REPORT ON A

‘RIGHT OF USE’

FOR COLLATERAL TAKERS AND CUSTODIANS

Presented to the UNIDROIT Secretariat

Rome, July 2003

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The editor is grateful to the UNIDROIT Secretariat for the facilities provided and for the exchange of ideas during a three-month internship at UNIDROIT in Rome.

This report has benefited greatly from the co-operation with Joseph Nivaro during the time spent at UNIDROIT.

A special word of thanks is dedicated to Klaus Löber, European Central Bank, for the inspiring discussions and the practical support provided in the course of the preparation of this report.

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INTRODUCTION

Introductory remarks

The UNIDROIT Project on Harmonised Substantive Rules regarding Securities Held with an Intermediary ('UNIDROIT Project'), the purpose of which is the unification of substantive law rules relating to securities held through intermediaries, currently discusses, *inter alia*, whether to include a right of use within the scope of its future instrument. The special thing about the UNIDROIT Project is that it does not only consider the right of a security taker to use pledged assets for its own purposes, but also the right of an intermediary or custodian[1] to do so with the assets of its clients.[2]

The goal of this report is to investigate whether a right of use is in the interests of collateral providers generally, and of clients of custodians in particular.

A right of use is the right of X to dispose in his own name and for his own benefit of Y's interest in securities. This report focuses on the legal basis for granting such a right of use. Market participants currently establish a right of use on the basis of a transfer of ownership or by granting a right of use in connection with a security interest.[3] Sometimes it is also argued that a right of use can be granted on the basis of a purely contractual arrangement.

In the introduction below, the three techniques of granting a right of use on the basis of 1) an outright transfer, 2) a proprietary security interest and 3) a contractual arrangement will be considered in that order. Because a right of use on the basis of an outright transfer is nothing new, this report will focus on a right of use granted on the basis of a security interest and of a contractual arrangement. It will be shown in chapters on Danish, Dutch, German, Italian and English law that both a security interest and a contractual arrangement entailing a right of use are essentially an outright transfer.

Today, a right of use on the basis of a security interest is envisaged in market documentation under New York law and, by way of statute, in the Collateral Directive[4], which has yet to be implemented in the national laws of the Member States of the European Union.[5] The American practice will be examined in this

[1] In this report no sharp distinction is made between 'intermediary', 'custodian' and 'depository'. All three terms refer to entities that administer book-entry securities. Cf. Bank of International Settlements, *A Glossary of Terms Used in Payment and Settlement Systems*, March 2003.

[2] See UNIDROIT 2002, Study LXXVIII – Doc. 1, nr. 10-11.

[3] The outright transfer method is used in the Global Master Repurchase Agreement (GMRA) for repos, in the Global Master Securities Lending Agreement (GMSLA) for securities lending and, if English law applies, in the 2001 Margin Provisions for derivatives (published by the International Swaps and Derivatives Association, or ISDA). The security interest approach is adopted in the ISDA 2001 Margin Provisions in those cases where New York law applies.

[4] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, *Official Journal* ('*OJ*'), L 168, 27 June 2002, p. 43-50.

[5] Implementation should take place before 27 December 2003. See on the progress of the national legislators in respect of the implementation of the Collateral Directive the regularly updated website of ISDA (www.isda.org, link to Committees, link to Collateral, link to the updates). Due to inconsistencies with the Hague Convention on the Law Applicable to Certain Rights in respect of

introduction. The chapters of this report analyse whether a right of use as envisaged in the Collateral Directive is compatible with the property law systems of (in alphabetical order) Denmark, Germany and Holland, Italy and the United Kingdom.

The Investment Services Directive ('ISD')[6] seems to envisage a right of use on the basis of contractual consent in the client-custodian relationship. The second indent of Article 10 of the ISD allows an investment firm[7] to 'use investors' assets for its own account with the investor's express consent'.[8] The exact meaning of this provision will be subject to further discussion in the chapters on Danish and Italian law, and in the conclusion to this report. The UNIDROIT Project seems to wish to take this issue further and give custodians a general right of use in respect of their clients' assets (see section 4 below).

Essentially, a right of use can be envisaged in two relationships – horizontal and vertical. The *horizontal right of use* relates to the situation in which a collateral provider and a collateral taker enter into transactions in commercial markets generally. Traditionally, collateralised transactions involving cash and/or securities, such as repo or securities lending transactions,[9] are entered into between major participants in the financial markets (e.g. commercial, investment and central banks, insurance companies, pension funds, etc.). Note, however, that it is also possible to choose to apply the Collateral Directive in respect of transactions with small and medium-sized enterprises. Whereas the collateral provider can therefore be anything from a small or medium-sized enterprise to a multinational enterprise or bank, the collateral taker will in practice usually be a major financial institution.[10]

The *vertical right of use* relates to the special situation in which a client grants a right of use to his custodian in respect of securities that the custodian holds in custody for the client. In this case, the fiduciary relationship between the parties should be taken into account. The intermediary should take the interests of clients who have entrusted their assets to its custody into consideration. In the chapters on Danish, Dutch (custody), Italian and English law, this issue will be given special attention. The legal

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Securities Held with an Intermediary (adopted in December 2002), the implementation of Article 9 of the CD may be affected or even delayed.

[6] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, *OJ* L 141, 11 June 1993, p. 27-46.

[7] An investment firm is a custodian of a special kind, which does not only have the goal of safeguarding assets, but also of investing the assets that clients have entrusted to its custody for the benefit of those clients.

[8] The second indent of Article 10 of the ISD was corrected in *OJ* L 170, 13 July 1993, p. 32.

[9] *'Repo'* or *'repurchase' transactions* can be defined as transactions in which party 'A' (seller) sells certain securities to party 'B' (buyer) for an amount of cash (the purchase price), while at the same time committing itself to buying back equivalent securities at a future date for a certain amount of money, including an interest component (the re-purchase price). In a *securities lending transaction*, a lender transfers a specific type of securities to a borrower for an amount of cash or other securities, while the lender and borrower commit themselves to transferring equivalent securities and/or cash at the end of the transaction. In this case the borrower typically pays an interest component.

[10] Applying of the Collateral Directive to situations where the collateral taker is by definition more powerful than the collateral provider is undesirable. The collateral taker can in this case dictate the terms of the collateral agreement (e.g. if a right of use is granted and how the collateralised assets should be valued in the event of a default). The Collateral Directive should therefore not apply to small- and medium-sized enterprises. See Article 1(3) of the CD. Cf. the Opinion of the Economic and Social Committee, *OJ* C 48, 21 February 2002, p. 1-3 (in particular sections 3.3-5); and T. Keijser, *Repos and Securities Lending Agreements*, University of Nijmegen, 2003, p. 47-51.

basis for granting a right of use in this case will be investigated, as will ways of protecting the interests of clients.[11]

Besides the issue of the legal basis of a right of use, this right can also be considered from an accounting, a regulatory, an operational and a tax point of view. These issues are mentioned briefly below. The tax issue is elaborated upon more extensively in the Tax Appendix to this report.

1. The outright transfer method

In the case of an outright transfer[12], it is obvious that the new owner has a 'right of use'. He can dispose of the assets he has acquired in any way he deems fit. A number of important standard agreements used internationally for collateralised transactions envisage the outright transfer of collateral.[13] Also under current Dutch and German practice, for example, collateral is provided (e.g. in the course of repos and securities lending transactions) on the basis of an outright transfer. Outright transfers are a perfectly feasible way of structuring collateralised transactions including a right of use. Outright transfers are the standard under American law[14], and are also sanctioned by Article 6 of the Collateral Directive.

An outright transfer has the advantage that the collateral provider knows exactly what is happening. If he gives someone a collateral interest in respect of his assets, including the right to dispose of them, he loses his ownership right. Particularly in the relationship between a client and a custodian, it seems important that the client should be aware of what right he is actually granting a custodian. If he grants a custodian a right of use on the basis of a security interest or on the basis of a contract, he might not be aware that he is actually giving up his ownership right. As will be demonstrated below, under for example current Dutch and English practice, a custodian can only be granted a right of use on the basis of an unambiguous transfer of ownership.

[11] Note that the Collateral Directive applies to transactions on the Over-The-Counter market generally, but will also be applicable if a client provides collateral to its custodian.

[12] In this report no sharp distinction is made between 'outright transfer', 'title transfer' and 'transfer of ownership'. All three terms refer to the passing of a property right or an interest of a proprietary nature from one party to another.

[13] See for example the Global Master Repurchase Agreement (GMRA; available on www.isma.com and www.bondmarkets.com), the Global Master Securities Lending Agreement (GMSLA; cf. www.isla.co.uk), the 2001 ISDA Margin Provisions (Part 3; English law), or the European Master Agreement for Financial Transactions (cf. www.fbe.be).

