<sup>174</sup> and an application of property rules by analogy.<sup>175</sup> The former entails that under particular circumstances, an obligation is accorded real characteristics and

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<sup>170</sup> On the other hand, the registry and account system is not public in the same way as possession of a corporeal is, which may explain why the real operation must be modified. Also see below, 17 5 2 Why is an investor protected against the creditors of an intermediary? And 17 5 3 Why is good faith acquisition provided for?

<sup>171</sup> Zöllner’s analysis of the justifications underlying transactional security provides a good example of scrutinising the principles and values underlying, not only property and obligations in their broader context, but also individual and specific aspects thereof – in this case *bona fide* purchaser rules. See above, 16 3 2 Wolfgang Zöllner. Likewise, the critical analysis of Van der Walt and Sutherland of the *Tigon* decision highlights the importance of underlying considerations and policy grounds. See above, 16 4 1 2 2 Quasi-possession and the mandament van spolie.

<sup>172</sup> Michaels “Systemfragen” in *HKK III* 94 [83].

<sup>173</sup> Scott *Scott on Cession* 17-19; Scott *Law of Cession* 4-6; Scott (2010) *THRHR* 633; Scott (2001) *De Jure* 218-219.

<sup>174</sup> The term goes back to G Dulckheit *Die Verdinglichung obligatorischer Rechte* (1951).

<sup>175</sup> C-W Canaris “Die Verdinglichung obligatorischer Rechte” in HH Jakobs, B Knobbe-Keuk, E Picker & J Wilhelm (eds) *Festschrift für Werner Flume zum 70. Geburtstag I* (1978) 371 372, 374.

effects.<sup>176</sup> The result is a complex mixture that must be doctrinally located between the law of property and the law of obligations.<sup>177</sup> In the case of shares and other securities he argues, however, that property rules are merely applied by analogy.<sup>178</sup>

What matters more than conclusive classifications, however, is the recognition that shares and other obligations can have absolute effect in the external sphere. Whether such rights or entitlements are, in the external sphere, classified as property,<sup>179</sup> analogous to property<sup>180</sup> or *sui generis*,<sup>181</sup> is not only irrelevant for the classification of the obligation in the internal sphere, which remains intact as an obligation, but is also, in the external sphere, less important than an illustration of old and new connections between property and obligations, a re-consideration of how they relate to one another, a return to underlying principles and perhaps the awareness that the boundaries are more permeable than generally assumed. This, naturally, does not absolve us from the duty of constructing new hypotheses for explaining and predicting legal consequences.<sup>182</sup> The increasing importance of incorporeal objects of wealth, coupled with the proliferation of legal relations at the boundary between property and obligations all necessitate a redetermination of the ambit of both property and obligations. Shares provide an illustration of a hypothesis that can be advanced in, if not redrawing the boundaries, illuminating individual aspects of the connection between property and obligations.

## 17 5 A selective application of the findings

### 17 5 1 General remarks

To show how the theoretical, doctrinal and conceptual considerations outlined above can be applied to intermediated holdings in South African law, three questions will be

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<sup>176</sup> 372.

<sup>177</sup> 372.

<sup>178</sup> 374-375.

<sup>179</sup> See above, 16 1 1 Joanna Benjamin and 16 3 4 Matthias Lehmann.

<sup>180</sup> See above 16 3 3 Eva Micheler. Also see Van der Walt (1989) *THRHR* 446, who writes in a contribution on the application of the *mandament van spolie* to incorporeals that incorporeal things do not exist. Rather, “the term is used to indicate that specific characteristics and functions of rights to (corporeal) things are applied by analogy to other rights (particularly obligations)” (own translation). Schroeder of course argues that all property, whether it relates to corporeal or incorporeal objects, does not exist as it is merely symbolic. In Schroeder’s sense it is not important whether objects are real in the physical sense; rather it is essential that they have reality; see above, 16 2 3 Jeanne Schroeder.

<sup>181</sup> See above, 16 2 1 Rogers and Mooney, 16 1 3 Eva Micheler, 16 3 2 Wolfgang Zöllner.

<sup>182</sup> In the words of U Mattei “Three Patterns of Law: Taxonomy and Change in the World’s Legal Systems” (1997) 45 *Am J Comp L* 5.

briefly considered. 1. Why is an investor protected against the creditors of an intermediary? 2. Why is good faith acquisition provided for? 3. Does the theory support the notion of quasi-possession and justify a recourse to the *mandament van spolie*? The aim is not to show that investors can be put into the same position they were in before systemic intermediation emerged. This, Gullifer finds, is unattainable due to differences in the systems and availability of information brought about by systemic intermediation.<sup>183</sup> Systemic intermediation raises novel issues and concerns and other risks, including the increased exposure to intermediary creditors as well as a renewed urgency to resolve the *bona fide* acquisition dilemma, are significantly amplified by systemic intermediation,

The model and underlying theory is essentially used to answer one crucial question: To what degree (if at all) can an obligation be given binding third-party effect and if, against which parties? There is no one-size-fits-all answer. The question must be asked and answered in respect of each individual obligation as it arises. Also, not every third-party effect is necessarily against the “world at large”. Some are limited third-party effects. Important, however, is that the model permits us to construe these third-party effects not as exceptions, but as flowing naturally from the nature and quality of the personal relationship as it manifests itself in the internal sphere of an obligation and as bolstered by underlying considerations.

#### 17 5 2 Why is an investor protected against the creditors of an intermediary?

In the relationship between an investor and an intermediary, the obligation is contained in the contract of mandate or in a contract containing elements of mandate. In terms of this obligation, the intermediary becomes the holder of an entitlement to collect, while the investor retains the core right.<sup>184</sup> The intermediary has the duty to collect performance and pass it on to the investor. This obligation is intrinsically connected to the core right, which, as was argued above, retains its essential character.<sup>185</sup> An examination of the internal sphere of the obligation is therefore object-related. The object it relates to is the share or the core right, which is capable of sustaining an existence sufficiently separable from the personal relationship between issuer and investor.

<sup>183</sup> L Gullifer “Ownership of Securities: The Problems Caused by Intermediation” in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 1 32.

<sup>184</sup> See above, 17 3 2 The burdening of a personal right

<sup>185</sup> See above, 17 3 4 Transformation of assets and the creation of new assets and rights

The ordinary principles of the law of agency, as supplemented by legislation, dictate that an intermediary must segregate any property or proceeds of the principal from own property.<sup>186</sup> Despite this rule and the conceptual split between the core right, retained by the owner, and the entitlement to enforce and collect that settles in the intermediary, there is some risk associated with the use of an intermediary. If shares are held through intermediaries, there is a risk that creditors of an intermediary will seek to attach the assets of the intermediary either, to satisfy a judgment, or in the case of insolvency of the intermediary.<sup>187</sup>

The special relationship that exists between an investor and an intermediary is therefore one of the underlying factors that should be taken into account when determining the third-party effect of shares. Based on the dynamics of the intermediary-investor relationship, shares should have a limited real effect; real because the owner thereof should be able to “vindicate” the right from a creditor of an intermediary and limited, because this effect does not operate against the world at large, but only against creditors of intermediaries. The limited real effect can also be explained with reference to the principle of publicity. Account entries made by an intermediary in favour of a client publicise that the intermediary does not hold shares for its own benefit. Publicity, it has been shown above, is a factor that justifies the limited real operation of rights.<sup>188</sup> The conclusion that a creditor of an intermediary cannot attach shares held through an intermediary is also supported by the burdening theory, which posits that an intermediary holds merely an entitlement to collect, not the core right. This entitlement is not a self-standing right.

Sommer’s account of the operation of the principle of privity in intermediated holding chains is also instructive.<sup>189</sup> The two explanations are not opposites, however. Sommer’s theory shows why the fact that the relationship is obligatory keeps third parties out in the first place. The explanatory model strengthens this conclusion by showing that, if creditors do intervene in the relationship, the contracting parties have stronger remedial protection. If anything, this conclusion reinforces the importance of privity in financial markets.

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<sup>186</sup> See above, 13 2 3 3 Agency and mandate.

<sup>187</sup> On intermediary risk, see 9 3 2 Relationship-based and systemic intermediation, text to n 52.

<sup>188</sup> See above, 17 4 3 Developing an explanatory model, text to nn 163-170.

<sup>189</sup> See above, 16 2 2 Joseph Sommer.

### 17 5 3 Why is good faith acquisition provided for?

The obligation at question in this scenario is a contract of sale in terms of which the performance of the seller consists of the duty to transfer shares. From the perspective of its internal sphere (the seller-buyer relationship), the obligation is object-related because it is connected to a share that originates from another subject-subject relationship between the issuer and the investor. The risk that third parties will be misled about ownership, holding or transfer of shares is significant. This is so because of the strong “object-related” nature of shares in the internal sphere i.e. the ability of shares to constitute an object sufficiently separable from the personal relationship that sustains it. In fact, the mobility of listed shares frequently surpasses that of movable things, unburdened as they are by a corporeal body, unconstrained by delivery requirements and amplified by their remarkable liquidity. The mobility of shares is a risk not only to third parties, but also to the owners thereof. According to the ordinary principles of property law, the risk to owners is mitigated by the principle of publicity, which functions in conjunction with the real operation of rights. Owners of property can therefore ordinarily enforce their rights *erga omnes*. The real operation of rights is bolstered by the *nemo plus iuris* doctrine – nobody can transfer to third parties rights that they themselves did not have. The protection of ownership is therefore two-pronged.

While publicity mechanisms in the form of registers and accounts similarly protect owners of shares by allowing them to enforce their rights against certain third parties, such as creditors of intermediaries,<sup>190</sup> they provide no protection to purchasers of shares, who are similarly exposed to the risks created by the characterisation of shares as highly mobile objects. In addition to a limited real operation of rights, a good faith purchaser rule therefore serves to allay this risk. The property-like features of shares and securities serve as a justification for such a rule. The rule gives recognition to the fact, also highlighted by Micheler, that shares are intended for circulation.<sup>191</sup> The rule is a special legal attribute of shares, but also of negotiable instruments and of money. It is interesting because it allows title to be renewed and therefore diminishes the real effect of rights by prohibiting rights to be “vindicated” from purchasers who acquired them in good faith. The good faith purchaser rule

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<sup>190</sup> See above, 17 5 2 Why is an investor protected against the creditors of an intermediary?