[14] See *Uniform Commercial Code; 2002 edition; Official Text and Comments*, West Group, (hereafter: 'UCC (2002 edition)'), p. 676-678 on repurchase and securities lending transactions. Cf. the outright transfer approach taken in the standard agreements for repurchase and securities lending transactions published by The Bond Market Association (TBMA) in 1996 and 2000 respectively (available on www.bondmarkets.com).

2. The security interest approach

At present, the provision of a right of use on the basis of a security interest is impossible in most, if not all, European jurisdictions. The Collateral Directive will change this situation.[15]

Collateral in the sense of the Collateral Directive serves two functions. A collateral taker uses it for recovery purposes and also to enter into further trades. Both functions are guaranteed in the case of a transfer of ownership. The new owner has the strongest imaginable 'security interest' and can dispose of the transferred assets as he pleases. The European legislator has now also enabled a second way of providing collateral. On the basis of Article 5 of the Collateral Directive, a right of use of collateral can be granted on the basis of a security interest. The security interest guarantees the possibility of recovery, the right of use the tradeability.[16]

On the basis of Article 5 of the CD, a right of disposal can be granted to a collateral taker. This means that a collateral taker has the right to transfer ownership of encumbered assets to a third party or to vest a security interest over those assets for the benefit of that third party. The collateral taker in return has an obligation to deliver equivalent assets to the collateral provider at the end of a transaction. These equivalent assets are deemed to have been owned by the collateral provider from the outset. This latter phenomenon will be referred to hereafter as 'proprietary substitution'.[17]

The right of use under the Collateral Directive is not in the interest of collateral providers. First, a general (i.e. also if there is no event of default) right for a secured party to dispose of pledged assets is incompatible with the property law systems of many, if not all, European countries. One may wonder if a collateral provider is not actually transferring ownership when he grants a right of use, in which case he is left with a contractual claim towards the collateral taker from the outset. Second, the collateral provider in any case has nothing more than a contractual claim from the moment the collateral taker exercises his right of use.[18] Generally, if you vest a security interest, you expect to remain owner of the collateral.[19] However, under the regime of the Collateral Directive, collateral providers are only left with a contractual claim.

Note that the collateral provider's contractual claim enjoys enhanced protection in the event of insolvency, because contractual set-off provisions are enforceable under the regime of the Collateral Directive. However, this is of no avail to the collateral

[15] Cf. the Opinion of the European Central Bank in respect of the Collateral Directive, *OJ* C 196, 12 July 2001, p. 10-13, section 16.
[16] See on the two functions of collateral: Keijser (2003), p. 3-10.
[17] Note that under the regime of the Collateral Directive a collateral provider is the owner of assets at the outset of a transaction ('moment 1'), is very likely to be left with a contractual claim during the entire course of the transaction ('moment 2'), and will only become owner again (on the basis of proprietary substitution) at the moment the collateral taker fulfils its obligation to deliver equivalent assets, usually at the end of the transaction ('moment 3').
[18] Cf. Article 5(2) of the CD.
[19] Even though Article 5 of the CD requires 'consent' to a right of use, it is doubtful that all collateral providers (including clients of custodians) realise that they actually grant a security interest (a limited right!) combined with a general right to dispose.

provider if the prices of the securities he has provided to the collateral taker go up considerably, and in the absence of proper margin arrangements that take changes in market prices into account. In this case, the collateral provider has an unsecured exposure to the risks of the collateral taker.

In many, if not all, European jurisdictions, a right of use on the basis of a security interest is incompatible with the current property law system. This is because a security interest only gives a collateral taker the right to dispose of collateral if there is an event of default. Until that moment, he has a duty of care and cannot appropriate the underlying assets (these two issues are stressed in the Dutch and German legal systems), whereas the collateral taker should have the right of redemption until the event of default takes place (this issue, which is basically the reverse side of the coin, is the focus in the English legal analysis).

The chapters below investigate how the 'right of use' under the Collateral Directive should be implemented. Whereas the legal theory of execution of pledged assets, re-pledge, the sale on commission and the consignment sale cannot serve as a sufficient basis for implementing the right of use, the theory of irregular pledge does reflect what actually happens. An irregular pledge basically entails a transfer of ownership. The irregular pledge will be discussed in the chapters on the Danish, German and Dutch legal systems, and will be the focus of the chapter on Italian law.

Note that the right of use as envisaged in the Collateral Directive does not only apply to the horizontal relationship between a collateral provider and a collateral taker, but also if a client provides collateral to its custodian. The Collateral Directive therefore enables custodians to dispose of their clients' assets on the basis of a security interest. The consequences of this probably unintended effect of the Collateral Directive will be discussed in depth in the chapters on the client-custodian relationship under Danish and Dutch law. Clients may very well not expect to lose their ownership right when they grant a security interest to their custodian, because they expect to remain owner until an event of default has taken place.

Note that the general civil law analysis in the chapters on Danish, German and Dutch, Italian and English law is to a large extent limited to the right of use on the basis of a security interest in a 'horizontal' relationship. In the 'vertical' relationship between a client and a custodian, the dogmatic considerations are, however, exactly the same. There is, however, an additional element that should be taken into account in this case. The relation between client and custodian is a special one (e.g. a trust or a comparable legal relationship) entailing a fiduciary duty of the custodian to take the interests of its clients into account. The difference in power between clients and custodians should be balanced. A custodian should take the interests of clients into account. In this case it is less desirable for a client who pledges assets to his custodian to think he is the owner of the assets, while he has actually transferred his ownership right to the custodian. It is submitted that an unambiguous transfer of ownership by the client to the custodian serves the interests of both parties. The client realises he loses his proprietary interest, and the custodian is free to dispose of the transferred assets as he wishes. As a result, optimal investor protection is guaranteed.

3. American law*

After a general section on the right of use based on a security interest it is appropriate to investigate the American approach. This section examines, if a right of use can be granted on the basis of a security interest under American law. Particular attention will be paid to the meaning of the word 'use' in this context. Can a 'right of use' mean an unlimited 'right of disposal' for own business purposes (i.e. for example the right to sell encumbered securities or to re-pledge them)?

Security interests over securities and securities entitlements[20]
Under U.S. law securities held with intermediaries are called 'securities entitlements' to distinguish them from certificated and uncertificated securities which are held directly from issuers of the securities. Part 5 of Article 8 of the Uniform Commercial Code ('UCC') deals with securities entitlements. Earlier Parts deal with certificated and uncertificated securities. Article 9 of the UCC deals with security interests in all kinds of personal property, including securities and securities entitlements.

Owners of securities and securities entitlements commonly use them as collateral for secured loans from their intermediaries (brokers). Rarely, if ever, would a loan be for 100% of the value of the property. The arrangement would provide for a 'margin' of equity. If the value of the entitlements should go down, there would be a 'margin call' to pay down the loan or provide additional collateral.

To 'perfect' their security interests in securities or securities entitlements, intermediaries must take 'control' of the property. 'Control' means different things for securities and entitlements, but the central idea is that the intermediaries must have power to dispose of the collateral. Disposition can mean many things, including outright sale. The primary reason for outright sale would be foreclosure on collateral when a debtor is in default.

Without default, the situation of margin lending results in dividing the beneficial rights in the property between the lender and the borrower. The lender has its security interest. The owner has the equity remainder interest. U.S. law provides that lenders can 'use' their portion of the property in many ways. The primary one, commercially, is re-pledge or re-hypothecation.[21] The intermediaries can use only their portion of the value of the collateral, they cannot invade the owners' portion.[22]

If so agreed, a secured party with possession of the collateral may also 'use or operate' collateral under Article 9-207(b)(4) of the UCC. In the light of case law on this use or operation, it is unlikely, however, that a collateral taker has a right to sell the encumbered assets outright unless there is a default. [23] Use or operation normally

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* The author is grateful to Professor C. Reitz for his supportive views in respect of the American law analysis.
[20] A considerable part of this subsection is based on an e-mail received from Professor Reitz. The author alone is responsible for the resulting text.
[21] Cf. Article 9-207(c)(3) of the UCC.
[22] Cf. the Official Comments on Article 9-207(c)(3) of the UCC in the UCC (2002 edition), cit. (footnote 14), p. 858-861 (in particular sections 5 and 6).
[23] See J. Willis (managing editor), *Uniform Commercial Code; Case Digest*, Callaghan & Company, (1984 Revision of Volume 6), Volume 6A, p. 509-513.

means enjoying an asset (e.g. driving a pledged car), without infringing upon the substance of the asset (the effect of which is that the rights of the owner of the asset are safeguarded). An outright sale is by definition an infringement of the original owner's right.

Article 9 of the UCC places legal limits on lenders' use of collateral that is in their control. The relevant section for securities and entitlements is 9-207(c) of the UCC. Without default, this section does not permit outright sale, which would compromise the owners' interest in their equity. This arrangement is fairly simple for certificated and uncertificated securities. It is worked out in similar fashion for entitlements in Part 5 of Article 8 of the UCC.

The commercial law provisions in the UCC are buttressed by stringent regulations of the Securities and Exchange Commission ('SEC') on use of 'customer property'.

The property law of the UCC and SEC regulatory law are consistent with contract arrangements between some intermediaries and some of their customers that give the intermediaries additional power over the collateral. This additional power is not provided by law. It arises by agreement and can be conditioned by that agreement. A common clause in such contracts is authorization to sell securities or entitlements. There are a number of reasons for this kind of contract clause. If sales occur, rights in the proceeds would be determined by the pre-sale rights in the collateral.

Under American law a secured party can therefore never dispose as if it is the full owner and without taking the collateral provider's proprietary interests into account. On the basis of Article 9-207 of the UCC the secured party must respect the original owner's remaining equity interest. In certain cases an enhanced right of disposal can be granted on the basis of contractual provisions, but in this case the original owner has a proprietary interest in the proceeds of the sale.

Margin lending facilities

In any case it is clear that the margin lending practice in the U.S. cannot serve as an explanation of a general right of disposal for a collateral taker.[24] In the course of 'margin account' or 'margin lending' facilities 1) a custodian attracts money from a third party, 2) which money is paid to the custodian's client, so that 3) the client can acquire assets, typically securities, in the market. Because the third party wants to be secured, 4) the client grants a right of pledge over its securities to the custodian, so that 5) the custodian can vest a right of re-pledge for the benefit of the third party. The client should under current regulations give explicit consent to a re-pledge by the custodian. This arrangement is to the benefit of the client, because in effect the re-pledge secures a cash flow from a third party that the client can use to acquire

[24] Cf. the Report of the Second Session of the UNIDROIT Study Group for the Preparation of Harmonised Substantive Law Rules regarding Securities Held with an Intermediary ('UNIDROIT Second Session Report'). Section 2.7(2) of this report suggests incorrectly that the margin lending practice in the UK and the US is a good starting point for introducing a general right for custodians to dispose of their clients' assets for their own business purposes.

securities. A custodian, therefore, does not have the right to re-pledge, let alone sell its client's assets in order to pursue its own commercial purposes.[25]

The special case of the New York derivatives market
In the New York derivatives market a right to 'use' securities means a right for the secured party to dispose of them for its own benefit without any limitation. Under Section 2.2(c) of the 2001 ISDA Margin Provisions (New York law) concerning the 'Use of Margin Received' a secured party will:

> '*notwithstanding Section 9-207 of the New York Uniform Commercial Code, have the right to: (A) sell, pledge, rehypothecate, assign, invest, use, commingle or otherwise dispose of, or otherwise use in its business, any Margin Received it holds, free from any claim or right of any nature whatsoever of the Provider, including any equity or right of redemption by the Provider* […]'.[26]

This interpretation of the word 'use' is not in line with what is commonly meant by the word 'use', i.e. the act of employing a thing, without destroying or wasting that thing, and not to sell that thing or encumber it with a security interest.[27]

The interpretation of the word 'use' in the ISDA Margin Provisions is in any case wider than that under Article 9-207 of the UCC. Whereas a collateral taker 'using' assets under Article 9-207 of the UCC should always take the proprietary interest of the collateral provider into account, the ISDA Margin Provisions exclude any such interest. Also, the ISDA Margin Provisions do not envisage any proprietary interest for the collateral provider in the proceeds of a disposal. The Margin Provisions state that the collateral taker can use the collateral provider's assets 'free from any claim or right of any nature whatsoever, […] including any equity or right of redemption'. Because the collateral provider has no proprietary right whatsoever, the structure of the ISDA Margin Provisions is essentially that of an outright transfer.

Outright transfer
A collateral provider can transfer ownership of assets to a collateral taker, for example on the basis of a sale (Article 2 of the UCC). In this case, it is obvious that the collateral taker has an unlimited right to dispose of the assets transferred. Note that under American law, standard collateralised transactions (other than margin transfers under derivatives transactions) such as repos and securities lending transactions are not structured on the basis of a security interest but as an outright transfer.[28]

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[25] See the UCC (2002 edition), p. 770; and S.L. Schwarcz, 'Indirectly Held Securities and Intermediary Risk', *Uniform Law Review / Revue de droit uniforme*, 2001-2, p. 291. Cf. the section on prime brokerage in chapter 5 on English law below.
[26] Cf. in almost the same wording Paragraph 6(c) of the 1994 New York Annex (ISDA Credit Support Documents). The ISDA Credit Support Documents are the predecessor of the 2001 ISDA Margin Provisions.
[27] Cf. *Black's Law Dictionary*, West Publishing Co., 1979, p. 1382-1384 ('use' and 'usufruct').
[28] Cf. the GMRA, the GMSLA and the TBMA standard agreements.

Conclusion
The European provisions concerning an unlimited right of use in the Collateral Directive, and possibly in the Investment Services Directive (see section 4 below) have been enacted in the belief that such unrestricted 'use' is also possible under American law.[29] 'Use' in the sense of Article 9 of the UCC must, however, be interpreted in such a way that the proprietary interests of the original owner are taken into account. Even if contractual provisions that allow a collateral taker to dispose of encumbered assets are enforceable between certain market participants, these provisions cannot entail that the pre-sale rights of the collateral provider are neglected. An unlimited right of disposal can under American law only be granted on the basis of an outright transfer of ownership.

The ISDA Margin Provisions (New York law) envisage a general right of disposal on the basis of a security interest. The collateral provider, however, is not given any claim of a proprietary nature whatsoever. Such an approach is not compatible with the essence of a security interest. The structure envisaged in the ISDA Margin Provisions is therefore very similar to that of an outright transfer.

4. A right of use on a contractual basis?

The Report of the Second Session of the UNIDROIT Study Group for the Preparation of Harmonised Substantive Law Rules regarding Securities Held with an Intermediary ('UNIDROIT Second Session Report')[30] envisages a right of use both for collateral takers in indirect holding systems and for custodians. This right of use can be granted on the basis of consent, i.e. a purely contractual arrangement.

Consent-based transfer techniques are not the novelty here. In a number of European jurisdictions (e.g. Italy and France) a transfer of title derives automatically from a contractual provision and has effects *erga omnes*. An act of delivery is not required in this case for a transfer of ownership to occur.[31] The issue here is that clients do not expect to transfer ownership when they consent to 'use'. When a client asks a custodian to manage his assets he does not expect that the custodian will start dealing in his assets for its own benefit. This is misleading.

Different types of interests of a proprietary nature in book-entry securities can be distinguished: 1) a direct ownership interest (e.g. the principle under Danish law), 2) a co-ownership interest in a fungible pool of securities (e.g. the Dutch law approach in case of holdings that fall under the regime of the Securities Giro Transfer Act); 3) a 'securities entitlement' (i.e. a right *sui generis* – the American law approach)[32]; 4) the

[29] Cf. for example J. Benjamin, *Interests in Securities; A Proprietary Law Analysis of the International Securities Markets*, Oxford, 2000, p.111 (footnote 74).
[30] UNIDROIT 2003, Study LXXVIII, Doc.7. Note that this draft report is subject to approval by the Study Group.
[31] In other countries on the other hand, such as Germany and The Netherlands, the starting point is that consent is not sufficient for a transfer of ownership and that an act of delivery is also required.
[32] See Part 5 of Article 8 of the UCC and the Explanatory Comments thereto in the UCC (2002 edition), cit. (footnote 14). Unlike under English law (see chapter 5 below), the trust concept is not used under American law in order to characterise the relationship between client and custodian. See the UCC (2002 edition), p. 674 (section 5).

right of a beneficiary in a trust situation (e.g. the English law approach).[33] Such proprietary interests of investors deserve protection.[34]

The UNIDROIT Second Session Report envisages a right of use for custodians in respect of the securities of their clients on the mere basis of the contractual consent of those clients. On the basis of this contractual consent investors lose their proprietary claim. As palliatives, the Second Session Report suggests 1) limitations as far as the volume of securities that can be used is concerned (e.g. a certain percentage) and 2) limitations as far as the length of the use is concerned (e.g. only short-term transactions).[35] However, these makeshift measures conceal a violation of the interests of clients of custodians. In the event of the custodian's insolvency they are left with nothing but a contractual claim.

Segregation

The UNIDROIT Second Session Report suggests that segregation 'eases the pain' connected with a general right of use.[36] It may be true that the segregation of the custodian's assets from those of investors is desirable from a general investor protection point of view, but it is of no relevance in a right of use situation. If a custodian has a right of use, it disposes of its clients' assets lawfully for its own benefit. It is not relevant if these assets are held on a segregated or non-segregated basis. The investor will lose his proprietary claim.[37]

Perfect match system

Under American law, a crucial investor protection mechanism is that a custodian should always have enough assets in place in order to meet its clients' claims (see Article 8-504 of the UCC). This is called the 'perfect match system'. A custodian must take clients' interests into account and can only dispose of its own share of a pool of assets. If it disposes of more, it is in breach of its obligation to hold sufficient assets to satisfy its clients' claims. A custodian therefore does not have the right to dispose of its clients' assets for the benefit of its own business.[38] The perfect match

[33] Contractual rights in respect of securities will not be considered.