<sup>191</sup> See above, 16 1 3 Eva Micheler.

illustrates that, even if an obligation is characterised as object-related in the internal sphere, there may be factors that mitigate against a third-party effect in the external sphere. It further shows that even if obligations as incorporeal objects share many features with corporeal assets, they are different in nature and must be analysed and treated differently.

17 5 4 Does the theory support the notion of quasi-possession and justify a recourse to the *mandament van spolie*?

“Quasi-possession” of shares must be associated with the right to be on the register. Van der Walt and Sutherland point out that the court in *Tigon Ltd v Bestyet Investments (Pty) Ltd*,<sup>192</sup> fails to sufficiently distinguish between two aspects, namely shareholding (or membership as it was then) and ownership (beneficial holding).<sup>193</sup> It is accurate that ownership is not necessarily co-extensive with shareholding. Yet, shareholding must derive in some way from ownership. Therefore, both an owner and a holder of a split-off entitlement to collect performance have the right to be on the register. In both cases, the obligation at question is therefore one between an issuer and an investor, in the latter case, the obligation is just intermediated by a third party, the nominee.

It was argued above that even if shares are capable of constituting an incorporeal object that is sufficiently separable from its subject-subject relationship, it does not change the characterisation of shares as personal rights in the internal sphere.<sup>194</sup> The right to be on the register is an inherent part of the subject-subject relationship. The obligation between the issuer and the investor is therefore not object-related. In addition it was found that the entitlement to collect, even if split-off from the core right, is not independent from it and therefore does not constitute a self-standing right.<sup>195</sup> It can therefore not constitute an object on which the right to be on the register can hinge.

That the existence of an independent, sufficiently separable object is of importance appears from the requirements for the *mandament van spolie*. The *mandament*, courts have found, can be extended to incorporeal rights, but these

<sup>192</sup> 2001 4 SA 634 (N).

<sup>193</sup> AJ van der Walt & PJ Sutherland “Dispossession of Incorporeals or Rights – Is the Mandament van Spolie the Appropriate Remedy?” (2003) 15 *SA Merc LJ* 95 101.

<sup>194</sup> See above, 17 4 3 Developing an explanatory model.

<sup>195</sup> See above, 17 3 4 Transformation of assets and the creation of new assets and rights

rights must relate to a corporeal object.<sup>196</sup> Even if setting aside the element of corporeality, the features inherent in this requirement are firstly, that, to sustain a *mandament*, a right must be object-related and secondly, that such an object must exist separately from the right. Boggenpoel therefore rightly identifies that it is important, as a first step, to determine the nature of the right.<sup>197</sup> More particularly, it must be ascertained whether, in the internal sphere, the obligation from which the right originates is object-related or not.

The court in *Tigon v Bestyret* failed to recognise that the matter concerns only the subject-subject relationship as it exists in the internal sphere. That shares are also incorporeal objects is irrelevant in the context.

## 17 6 Back to “embodied” rights?

Rights in a financial setting, Sommer points out, have oscillated between being “embodied” and “account-based”.<sup>198</sup> The next shift, he predicted in 2000, may well be back to “embodied-rights” if we can devise the technology to link a unique electronic token to an unassailable electronic register.<sup>199</sup>

That technology is now widely thought to be available in the form of distributed ledger technology, such as the blockchain.<sup>200</sup> The basic operation of the blockchain can briefly be summarised as follows:

“The blockchain is a computer network that encrypts each incoming ledger transaction and aggregates it into a group of similarly-timed transactions, termed a ‘block.’ Each block serves as a data storage container that connects in chronological order to the previous block in the transactional chain. A new block can only connect to the transactional chain after ledger users reach consensus as to the block’s validity.”<sup>201</sup>

If each block represents a number of transactions and the chain is extended through the addition of new blocks, the blockchain is a ledger that contains the

<sup>196</sup> See above, n 242.

<sup>197</sup> ZT Boggenpoel *Property Remedies* (2017) 118.

<sup>198</sup> JH Sommer “Against Cyberlaw” (2000) 15 *Berkeley Tech LJ* 1145 1172.

<sup>199</sup> 1172-1173.

<sup>200</sup> Note that not all distributed ledger technologies are based on the blockchain, but the blockchain is probably the most established and popular format; see K Bolin “Decentralized Public ledger Systems and Securities Law: New Applications of Blockchain Technology and the Revitalization of Sections 11 and 12(A)(2) of the Securities Act of 1933” (2018) 95 *Washington Uni LR* 955 960.