[34] Cf. on the different types of interests in securities the Report of the European Financial Market Lawyers Group (EFMLG), *Harmonisation of the Legal Framework for Rights Evidenced by Book-Entries in respect of Certain Financial Instruments in the European Union*, June 2003, section I(A)(3). The Second Giovannini Report proposes to standardise the treatment of property rights in securities across the European Union. See The Giovannini Group, *Second Report on EU Clearing and Settlement Arrangements*, Brussels, April 2003, ('Second Giovannini Report'), p. 12-18.

[35] See section 2.7(2) of the UNIDROIT Second Session Report. The *quality of the third party* to whom the securities have been sold or pledged is not relevant in this respect; to the clients it is the *quality of the custodian* that matters (and in particular if the custodian has enough assets in place, or – even though this does not guarantee the interests of clients in a satisfactory way, because they are left with a contractual claim in this case – is in a position to buy or redeem such assets).

[36] See section 2.7(2) of the UNIDROIT Second Session Report.

[37] In Denmark (see chapter 1 below) and the United Kingdom (see chapter 5 below), the underlying principle is that assets of investors and custodians are held on a segregated basis. In The Netherlands (see chapter 3 below) and in the United States (see the UCC (2002 edition), p. 766) the assets of clients and custodians are often held together on a commingled basis. See on segregation also the EFMLG Report (2003), p. 18-19.

[38] Note, however, that third party purchasers are generally protected, unless they act in bad faith. This guarantees a smooth functioning of the securities markets, without cumbersome investigation duties hindering liquidity. Cf. the UCC (2002 edition), p. 767-769.

system is also a general investor protection mechanism which is not specifically relevant in a right of use scenario.[39]

The idea that securities should be treated in the same way as money should be rejected. The claims of customers in respect of money are contractual claims. In the case of cash accounts, banks are not obliged to have enough cash available to pay all customers. The perfect match system does not apply in this case. Note that as far as securities are concerned, investors in Europe are usually given a claim of a proprietary nature (see above). Also, investors in the United States are given a claim of a proprietary nature protected by a perfect match system. Current American and European standards in relation to securities holdings are therefore essentially different from those in relation to cash accounts.

This means that when a custodian disposes of assets in a fungible pool, it should not be allowed to touch clients' assets for its own benefit, unless an explicit outright transfer has taken place (the Dutch, Danish, Italian and English law approach), or unless it keeps enough assets in place to satisfy all clients' claims (the American law approach).

The idea of a custodian's right of use based on consent that gives the custodian the right to dispose of the assets of its clients for its own benefit, must be rejected. It seriously infringes these clients' interests. A client only expects to lose his property claim after an unequivocal transfer of his proprietary interest and certainly not when he consents to 'use' by the custodian.

5. Economic impact

The argument that has been presented in favour of a right of use on the basis of a security interest is the positive effect it has on the liquidity of the financial markets.[40] Exactly the same effect can, however, be reached by way of the outright transfer technique. This latter option is the current market standard for collateralised transactions in, for example, the United Kingdom, The Netherlands and Germany. The most obvious downside of the right of use on the basis of a security interest or mere consent is that collateral providers and investors may not expect to lose their ownership interest when granting a right of 'use'. This disadvantage is not present in the case of an unambiguous transfer of ownership. The goal of liquid markets can be reached perfectly well by using the outright transfer technique, which honours the interests of all parties involved.

6. Voting rights and income payments

An owner of securities is entitled to execute voting rights and receive income payments made on those securities. It is therefore important for the institutions that issued the securities concerned to determine whether a right of use leads to a change

[39] Cf. section 2.7(2) of the UNIDROIT Second Session Report; and the Second Giovannini Report, p. 12-18.
[40] Cf. Recital 19 of the CD and the ECB Opinion, cit. (footnote 15), section 16.

in ownership and at what moment. As soon as a transfer of ownership takes place, the new owner has the right to vote and to receive income payments.

7. Accounting, capital adequacy, and registration by custodians

Accounting issues, the capital adequacy treatment of transactions with a right of use, and the way a right of use should be registered by custodians are not the focus of this report. Accountants should decide who is shown in the books as the legal owner of securities. Regulators should determine what capital adequacy regime applies in the case a right of use has been granted. And custodians should show in their records that a general right of disposal has been granted in respect of securities on the basis of a security interest or contractual consent. On the basis of the legal analysis in the chapters below it is submitted that the right of use should be treated as an outright transfer.

8. Tax

As noted above, the tax treatment of a right of use should also be considered. Should a transaction involving a right of use be treated as a security interest or an outright transfer for tax purposes? The Tax Appendix to this report investigates what the consequences of the right of use of the Collateral Directive will be from a tax point of view. The effect on different taxes will be considered. The focus will be on consequences for corporate income tax and withholding tax, but some attention will also be paid to participation exemptions.

1. RIGHT OF USE UNDER DANISH LAW*

Introduction

This chapter discusses the legal aspects of a right of use under Danish law.

The chapter is divided into two main sections – a section dealing with the 'horizontal' relationship, i.e. the right of use of a collateral taker with a security interest over securities (section 1), and a section dealing with the 'vertical relationship', i.e. the right of use of a custodian holding securities on behalf of its clients (section 2). The distinction between vertical and horizontal rights of use is made for structural and overview purposes and it should be noted that the issues applicable to the horizontal relationship, i.e. the relationship between collateral provider and collateral taker, generally also apply to the relationship between a custodian and its clients (the vertical relationship).

Danish law provides for a right of use in the vertical relationship. A dealer in securities[41] can use securities in its custody for its own benefit, provided that the client explicitly consents to the dealer's use.[42] A corresponding provision does not currently exist under Danish law in the horizontal relationship, but is envisaged by Article 5 of the European Collateral Directive ('CD')[43].[44]

Section 1 below will primarily focus on the implementation of Article 5 of the CD in Danish law by investigating if similar Danish legal concepts exist. Section 2 on the vertical relationship will deal with the theory of custody holdings under Danish law and with the special statutory rules for a dealer in securities' right to dispose of the securities in its custody.

1. The relationship between a collateral provider and a collateral taker

The right of use in Article 5 of the Collateral Directive entails a general right of disposal for a collateral taker in respect of securities provided to it as collateral (if such a right has been agreed),[45] as well as proprietary substitution. Because these legal issues are new to Danish law, they will be considered from a Danish law perspective below, in sections 1.A and 1.B respectively.

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* The author is grateful to Professor Bang-Pedersen for his constructive remarks in respect of this chapter.

[41] A dealer in securities is a credit institution, an investment company or a mortgage credit institute. See Article 4(1) of the Danish Securities Trading Act ('STA'), Act No. 587 of 9 July 2002.

[42] See Article 3b(2) of the Danish Financial Business Act ('FBA'), Act no. 660 of 7 August 2002. Article 3b of the FBA is the implementation of the second indent of Article 10 of the Investment Services Directive (see footnotes 6 and 8 above). See further section 2 below.

[43] See footnote 4 above.

[44] At the time of writing the implementation of the Collateral Directive is being discussed by a working group established by the Danish Ministry of Justice. The working group has not yet presented a draft. Note however that the working group established by the Danish Ministry of Justice has implied that it will put forward as broad an implementation of the Collateral Directive as possible. See the ISDA website, referred to in footnote 5 above.

[45] Danish: *Brugsret for panthaver til de pantsatte vaerdipapirer*.

Because a right of use is possible in the vertical relationship, it is likely that the implementation of Article 5 of the CD will follow the same structure, i.e. a formula based on contractual consent.[46] In this context, it should be noted that the following analysis assumes that a 'right of use'-clause contained in a horizontal agreement will not be deemed invalid under the Danish Contract Act. This situation might become relevant if the Directive is implemented without narrowing its scope and if the Collateral Directive covers small- and medium- sized enterprises.[47] In this case, a Danish court might deem a 'right of use'-clause contained in a collateral agreement to be unfair to the collateral provider.[48]

A. Right of disposal under Danish law

By a right of use, Article 5 of the CD means that the collateral taker can – if so agreed – dispose of the pledged securities as the owner of those securities.[49] Danish law only allows a collateral taker to dispose of assets provided to it as collateral (*'pant'* or *'sikkerhed'*) in special circumstances.

A right of disposal in the horizontal relationship can occur under current law in relation to a realisation (section 1.1 below). Second, a collateral taker can dispose of received collateral by re-pledging it for the benefit of a third party (section 1.2). Under reservation of title arrangements (or proprietary representation), the 'purchaser' has a limited right to dispose of assets to which the 'seller' has reserved title (section 1.3). The notions of 'regular' as opposed to 'irregular' usufruct arrangements and of 'regular' and 'irregular' pledge constructions under Danish law will be analysed in sections 1.4 and 1.5. Finally, the issue of a consent-based right of disposal and the issue of when the collateral provider loses its ownership rights will be analysed in section 1.6.

1.1 Realisation

Realisation is a collateral taker's right to realise received collateral. Realisation under Danish law can take place in the event of a breach by the collateral provider of the underlying obligation (in relation to which the security interest is vested).[50]

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[46] See Article 3b of the FBA and cf. section 2 below regarding the vertical relation.

[47] See Article 1(2)(e) of the CD. The Collateral Directive contains an opt-out provision in Article 1(3), which allows the scope to be narrowed.

[48] See Article 36 of the Danish Contract Act. This could be so due to – for example – the possible difference in (economic) bargaining power between the collateral provider and the collateral taker (for example a bank). This is an argument to restrict a right of use to parties that are equal, e.g. banks. This is the solution chosen by the Swedish government in the course of the implementation of the Collateral Directive into Swedish law (see DS 2003.38).

[49] Cf. Article 2(1)(m) of the CD.

[50] See W.E von Eyben: *Panterettigheder* (1958), p. 300 and Rordam & Carstensen: *Pant* (1998), p. 335 (mortgage), p. 355 (pledge), p. 375 (chattel mortgage) and p. 413 (claims). Note that the realisation of securities should follow the specific rules set out in Article 538(2) of the Danish Administration of Justice Act according to which the realisation of securities can only take place through a sale by a member of the Danish Stock Exchange or a bank. See Rordam & Carstensen: *Pant* (1998), p. 413.

Realisation can therefore only take place in the event of the collateral provider's default. Contrary hereto, the Collateral Directive assumes a general right of disposal, i.e. a right to dispose regardless of whether the collateral provider has defaulted. The right of use under the Collateral Directive therefore goes further, as it entails a right to dispose under 'normal circumstances'. Realisation under Danish law cannot therefore serve as a basis for implementing the right of use.

1.2 Re-pledge

The position on re-pledging under Danish law is similar to that on the right of use.

Re-pledging ('*frempantsaetning*') should be understood as a collateral taker's right to dispose of his right of pledge over assets received as collateral from a collateral provider and/or a right of disposal of the underlying secured claim for the benefit of a third party. Danish law allows for a detachment of the right of pledge from the underlying claim in relation to which the pledge is vested. This means that the right of pledge and the secured claim can be re-pledged together or separately.

Re-pledging is, however, subject to certain restrictions. Under Danish law, the collateral taker's re-pledging must be confined to the amount of the secured claim, which means that the re-pledge cannot exceed the value of the original pledge.[51]

'*Frempantsaetning*' under Danish law does not mean that the collateral provider's asset is encumbered with an 'extra' security interest. Encumbrance with an extra security interest would be a prerogative reserved for the collateral provider. '*Frempantsaetning*' merely entails a disposal of the rights originally received from the collateral provider. Therefore this situation is not equivalent to the right of use under the Collateral Directive, which allows a collateral taker to dispose of the assets of the collateral provider.

From the above it also follows that re-pledging – as understood under Danish law – cannot cover a right to sell the received collateral to a third party (and not just a right to re-pledge). The right of re-pledge under Danish law can never entail allowing a collateral taker a right to transfer ownership of collateralised assets. Re-pledging cannot therefore be a satisfactory explanation for the right of use under the Collateral Directive.

1.3 Proprietary representation

The two main characteristics envisaged by the right of use under the Collateral Directive are the collateral provider's retention of title to the asset and the collateral taker's right of disposal. Reservation of title arrangements – such as the conditional

[51] See Danish Code (*Danske Lov*) Article 5-7-4. Case law and literature are in accordance herewith, see e.g. UfR 1984.123H and Rordam & Carstensen: *Pant* (1998), p. 110ff (mortgages), p. 339ff (pledge), p. 359 (chattel mortgage).

sale and the consignment sale[52] – under Danish law contain the 'retention of title'-feature. The following subsections analyse to what extent reservation of title arrangements allow for a right of disposal in order to determine whether these arrangements are a suitable basis for implementing Article 5 of the Collateral Directive.

a. The conditional sale

A valid reservation of title under Danish law can be made by way of a conditional sale.[53] The conditional sale is characterised by the fact that the seller retains ownership of the goods concerned (of course after having delivered them) until the purchaser has paid.[54]

The question is to what extent the purchaser can dispose of an asset subject to a conditional sale. The principle under Danish law is that the purchaser has the rights of an owner but must respect the underlying reservation of title. This means that the purchaser can, *inter alia*, let the asset to a third party and agree to take the asset out of the country. The right of disposal also grants the purchaser the right to encumber the asset with a security interest, provided that the security interest respects the underlying reservation of title.[55] The right of disposal does, however, not allow the purchaser to sell the asset on to a third party.[56]

In the event of a purchaser's wrongful sale to a third party, the starting point under Danish law is that the seller can trace the assets and can enforce his right against third parties who have acquired the asset in good faith and against creditors.[57] In case law, some exceptions have been made to this principle where a seller is careless or passive, in cases of reputed ownership[58] and in consignment sales[59].

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[52] The sale on commission also constitutes a reservation of title arrangement. However, since the central feature of the sale on commission is that the commission agent does not act in its own interest – which is exactly the case in a 'right of use'-situation – it will not be further investigated in this chapter.
[53] Danish: *Salg med ejendomsforbehold*. See Article 28(2) of the Danish Sale of Goods Act.
[54] The rules relating to conditional sales are contained in the Danish Sale of Goods Act, the Danish Credit Agreements Act and any conditional sale agreement as entered into by the parties.
[55] There is however the risk that the security interest will be worth nothing in the event of the seller's enforcement of his ownership right. Also, it should be noted that these rights are normally restricted by the conditional sales agreement, and actions in breach of this agreement would be an event of default.
[56] See Werlauff & Lynge Andersen: *Kreditretten* (1995), p. 123, and Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 151. This would make it a consignment sale (see above).
[57] Danish law authorises revendication in the cases of theft and unauthorised disposals of goods by a pledgee, borrower or custodian and the goods may be revendicated even from a party who acquires them in good faith in the market. The explicit right of revendication is therefore unconditional and it is indisputable that good faith is no admissible defence. See Article 82 of the Danish Insolvency Act and Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 181 and Lynge Andersen & Werlauff (1995): *Kreditretten*, p. 123. It is questionable if the same will apply in relation to securities holdings due to the registration system applicable to securities. See Article 36 of Executive Order 925 of 17/10/1996 (Bkg 925 of 17/10/1996) concerning the Book-Entry etc. of Electronic Securities in a Central Securities Depository ('Book-Entry Executive Order').
[58] Reputed ownership is the situation where the seller knew or ought to have known that the purchaser would sell on the assets. Danish: *legitimationsekstinktion*.
[59] See section 1.3.b below.

The conditional sale allows a purchaser to dispose of assets to a limited extent. The conditional sale under Danish law lacks the fundamental characteristic of a general right of disposal. The conditional sale is not therefore suitable as a basis for implementing the right of use in Danish law.

b. The consignment sale

The consignment sale[60] is a form of sale in which a consignor – as with a conditional sale – retains title to assets sold to a consignee,[61] but where the consignor grants the consignee a right to resell the assets.

The consignment sale is therefore fundamentally different from the conditional sale in the sense that the purchaser is actually allowed to sell the assets to third parties. Further, contrary to the rules relating to conditional sales, the rules relating to consignment sales are not provided for under Danish statute.[62]

Since the consignment sale allows for a general right to resell the consignment goods, the interesting problem is whether proprietary substitution as envisaged by the Collateral Directive takes place when the consignee resells the consignment goods.

It is a well-established principle under Danish law that when the consignee resells the consignment goods to third parties in accordance with the consignment agreement, the consignor's proprietary interest in the goods is lost.[63] Because the *naturale negotii* of the consignment sale is that the consignee has to sell the goods to third parties, the consignor – by definition – is aware that he can lose his property right at any time. The consignor will – in principle – only have a contractual claim against the consignee. However, note that Danish law in certain exceptional situations acknowledges that a seller may shift his proprietary interest in the asset to an interest in the debt of a third party due to the purchaser for replacement of the aforementioned assets.[64] The starting point is, however, that in the event of the consignee's insolvency, the consignor will only have an unsecured claim on the consignee's estate. The decisive moment for the loss of the consignor's proprietary right is when a contract is concluded with a third party concerning the purchase of the consignment goods.[65]

Consequently, and as opposed to the right of use envisaged under the Collateral Directive, no proprietary substitution takes place in a consignment sale.

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[60] Danish: *konsignationssalg*.

[61] In order for the consignor's retention of title in the assets sold to be respected by the consignee's creditors, certain requirements have to be fulfilled. See on these requirements Article 34 and 50 of the Danish Credit Agreements Act, Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 153 and Lynge Andersen & Werlauff (1995): *Kreditretten*, p. 128.