<sup>201</sup> Bolin (2018) *Washington Uni LR* 960 (footnotes omitted). Also see M Nofer, P Gomber, O Hinz, D Schireck “Blockchain” (2017) 59 *Bus Info Systems Engineering* 183.

complete transaction history of the asset in question.<sup>202</sup> The ledger is distributed because a record of all transactions is stored on each computer of the network.<sup>203</sup> It is also decentralised because the validity of transactions is not evaluated and verified by a central authority, but through a decentralised consensus mechanism. If a transaction is requested it is not added to the blockchain automatically. Rather, a network of devices, known as nodes, assess the validity of the transaction based on cryptographic algorithms and if they reach consensus the transaction is timestamped and grouped together with similar transactions to form a block that is added to the blockchain.<sup>204</sup>

The stated benefits of the distributed ledger technology include transparency of the ledger, immutability of the ledger, a reduction of processing time which enables an immediate exchange, the easy verifiability of transactions, a reduced need for intermediaries as well as significant cost-savings flowing mainly from a reduction of both transaction costs and transaction time.<sup>205</sup>

Although the blockchain technology is most commonly associated with cryptocurrencies, the potential application of the technology to a wide variety of industries is attracting considerable attention. The technology is said to be particularly suitable for industries and transactions that traditionally rely on intermediaries to establish a level of trust between transacting parties.<sup>206</sup> Therefore, the financial industry is at the forefront of the endeavour to extend the technology to a wide array of financial products and mechanisms. “Crypto-securities” represent one such area of application.

In the context of securities the technology has the potential to address multiple problems: 1. The lack of transparency of the central register and the intermediary records. It is not apparent from the central register or the records maintained by the intermediaries who the true beneficiary of the rights is. In addition, it is impossible to retrace previous holdings. Increased transparency not only makes “true ownership” visible, thereby eliminating the distinction between legal and beneficial ownership that exists in some legal systems. It also makes transacting easier because a purchaser

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<sup>202</sup> Nofer et al (2017) *Bus Info Systems Engineering* 183-184.

<sup>203</sup> Bolin (2018) *Washington Uni LR* 959.

<sup>204</sup> Bolin (2018) *Washington Uni LR* 957-958; Nofer et al (2017) *Bus Info Systems Engineering* 184; R Reade & D Mayme “Securities on Blockchain” (2018) 73 *Bus L* 85 87.

<sup>205</sup> For these advantages in the context of shares, see Reade & Mayme (2018) *Bus L* text to nn 49-103.

<sup>206</sup> Nofer et al (2017) *Bus Info Systems Engineering* 186.

has certainty about the ownership of the seller. The use of distributed ledger technologies can therefore re-establish a direct relationship between an issuer and an investor. This not only facilitates the direct flow of benefits, but also gives an investor direct legal recourse against the issuer.<sup>207</sup> 2. The risks created by long intermediary chains. In intermediated environments an investor is exposed to significant risks, including systemic risk, risks associated with complexity and intermediary risk.<sup>208</sup> An investor holding through intermediaries is exposed not only to the risk of insolvency of the issuer, but additionally to the risk of intermediary failure.<sup>209</sup> Micheler points out that investors no longer hold shares or securities, but something else, namely beneficial interests or so-called “interests in securities”.<sup>210</sup> The analysis above shows that this is not true in all legal systems observed, but only in some.<sup>211</sup> The systems are, however, functionally equivalent in that the investor receives the benefits that flow from shares while other functions, such as the collection of the performance, are performed by intermediaries. Even if ownership continues to vest in the investor, the lack of transparency in record-keeping means that it is difficult to determine who holds which rights or entitlements. Investors are therefore exposed to intermediary risks in all the legal systems surveyed. 3. The lack of direct contact between buyers and sellers of securities. The intermediated nature of securities holding implies that sales transactions cannot proceed directly between a buyer and a seller of securities. Distributed ledger technology, by making intermediation obsolete, enables peer-to-peer transactions.<sup>212</sup> The technology is therefore said to be “trustless” because it enables transactions without the mediation

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<sup>207</sup> For an illustration of how intermediation hinders investors from taking legal steps directly against the company, see the discussion by E Micheler “Custody Chains and Asset Values: Why Crypto-Securities are Worth Contemplating” (2015) 74 *Cambridge LJ* 505 515-519 of the two cases of *Eckerle v Wickedder Westfahlenstahl GmbH* [2013] EWHC 68 (Ch); [2014] Ch 196 and *Secure Capital SA v Credit Suisse AG* [2015] EWHC 388 (Comm). Also see the appeal decision in *Secure Capital SA v Credit Suisse AG* [2017] EWCA Civ 1486 which upheld the decision of the High Court.

<sup>208</sup> For a brief overview of the risks associated with intermediation, see 9 3 2 Relationship-based and systemic intermediation, text to nn 49-55.

<sup>209</sup> E Micheler & L von der Heyde “Holding, Clearing and Settling Securities Through Blockchain/Distributed Ledger Technology: Creating an Efficient System by Empowering Investors” (2016) 11 *JIBFL* 652 653.

<sup>210</sup> Micheler (2015) *Cambridge LJ* 506.

<sup>211</sup> See above, 17 3 4 Transformation of assets and the creation of new assets and rights

<sup>212</sup> Schroeder terms this a “post-modern phenomenon” that reinstates a “pre-modern, direct, unmediated way of transferring value or securities”; see JL Schroeder “Bitcoin and the Uniform Commercial Code” (2016) 24 *Uni Miami Bus LR* 1 67-69.

of a trusted third party.<sup>213</sup> In fact, it does not even require trust between the transacting parties.

Doubt must be expressed whether the elimination of intermediaries is realistic. Not only do intermediaries have strong vested interests in the industry, but the example of crypto-currencies shows that new intermediaries tend to emerge. The economic theory of intermediation shows why this may be the case. Intermediation was initially devised to counter high transaction costs and information asymmetries. These are “trust” functions i.e. the intermediary acts as a trusted third party to bridge the lack of trust between the transacting parties. Intermediation theory also shows that, while the trust function remains essential, intermediaries have long transcended this trust paradigm, providing functions aimed at system access, reduction of complexity and convenience. It must be tested whether distributed ledger technology can accommodate all of the highly specialised functions performed by intermediaries in settlement and payment systems today. The technology certainly has disruptive potential. On the other hand, existing intermediaries may embrace the technology or certain components of it to enhance existing services.<sup>214</sup> It is also conceivable that the technology will be characterised by a de-intermediation followed by a re-intermediation.

While most of the academic legal research on distributed ledger technologies focuses on crypto-currencies and smart contracts, crypto-securities, or the possibility of applying the technology to various stages of the life cycle of shares and securities, be it to the issuing of shares, ownership recording and tracing, investor-issuer communication, trading or settlement and payment, is receiving increasing attention. In the US this academic interest has been further animated by the amendment of Title 8 of the Delaware Code to provide for the use of distributed ledger technology in the context of corporate record-keeping, such as company records and stock ledgers.<sup>215</sup> A number of scholars have also analysed the technology within the

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<sup>213</sup> Bolin (2018) *Washington Uni LR* 957-958; TI Kiviat “Beyond Bitcoin: Issues in Regulating Blockchain Transactions” (2016) 65 *Duke LJ* 569 574.

<sup>214</sup> D Mills, K Wang, B Malone, A Ravi, J Marquardt, C Chen, A Badev, T Brezinski, L Fahy, K Liao, V Kargenian, M Ellithorpe, W Ng & M Baird “Distributed Ledger Technology in Payments, Clearing, and Settlement” (2016) *Finance and Economics Discussion Series 2016-095, Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, DC* 10 <<https://www.federalreserve.gov/econresdata/feds/2016/files/2016095pap.pdf>> (accessed 20-06-2018); Schroeder (2016) *Uni Miami Bus LR* 69.

<sup>215</sup> See Title 8 of the Delaware Code, particularly §§ 219 and 224. Also see JT Laster & MT Rosner “Distributed Stock Ledgers and Delaware Law” (2018) 73 *Bus L* 319.

context of Article 8 of the UCC, concluding that securities recorded on the blockchain can be said to fall within “uncertificated securities” as defined.<sup>216</sup> Questions remain about the proper regulation of the blockchain environment. Regulators are, inter alia, grappling with the question whether assets recorded on the blockchain fall within the ambit of the definition of “securities”.

In South Africa, the South African Reserve Bank has launched the Fintech Unit in 2017 followed by the recent successful completion of a trial RTGS platform based on distributed ledger technology known as Project Khoka that performs some of the functions ordinarily facilitated by the South African Multiple Organ Settlement (SAMOS) system.<sup>217</sup> South Africa’s CSD, Strate, has also entered into an agreement with NASDAQ to develop a solution for voting based on the distributed ledger technology<sup>218</sup> and is exploring the use of the technology in other post-trade processing functions. In addition, South African financial institutions, including major commercial banks have joined forces to explore the transformative potential of the technology through the South African Financial Blockchain Consortium (SAFBC).

In theory, distributed ledger technology can be used in two different ways: 1. To establish a digital version of a financial asset, such as a share or other security, to replace the physical version, such as a certificated share; or 2. As a record-keeping system, to record, monitor, identify and validate transactions in financial assets as well as ownership thereof.<sup>219</sup> These options in turn spawn a number of design choices. Securities can be issued as digital assets or as tokens representing physical, certificated securities.<sup>220</sup> The data set can therefore be the security or bundle of rights itself or it can be a digital token thereof. Both can constitute a reification of legal rights in terms of which the “possessor” of the native digital asset or the token becomes entitled to performance. Such a design also has implications for the theft of digital assets or tokens, as seen in the case of crypto-currencies. Alternatively, the distributed ledger can simply record and represent transactions in securities. These design choices are comparable to the options available when

<sup>216</sup> Schroeder (2016) *Uni Miami Bus LR* Part 3; Reade & Mayme (2018) *Bus L*.

<sup>217</sup> For the basic functioning of SAMOS in the settlement of share and securities transactions see above, 13 2 5 1 Commercial mechanisms. For more details of Project Khoka, see South African Reserve Bank *Report: Project Khoka* (2018).