[62] The rules governing consignment sales are therefore first and foremost dependent on the consignment agreement entered into between the parties. By way of analogy compare statutory provisions in respect of related legal areas such as the conditional sale and the sale on commission.

[63] See Jan Kobbernagel: *Forhandlerkonsignation* (1949), p. 132.

[64] Danish term: *surrogat*. Such *surrogat* arises in the event of damage claims, insurance money or appropriation. See section 1.B below.

[65] See von Eyben & Moegelvang-Hansen: *Kreditorforfoelgning* (1998), p. 271f.

1.4 Regular and irregular usufruct

A right of usufruct[66] (*'brugsret')* under Danish law is characterised by the fact that the beneficiary of the right of usufruct – the usufructuary – has a general right to make normal commercial use of the property of the provider of the right of usufruct.[67] As a consequence hereof, the usufruct requires possession by the usufructuary of the object to which the right of usufruct relates.[68] A right of usufruct can be regular or irregular.

Under a regular usufruct arrangement, the usufructuary is under an obligation to redeliver the property *in specie* at the end of the usufruct period. Since the regular usufruct entails a redelivery *in specie,* the usufructuary will naturally not be able to dispose of the assets by way of sale.[69] If the usufructuary disposes unlawfully of the assets, the provider of the usufruct under a regular usufruct arrangement would – in principle – be able to trace the assets in the hands of third parties and revendicate the assets.[70] As a consequence, the regular usufruct arrangement under Danish law is by its very definition unfit to serve as a basis for implementing the right of use of the Collateral Directive.

On the other hand, an irregular usufruct occurs when the usufructuary has the right to dispose of the encumbered assets and is under an obligation to deliver generic assets at the end of the usufruct-period. The irregular usufruct arrangement entails a transfer of ownership from the provider of the usufruct to the usufructuary. This follows automatically from the requirements put forward by the Danish principle of property law that assets subject to a right of usufruct must be specific and identifiable.[71] If these requirements are not met, the provider of the usufruct will not be able to enforce its proprietary right against the usufructuary's third parties. The prudent solution would consequently be to structure the irregular usufruct arrangement as a transfer of ownership. Further, the construction as an outright transfer implies that the usufructuary would be able to dispose of the assets by sale to a third party. The transfer of title mechanism in relation to the irregular usufruct is comparable to the right of disposal envisaged by the Collateral Directive.

As a consequence, the provider of the usufruct will be deemed to have lost his property right when the contract between the provider of the usufruct and the usufructuary is concluded. The provider of the usufruct will not therefore be able to trace the assets. Note that the moment of loss of ownership rights is different from that under the Collateral Directive. Under the Collateral Directive, the collateral

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[66] The term 'usufruct' means the right of the usufructuary of enjoying a thing, title to which is vested in the provider of the usufruct, and to draw from the same all the profit, utility, and advantage which it may produce, provided this is without altering the substance of the thing. See *Black's Law Dictionary* (5th ed., 1989), p. 1384. Danish term: *Brugsrettigheder*.

[67] See Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 13 and Vinding Kruse: *The Right of Property* (1939), p. 138.

[68] See Vinding Kruse: *The Right of Property* (1939), p. 138 and perhaps also W.E. von Eyben: *Formuerettigheder* (1958), p. 19.

[69] See Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 13 and 188ff.

[70] See Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 13 and 188ff, which bases the revendication on an analogy to Danish Code Article 5-8-12 (lending) and Article 5-7-4 (pledges).

[71] See Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 61ff, and Roerdam & Carstensen: *Pant* (1998), p. 68ff.

provider remains the owner of the securities until the collateral taker disposes of them.

A subsequent question is whether an irregular usufruct also entails proprietary substitution as envisaged by the Collateral Directive. Since the usufructuary has given up all proprietary right to the usufruct assets, the usufructuary's redelivery obligation under an irregular usufruct is merely a contractual claim. Consequently, no proprietary substitution takes place. The concept of irregular usufruct under Danish law does not therefore encompass the proprietary substitution which Article 5 of the CD advertises. If irregular usufruct were used as the basic template for implementation of Article 5 of the CD in Danish law, a statutory provision in relation to proprietary substitution would be required.

1.5 Regular and irregular pledges

The notion of a 'regular' pledge entails two things: the delivery of an asset as collateral by the pledgor and the redelivery of exactly the same asset *in specie* by the pledgee, at the end of the term of the pledge. During the term, the pledgor by definition remains the owner of the pledged assets. These characteristics of the regular pledge have two implications. First, the pledgor can trace the assets in the hands of third parties,[72] and secondly, the pledgee by definition cannot dispose of the pledged asset by sale, except in the case of realisation after default.[73]

On the other hand, an 'irregular' pledge entails that the pledgee can return equivalent assets to the ones received rather than *in specie*. Such a construction would not be afforded protection in Danish courts if based on a regular pledge, because of the conflict with the requirements that assets be specific and identifiable. The irregular pledge structure can therefore assist in implementing a right of use entailing a general right of disposal. The irregular pledge – like the irregular usufruct – automatically implies an outright transfer with the obligation to redeliver equivalent assets.

In the case of an irregular pledge, the pledgee is considered the absolute owner of the pledged assets. Accordingly, the pledgee can dispose of the pledged collateral as it deems fit. The transfer of ownership takes place at the moment the contract is concluded.[74]

Note that the pledgor can still rely contractually on the pledge agreement to reclaim equivalent assets. This claim is, however, purely contractual and is worth little in the event of the pledgee's insolvency. The pledgor's rights are then satisfied according to the *pari passu* principle.

The question remaining is whether irregular pledge also encompasses the proprietary substitution which Article 5 of the CD requires. The answer to this question is

[72] In order for the collateral provider to be protected against creditors and bona fide purchasers the pledged collateral must be identifiable and specific as required by the Danish Law on Mortgages. See Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 61ff, and Roerdam & Carstensen: *Pant* (1998), p. 68ff.
[73] See Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 187.
[74] See section 1.4 above and cf. the different approach in respect of the timing issue in Article 5(2) of the CD.

negative, as in the case of the irregular usufruct (see section 1.4 above). The implementation of the right of use based on the Danish irregular pledge would need a special statutory provision to implement the feature of proprietary substitution as contained in Article 5(3) of the Collateral Directive.

1.6 Consent-based right of disposal

The implementation of Article 5 of the CD will probably be based on the consent-based right of disposal applying to securities held by a dealer in securities (vertical relationship).[75] However, important proprietary issues relating to the consent-based formula will still have to be addressed. These issues – especially the issue of when the collateral provider's loss of ownership rights occurs – are analysed in this section, whereas the content and further requirements of Article 3b of the Financial Business Act are dealt with below in section 2.

Because dispositions regarding dematerialised securities and immobilised physical securities have to be registered with the CSD and the depository respectively, unauthorised disposals by a pledgee or a custodian cannot occur in principle.[76] It follows from this that a collateral taker's right of disposal depends on the collateral provider's consent.

However, if the collateral provider consents to the collateral taker's right of disposal, the collateral provider impliedly also agrees to be left with a contractual claim against the collateral taker for the redelivery of equivalent assets. By consenting to this replaceability of his securities, the collateral provider essentially agrees to transfer his right of ownership to the collateral taker in exchange for a contractual redelivery claim.[77] A collateral arrangement entailing a right of disposal is exactly like an irregular structure.[78] It must therefore be concluded that a right of disposal based on the collateral provider's consent means that the collateral provider transfers title to the collateralised securities to the collateral taker.

On the assumption that the collateral provider gives his consent to disposal, the remaining question relates to the point in time when the collateral provider loses its proprietary interest. Two solutions are possible.

The first solution is that, since the consent-based formula essentially means that the collateral provider gives up his proprietary interests in the securities in return for a contractual redelivery claim in respect of equivalent securities, the collateral provider loses his property rights when the collateral agreement is concluded. This result is in accordance with general Danish property law principles and is also the result of the irregular pledge and irregular usufruct structures.

The second solution makes the time of transfer of title and the collateral provider's loss of proprietary rights dependent on the collateral taker's actual use of the securities. The collateral provider therefore loses its proprietary interest at a later

[75] See Article 3b(2) of the Financial Business Act.
[76] See section 2 below.
[77] Cf. the discussions on the consignment sale, the irregular usufruct and irregular pledge.
[78] I.e. either an irregular usufruct or an irregular pledge.

moment in time where the collateral taker disposes of the securities for the benefit of a third party. This solution resembles the solution of the consignment sale and is also the solution envisaged by Article 5 of the CD.

Both solutions have advantages. The first solution seems advantageous, because it is in line with general property law principles and therefore simple to understand. The granting of a right of use automatically means that the collateral provider loses its proprietary interest. The consequences of such a contract are foreseeable. From this point of view it is preferable. Under the other solution, the collateral provider remains the owner of the collateralised securities until the collateral taker decides to make use of its right of disposal. Extending the time of transfer of ownership means that the collateral provider is protected for a longer period of time, which is crucial in the event of the collateral taker's insolvency.