<sup>218</sup> Strate “Nasdaq to Deliver Blockchain e-Voting Solution to Strate” (22 November 2017) <<http://www.strate.co.za/blog/2017/11/nasdaq-to-deliver-blockchain-e-voting-solution-to-strate/>> (accessed 20-06-2018).

<sup>219</sup> Reade & Mayme (2018) *Bus L* 89.

<sup>220</sup> Mills et al (2016) *Finance and Economics Discussion Series 2016-095* 25, 28.

paper-based securities were either immobilised or dematerialised and a certain level of path-dependency in legal development may determine which option is elected.<sup>221</sup> Whether digital ledger technology therefore signifies a return to “embodied rights” must not only be determined by commercial and technological considerations, but by legal design:

“The ownership rights and obligations associated with digital tokens and assets may not be clearly defined in today’s legal framework. Many ownership interests in assets, such as negotiable instruments and securities, are already represented using physical or bookentry records, and the corresponding legal frameworks are robust and have developed over time. Careful legal analysis must be done to understand how ownership of digital tokens on a distributed ledger fit into the current legal frameworks and what gaps need to be filled by contractual agreements or new laws and regulations.”<sup>222</sup>

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<sup>221</sup> On path dependence in law, see E Micheler *Property in Securities: A Comparative Study* (2007) 9.

<sup>222</sup> Mills et al (2016) *Finance and Economics Discussion Series 2016-095* 28.

## Chapter 18: Conclusion

### 18 1 Introductory remarks

The two dimensions of shares which shape how this thesis is structured are the internal and the external spheres. These two perspectives were chosen because they are the main elements of an explanatory model that can assist in articulating what the rights and interests in obligations acting as objects are.

The structure of obligations is highly complex and multifaceted. Shares are paradigmatic of obligations that evidence both “obligatory” and “proprietary” features and effects. This dichotomy has attracted the attention of legal scholars, not least because of the general sentiment that a legal characterisation of shares and securities as purely obligatory fails to sufficiently protect their owners. These uncertainties are compounded by the changes effectuated by the computerisation of markets that are accompanied by the phenomenon of systemic intermediation. The legal characterisation of shares is neither static nor does it exist in a vacuum, thereby necessitating an examination of the impact of these changes on an understanding of their legal nature.

### 18 2 The internal sphere

Located within the internal sphere of any obligation is a personal bond. In the context of shares, this bond entails the relations between a company that issues shares and an investor that purchases them, whether on the primary or on the secondary market. The chapters that comprise the analysis of the internal sphere thematise the nature and content of the personal bond. Shares are instruments utilised by a company to raise equity capital. Yet, to conceptualise shares simply as proportions of a company’s share capital, negates that shares assume the guise of capital themselves. Shares are titles to revenue that trade more or less freely on markets for capital.<sup>1</sup> While the connection to the company is not severed – the existence and value of shares hinges on the bond with the company – it is depersonalised.

The impersonal nature of the bond is further emphasised by two distinct, yet complementary theories.<sup>2</sup> The entity theory propounds that the company is an entity

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<sup>1</sup> See, Chapter 3: The concept of capital.

<sup>2</sup> See, Chapter 4: Considerations of ownership.

that is legally distinct from its shareholders, who have no access to its assets and are not liable for its debts. The nexus theory enquires not only into how a company comes into existence, but also questions whether shareholders can be regarded as owners of the company on a more abstract, conceptual level. By (mostly) asserting that shareholders own only their share, which gives them access to a number of rights and entitlements, it cements the separation between the company and its shareholders. By directing the focus to the rights of shareholders, the nexus theory provides context as to the nature and content of the obligatory bond. A scrutiny of the rights and entitlements that flow from shares reveals the economic content of these rights, which include the right to share in the profits of the company throughout the period of its existence, the residual right to surplus funds at its liquidation as well as control and participation rights.<sup>3</sup> The rights and obligations that flow from the bond between the company and its shareholders are not highly personal in nature.

To conclude the analysis of the internal sphere, the contractual aspects of shares were highlighted.<sup>4</sup> Although the constitutional document is regularly treated as if it is a contract between the company and every shareholder, it evidences very few characteristics of a true contract. The contractual notion resonates more clearly with the process of selling shares on the market, which is achieved by a contract of allotment. Shares are therefore the result of a complex process of contracting which requires significant inputs from legislation and the result of which is an obligation of an impersonal nature.

### **18 3 The external sphere**

Whereas the internal sphere can be described as an amalgamation of the characteristic features, rights and duties that comprise the obligatory bond, the external sphere is aimed at determining the effect of the obligation in relation to third parties. In the context of shares and securities this relates to the way in which the relationship between the issuing company and the investor can be intermediated so that the intermediary enforces the rights against the company. It also comprises the way in which shares can be transferred from one investor to another. In addition, it raises the question whether obligations can have a property-like, third-party or real effect.

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<sup>3</sup> See, Chapter 5: Rights, obligations and classes of shares.

<sup>4</sup> See, Chapter 6: Issuing shares.

Holding and transfer are uncontroversial in the sense that it is generally accepted that most obligations can be held and exercised through intermediaries and that they are transferable. The difficult question in relation to both is what the appropriate legal mechanisms are to achieve them in the context of computerisation and systemic intermediation. The legal nature of holding and the legal nature of transfer are therefore subsidiary questions to be considered when examining the legal nature of shares.

In Part 2 these two questions have been considered from a comparative perspective. While the solutions to the first question are doctrinally different in that they range from trusts in English law, deposit in German law and agency in South African law, they share a common feature: In the context of the legal nature of intermediated holding, the responses to commercial changes are doctrinally path-dependent, with the exception of the introduction of security entitlements in US law.<sup>5</sup> These rules are accentuated and modified by statute where necessary.

When considering the legal nature of transfer mechanisms, however, the solutions suggest a departure from existing doctrinal explanations. Mechanisms of assignment in English law and negotiation in US law have been replaced by transfer mechanisms based on account entries.<sup>6</sup> Only in German law is the existing property-based transfer mechanisms of delivery modified, but many authors argue that it is ill-fitting.<sup>7</sup> On the basis of the comparative examples and with due consideration of relevant legislative provisions and applicable literature, it was found that South African law similarly evidences a discomfort with existing legal principles as they apply to cession. While these can be modified by postulating the account entries as a formality with which valid cessions of shares have to comply,<sup>8</sup> it is suggested that the continued application of cession should be scrutinised more fundamentally.<sup>9</sup> In

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<sup>5</sup> While this may be a departure from previously applied principles of bailment, it has been pointed out above, that it evidences similarities with the common law concept of trusts. See above, Chapter 14: Concluding remarks.

<sup>6</sup> In English law there is some debate on characterising the transfer as a novation, but there is widespread consensus that existing rules on assignment have become difficult to apply to interests in securities and that their transfer follows special rules. See for example E Micheler “The Legal Nature of Securities: Inspirations from Comparative Law” in L Gullifer & J Payne (eds) *Intermediated Securities: Legal Problems and Practical Issues* (2010) 131-147.

<sup>7</sup> See for example the criticism by M Lehmann *Finanzinstrumente: Vom Wertpapier- und Sachenrecht zum Recht der unkörperlichen Vermögensgegenstände* (2009) 416-417.

<sup>8</sup> This is the suggestion put forth by RA de la Harpe “Securities Registration and Transfer (ss 49-56)” in JL Yeats (ed) *Commentary on the Companies Act of 2008* (OS 2018) 2-506 2-1031–2-1055.

<sup>9</sup> See, 13 2 5 2 Legal framework.

particular, account entries are difficult to reconcile with the consensus-seeking principles of cession. Also, in the case of transfers based on account entries, the identities of the parties are not only obscured, for example by nominee holdings, but are in fact irrelevant for the transfer. The identity of the transacting parties is, however, of vital importance for cession. In addition to placing in jeopardy questions on the continued applicability of cession-based transfer mechanisms, the legislation also leaves other uncertainties unresolved. These include the question as to how the statutory provisions can be reconciled with the commercial mechanism of netting. Furthermore, there is considerable uncertainty on the power of courts to order as valid transfers that have taken place between the parties without account entries having been effected on the books of the relevant intermediaries and the continued reliance by courts on the principles of cession in this context.

#### **18 4 Synthesis**

Part 3 synthesises the various debates by considering the legal nature of shares, including the subsidiary questions named above, from a more theoretical vantage point.

Traditional doctrinal categories such as property and obligations, the discourse shows, are not the only way in which the legal nature of securities can be conceived. Concepts expressed in functional terms are a workable alternative and a necessary supplement.<sup>10</sup> In fact, the great benefit of a functional approach is that it lays open the underlying, evaluative considerations and criteria that frequently remain hidden behind the overly abstract categories of traditional doctrinal systematisations.<sup>11</sup> While the approach taken by Article 8 of the UCC is exemplary of a functional approach, functionalism can similarly inform doctrinal reasoning by indicating where modifications or deviations may be apposite. In the context of transfer mechanisms, a functional perspective, in conjunction with the concept of a more formalistic “law of accounts” can at once explain the departure from existing doctrinal approaches and lay the theoretical foundations for conceptualising new approaches.

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<sup>10</sup> See, 17 1 A functional approach.

<sup>11</sup> As F Cohen “Transcendental Nonsense and the Functional Approach” (1935) 35 *Columbia LR* 840 writes: “It is the great disservice of the classical conception of law that it hides from judicial eyes the ethical character of every judicial decision.”

While the conceptual framework, whether grounded in doctrinal or functional reasoning, may be the key determinant for an analysis of the legal nature or characterisation of rights, the discussion on the “law of accounts” demonstrates that from a transactional perspective, a “law on securities” has two legs; a conceptual and a procedural one.<sup>12</sup> A “law of accounts” is useful because it allows complex legal processes to be simplified and encourages order and clarity. It also permits the nature of the rights or objects to fade into the background, emphasising instead the common procedural characteristics shared by a multitude of rights recorded on accounts. For a proper functioning of transactions in securities there must, however, be a constant synergy between concepts and procedure.