The Collateral Directive adopts the same view as the consignment sale (i.e. the second solution).[79] This deviates from the normal principles of Danish law, i.e. that proprietary rights are transferred when the agreement transferring title is concluded.[80] The working group established by the Danish Ministry of Justice will therefore most likely opt for a solution whereby the collateral provider loses its ownership rights when the collateral taker uses the securities.

B. Proprietary substitution under Danish law

Proprietary substitution within the meaning of Article 5(3) of the CD means that securities transferred under a contractual obligation to deliver equivalent assets fall under the same proprietary relationship as the original assets, i.e. the owner of the original assets is deemed to have been the owner of the substituting equivalent assets from the moment the transaction was entered into.

The issue of proprietary substitution raises the issue of voidable transactions, i.e. transactions that take place within a so-called 'suspect period' before a party's insolvency. The rules relating to voidable transactions are contained in chapter 8 of the Danish Insolvency Act. In the event of an imminent insolvency of the collateral taker, if the collateral provided has been used by the collateral taker and subsequently re-credited to the collateral provider's account during the 'suspect period', it may be more vulnerable under Danish insolvency law. The transaction may be invalidated, even though economically no new collateral has been provided. However, it is also a general principle under Danish law that transactions taking place in the normal course of business are not voidable. Therefore, provided that the collateral is provided in the normal course of business (and there is no intention to give the collateral provider a preferential position), a proprietary substitution will not be voidable under Danish law.[81]

[79] See section 1.3 above.
[80] See sections 1.4 and 1.5 above.
[81] Cf. the Articles 8(1)(b) and 8(4) of the CD.

Proprietary substitution as understood above is not a very common feature of Danish law. Danish law only allows for proprietary substitution in the case of perishable goods and in the case of replacement[82] (see sections 1.7 and 1.8 below).

1.7 Perishable goods

The Danish Law on Mortgages allows a collateral taker to dispose of received collateral if the collateralised assets can be deemed 'perishable'. In such an event, Danish law – as is the case under German law – grants the collateral provider an ownership right in respect of the replacement goods.[83]

It is, however, questionable whether the proprietary substitution that takes place in the case of perishable goods will fit the notion of proprietary substitution under Article 5 of the Collateral Directive. This is so for two reasons. First, securities are not covered by the concept of perishable goods. Second, proprietary substitution is possible in the case of perishable goods in order to ensure that realisation can take place, and not to facilitate further trades.

Consequently, the notion of perishable goods as understood under Danish law cannot satisfactorily explain the introduction into Danish law of the rule of proprietary substitution as envisaged under the Collateral Directive.

1.8 Replacement

Replacement ('*surrogater'*) takes place when the pledged collateral is damaged and proceeds are received by, or are due to, the pledgor in order to substitute the original collateral.[84]

The starting point under Danish law is that replacement can only take place under special circumstances. It follows from general principles that proceeds received by, or due to, the pledgor in exchange for pledged property are not subject to the right of pledge. The reason for this relates to the requirement under the Danish Law on Mortgages to be able to specify and identify the pledged assets.

However, an exception is made if the proceeds arise from an expropriation by the Danish state, insurance and claims for damages.[85] Assets resulting from such a situation are subject to a security interest. Danish courts have been very reluctant to accept circumstances under which replacement can take place, other than exceptions in the event of expropriation, insurance and claims for damages. This means that substitution will not take place in other situations. A new right of pledge is needed in these cases.

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[82] Danish term: *surrogater* or *erstatningsvaerdier*.
[83] See W.E. von Eyben: *Panterettigheder* (1958), p. 301.
[84] See UfR 1994.101 V and Roerdam & Carstensen: *Pant* (1998), p. 93 and 95, Knud Illum: *Dansk Tingsret* (1976), p. 95 and Hayton, Kortmann & Verhagen (eds.): *Principles of European Trust Law* (1999), p. 182.
[85] See Roerdam & Carstensen: *Pant* (1998), p. 93f and W.E. von Eyben: *Panterettigheder* (1958), p. 89.

As a result, current Danish law does not cover the proprietary substitution rule envisaged by the Collateral Directive. A statutory provision is needed to implement this feature.

1.9 Conclusion to the horizontal relationship

The right of disposal as envisaged by the Collateral Directive entails two things: a right of disposal and proprietary substitution.

In relation to the right of disposal, Danish law contains legal concepts which to a certain extent allow a person given possession of an asset, but who is not the legal owner of the asset, to dispose of that asset. These legal concepts are the realisation of a right of pledge, the right of re-pledge, the conditional and consignment sales, and the irregular rights of usufruct and pledge. The concept of a right of disposal is therefore not completely unfamiliar to Danish law. In addition, such a right of disposal is contained in Article 3b(2) of the Financial Business Act, which allows for a dealer in securities to dispose of its clients' securities on a consensual basis. The question of how far a right of disposal can be taken under Danish law has been investigated. Do the legal concepts mentioned allow for a general right of disposal? Can such a right be constructed on the basis of a contractual consent?

The analysis above clearly shows that a *general* right of disposal – a right that is also envisaged in Article 5 of the Collateral Directive – is not usually possible under Danish law. A collateral arrangement, under which a collateral provider retains ownership of the collateral but where the collateral taker is granted the same rights over the collateral – i.e. the rights of an owner – as the collateral provider, is currently not possible. Only if legal ownership is transferred to the collateral taker does he have a general right of disposal.

Neither realisation nor the conditional sale covers a general right of the collateral taker to dispose of the collateralised assets. Realisation is restricted to default situations and subject to strict requirements. The conditional sale falls on the issue of the purchaser's right of disposal, which under Danish law is restricted. These concepts cannot be used to implement the right of use in Danish law.

Re-pledging is only interesting because the situation – a pledgee's right to re-pledge – is similar to the situation envisaged by Article 5 of the CD. However, under Danish law, re-pledging does not by definition allow the pledgee to sell the pledged collateral. Re-pledging is therefore also not suitable for implementing the right of use in Danish law.

The consignment sale, and the irregular usufruct and irregular pledge seem to come closest to the 'right of disposal' feature. Under the consignment sale, the irregular usufruct and the irregular pledge, the right of disposal is general and therefore covers a disposal by way of sale as envisaged by the Collateral Directive. The consignee's sale is the whole purpose of the consignment arrangement. Under the irregular usufruct and pledge, the right of disposal is a result of the transfer of title from the provider of the right of usufruct to the usufructuary and from the pledgor to the pledgee. All three disposal structures therefore allow for a general right of disposal.

Since Article 5 of CD is closest to the situation arising under the irregular structures, because it is a collateral arrangement and not a sales situation, it must be concluded that the consignment sale is not the basis for implementing the right of disposal in Danish law.

Whether the introduction of a right of disposal into Danish law is based and characterised as an irregular usufruct or an irregular pledge seems irrelevant. Both concepts essentially entail the same thing, i.e. the vesting of a limited right, which entails an outright transfer, because of the right of use and the obligation to redeliver equivalent assets. It seems most correct, because Article 5 CD relates to pledge structures, to characterise the security interest combined with a right of use as an irregular pledge under Danish law. It has also been shown that the consent-based formula – as envisaged in the Danish Financial Business Act – resembles the irregular structures and involves a transfer of title.

A major difference between the Collateral Directive and the irregular structures concerns the timing of the collateral provider's loss of title. The timing issue will – because the Collateral Directive stipulates as much – have to be implemented in Danish law so that the collateral provider loses his property right at the time the collateral taker disposes of the assets for the benefit of a third party.

The question therefore remains whether the irregular pledge also entails proprietary substitution as under Article 5 of the Collateral Directive. As can be seen above in sections 1.3 – 1.5, neither the consignment sale, the irregular usufruct nor the irregular pledge entail proprietary substitution. This means that the proprietary rights to the transferred assets are lost. The consignor, the provider of the usufruct and the pledgor are left only with a contractual claim against the consignee, the usufructuary and pledgee respectively. Needless to say, such a claim is unsecured in the event of the insolvency of the consignee, usufructuary or pledgee. Proprietary substitution is possible only in limited circumstances, such as in the case of perishable goods, damages, insurance claims (see section 1.B). The feature of proprietary substitution envisaged by Article 5 of the CD cannot therefore be implemented in Danish law by referring to conventional legal structures.

An analysis of the horizontal relationship therefore finds that Danish law covers the feature of a general right of disposal, albeit with difficulty, but does not cover proprietary substitution. The implementation of Article 5 of the Collateral Directive in Danish law will need statutory provision.

2. The relationship between the custodian and its client

Apart from certain special custody arrangements (e.g. a dealer in securities' custody arrangement) the rules governing custodial relationships under Danish law are not codified. After an analysis of the non-statutory custody relationship (in section 2.1), the rules regarding securities custody arrangements will be discussed (in section 2.2).