In the context of what has been termed systemic intermediation, the question of the legal nature of holding and transfer has another facet: It throws open the question whether intermediation transforms shares and securities in such a way that separate assets with their own character can be said to come into existence. Systemic intermediation, it has been set out above, emerged prior to computerisation, but is today significantly shaped by it.<sup>13</sup> It describes a form of intermediation that is structural in the sense that it is frequently not optional and the intermediaries regulate access to essential system infrastructure such as a clearing and settlement system. It is also relationship-based in that it results in a vertical layering of pairwise relations.

Against this background, two theoretical models have been considered.<sup>14</sup> On the basis of the theory on the burdening of rights, the core right (the security) is said to remain in the hands of the investor and an entitlement to collect is split-off and transferred to an intermediary. This theory, it is argued, most accurately reflects the doctrinal foundations of intermediation in South African law, which knows no dual conception of ownership and therefore requires a distinction to be drawn between registration and ownership. Its results are firstly, that no assets separate, but derived from a core asset (such as a share) are created; and secondly, that undivided ownership of the share continues to vest in the ultimate investor.<sup>15</sup>

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<sup>12</sup> See, 17 2 A law of accounts.

<sup>13</sup> See, 9 3 2 Relationship-based and systemic intermediation and 9 3 1 The economic theory of intermediation.

<sup>14</sup> See, 17 3 Models of Intermediation.

<sup>15</sup> De la Harpe “SS 49-56” in *Commentary on the Companies Act* similarly rejects the “dual ownership variant”, see 2-1061–2-1067.

An alternative theory is proposed in the context of English (and US) law based on the idea that the core right is located at the level of a central intermediary or group of intermediaries while the investor holds an entitlement to receive the benefits. This entitlement, which encompasses the benefit as well as a number of contractual rights against an intermediary, is construed as a separate asset and is duplicated and modified at every tier of intermediation. It is termed a “securities entitlement” in US law and an “interest in securities” by leading commentators on English law.

The conceptual difficulties that arise as a result of systemic intermediation extend beyond the questions of how shares or interests in shares, however they are construed, can be held and how they can be transferred. More fundamentally, it is questioned whether “property rights” can vest in relation to systemically intermediated shares and if, in whom these rights vest.

An investor owns shares, but the use of ownership in a more colloquial sense does not denote that shares so owned are also property in the technical sense. The question is therefore not: “Are shares property?” – In terms of the traditional division between obligations and property they are not. Shares are obligations. The correct question to ask is whether obligations can have a “proprietary” or real or limited real effect. Asking and answering the one question or the other can lead to different outcomes as appears from a review of the literature in chapter 16.<sup>16</sup>

Engaging with the overlap between the law of obligations and the law of property inherent in shares and securities is not an easy task. It is made more arduous by the fact that the boundary between the law of property and the law of obligations remains highly contested. No theory succeeds in drawing a wholly harmonious and gapless picture.<sup>17</sup> The importance of the discussion in the context of shares lies not so much in finding the definite boundary between property and obligations, but in showing the circumstances under which obligations can have absolute effect. The focus therefore falls on the second question posed above.

The explanatory model brings together the internal and the external spheres of shares by suggesting that the characterisation of an obligation in the internal sphere

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<sup>16</sup> See, Chapter 16: The legal nature of shares: selected views.

<sup>17</sup> See, 17 4 1 Drawing the boundary between property and obligations.

can reveal whether an obligation is object-related.<sup>18</sup> The object to which an obligation can relate may be a corporeal thing, but it may also be another obligation that assumes the guise of a thing by being impersonal or “personality-poor”. As such it becomes separable from its subject-subject relation that defines the internal sphere. It also has an independently determinable value, in other words, it has a value that can be expressed in economic terms. Based on this analysis it is concluded that shares can function as objects of other obligations. Thus, if transactions or obligations are entered into that involve shares, such shares can function as the objects of these obligations. The purpose of this finding is to show that such object-related obligations may have real or limited real effect in their external sphere i.e. in relation to third parties. This model is subsequently used to explain why, within the obligatory realm of the investor-intermediary relationship, the investor is protected from some third parties, such as creditors of the intermediary. This is an illustration of limited real effect. In addition, the model can show why an acquisition of ownership in good faith is provided for.

The value of this model is that it redirects the focus away from overly doctrinal arguments to the evaluative exercise that necessarily underlies the consideration of the third-party effect of obligations. In a more abstract sense the model can have value beyond shares and extend to other accounts-based obligations that exhibit strong property-like features.

A theoretical analysis of the legal nature of shares, which formed the subject of Part 3, in conjunction with an enquiry into the progression of concepts and mechanisms for holding shares and transferring ownership therein, which was undertaken in Part 2, is not merely an academic exercise. The nature of rights, how they vest and in whom they vest have implications in the commercial sphere. In addition, new commercial developments need a sound legal foundation that addresses the functional and transactional needs of markets, but is also sufficiently backed by sound conceptual legal reasoning.<sup>19</sup>

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<sup>18</sup> See, 17 4 3 Developing an explanatory model.

<sup>19</sup> See, 17 6 Back to “embodied” rights?

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