2.1 Non-statutory custody relationships

A depositor's deposit of an asset with a custodian can be 'regular' or 'irregular'. A regular custody arrangement comprises all those custody arrangements under which the custodian does not have a right to dispose of the deposited assets.[86] A *depositum irregulare*, on the other hand, is a custody arrangement under which the custodian is entitled to dispose of the deposited assets for the benefit of third parties subject to the obligation to deliver equivalent assets at a later date.

The principle behind a *depositum regulare* under Danish law is that if a deposit does not consist of exactly the same assets as originally deposited, then, although it is segregated, the deposit is not protected from the custodian's creditors. The different regular deposit constructions available under Danish law are, *inter alia*, (1) an arrangement whereby the depositor remains the owner of the individual deposited assets (individual deposit), and similarly (2) an arrangement under which the deposit consists of assets belonging to different clients, but where the assets can be identified and specified individually (an 'omnibus deposit')[87]. Danish courts have also recognised (3) a *depositum regulare,* where assets are held on a fungible basis[88]. In the third situation, the depositor was thought to have given up his proprietary claim in respect of the individually specified deposited assets in exchange for a co-ownership right to them, which means that the custodian is under the obligation to deliver equivalent assets to the investor, if so requested.[89] This should be contrasted with the position of the custodian in the event of an individual or omnibus deposit, where he is under an obligation to return the deposited assets *in specie*.

Since a custodian's right of disposal under Danish law would be incompatible with a regular deposit, a right of use must take its starting point in the creation of a *depositum irregulare*. A *depositum irregulare* combines a transfer of title to the depositor with an obligation to acquire and redeliver equivalent assets.[90]

2.2 Custody of securities

The rules governing the custody of securities under Danish law depend on the nature of the custodian and on the nature of the securities. Danish securities custodians can be divided into (1) central securities depositories ('CSD')[91], (2) dealers in securities

[86] If the custodian under a *depositum regulare* disposes of the deposited assets in favour of a third party without the consent of the depositor, the depositor can trace the assets and revendicate them from (bona fide) third parties, provided that the assets are specific and identifiable. This is the starting point for goods and other movables. See Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 187.

[87] An example hereof is the '*samledepot*' of physical or dematerialised securities. See section 2.2.2 below.

[88] See UfR 1949.691 O, UfR1927.21 H, UfR1928.216 H, UfR 1997.762.

[89] This was for example the case in UfR 1927.21 H and 1928.216 H where the Danish Supreme Court recognised a pledgor's proprietary right to fungible shares against the pledgee's insolvency estate, although the identity of individual shares could not be established. These two decisions allowed the pledgor to claim as many equivalent shares as originally pledged.

[90] See Elmer & Skovby: *Ejendomsretten* 1 (1995), p. 40f and Bernhard Gomard: *Obligationsret* 1 (1989), p. 85f.

[91] The Danish CSD – Vaerdipapircentralen – administers dematerialised securities.

(typically a bank or an investment firm)[92], and (3) persons – legal entities as well as physical persons – who are neither a CSD nor a dealer in securities and who hold physical (bearer) securities in custody for their clients[93].

Below it will be investigated if the Danish CSD Vaerdipapircentralen ('VP')[94] and dealers in securities have a right of use in respect of the interests in securities of investors.

2.2.1 Central securities depository

The custody rules relating to the Danish CSD are contained in the Danish Securities Trading Act ('STA')[95]. The STA does not provide for a right of use of the VP in respect of securities it has in custody. Therefore the VP currently does not have a right of use in respect of investors' assets.[96]

The custodial relationship between the VP and an investor keeping a securities account with the VP must be characterised as a regular deposit excluding a right of use. This is supported by Article 31 of the Book-Entry Executive Order[97], which requires the VP to register securities belonging to a specific investor in an individual account[98]. Securities kept by the VP are considered to be the separate property of individual investors. This means that in the event of the VP's insolvency, the investors' securities will be exempt from the insolvency proceedings, provided that the ownership is duly evidenced in the records of the VP or in transcripts thereof. The VP's redelivery obligation is therefore an obligation *in specie*. A right of use cannot be granted to the VP.

2.2.2 Dealers in securities

The rules governing the business of dealers in securities are contained partly in the STA and partly in the Financial Business Act ('FBA')[99]. Article 3b of the FBA

[92] Dealers in securities hold immobilised physical securities and can hold dematerialised securities on a 'nominee'-basis for its clients (see below).
[93] An example of such a custody relationship is the holding of physical securities by attorneys on behalf of their clients. The non-statutory rules relating to regular/irregular deposits apply to securities holdings of this kind (see section 2.1 above). These securities holdings will not be analysed any further.
[94] The VP is currently the only central securities depository in Denmark and all securities kept in the VP are dematerialised. See Article 59 of the STA.
[95] See footnote 41 above.
[96] CSDs are not encompassed by Article 3b of the Danish Financial Business Act, because they are not dealers in securities within the meaning of Article 4 of the STA. Cf. Benjamin: *The Law of Global Custody* (2003), Ch. 7.52.
[97] See Executive Order 925 of 17/10/1996 concerning the Book-Entry etc. of Electronic Securities in a Central Securities Depository ('Book-Entry Executive Order').
[98] The account has to state (1) the name of the account controller, (2) the ISIN number and nominal value of the securities, (3) the name, address and ID-number of the investor, and (4) to whom the CSD should make payments. See Article 31 of the Book-Entry Executive Order. Note that the VP has over 2.7 million accounts of owners of securities.
[99] See footnote 42 above.

contains the rules relating to a dealer in securities' holding of securities for its clients.[100]

The term *dealer in securities* is defined in Article 4 of the STA. Dealers in securities are entities with the exclusive right of addressing the public on a professional basis, offering themselves as buyers and sellers of and intermediaries for securities.[101] Credit institutions, investment companies and mortgage credit institutes can be dealers in securities.[102] In order to conduct business as a dealer in securities, an authorisation by the Danish Financial Supervisory Authority is mandatory.[103]

According to Article 3b of the FBA, a client has a proprietary claim in respect of securities held by a dealer in securities in order to protect the client against the dealer's insolvency. Securities held by a dealer in securities can be physical (bearer) securities or dematerialised book-entry securities (*'fondsaktiver'*)[104]. Physical securities entail the opening of a physical deposit with the dealer where the securities are immobilised, while dematerialised securities require the opening of an account with the VP. It is submitted that the legal issues relating to physical deposits and to securities accounts opened with the VP are the same as far as the right of use is concerned.[105] In the following, therefore, references to deposits should be understood as encompassing both types of deposits.

A dealer in securities can maintain its clients' securities in two ways – either in an *individual* deposit or in an *omnibus customer* deposit *('samle depot')*.[106] These two kinds of deposits are treated in turn below. The conditions under which a dealer in securities can dispose of its clients' assets will be investigated.

2.2.2.1 Individual deposits

An *individual* deposit is a separate and segregated deposit held with a dealer in securities or with the VP in the investor's name.[107] The individual deposit is therefore a *depositum regulare* in principle. The investor has a proprietary right to particular securities held on deposit.[108] In principle, the dealer cannot therefore dispose of assets in its custody.[109]

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[100] Note that major amendments have been made to the current FBA, but without substantial changes to the current Article 3b. The new FBA (*Lov om finansiel virksomhed*; see L 176 – Till A 4642) was enacted on 4 June 2003, and will enter into force on 1 January 2004. Article 3b of the FBA will become Article 72 of the new FBA.

[101] See Article 4(1) of the STA.

[102] The list of dealers in securities is exhaustive. See Article 4(3) of the STA.

[103] See Article 8 of the STA.

[104] *Fondsaktiver* are tradable book-entry securities registered with the VP. See Article 59 (1) and (2) of the STA. Cf. Kruger Andersen & Jul Clausen: *Boersretten* (2003), p. 131.

[105] Cf. Rammeskow Bang-Pedersen (2003): *Internationale aspekter af insolvens- og tingsretten*, p. 690.

[106] See Article 3b(3) of the FBA.

[107] Danish law requires Danish financial institutions to segregate their own assets from clients' assets, whether these assets are held in custody in Denmark or abroad. See Article 3b(3)(2) of the FBA and Kruger Andersen & Jul Clausen: *Boersretten* (2003), p. 88f.

[108] In the event that dematerialised securities are registered by a dealer in securities in its capacity as an Account Controller and have been registered with the VP on an individual account in the name of the investor, they are exempt from any insolvency proceedings according to Article 82 of the Danish Insolvency Act. The ownership of the individual securities – in the event of the dealer in securities'

An investor can grant the dealer a right of disposal in the case of an individual deposit. Granting a right of disposal to a dealer in securities must fulfil the requirement set out in Article 3b(2) of the FBA. Under this provision, a dealer in securities cannot dispose of securities in its custody without the investor's consent. The investor's consent must be explicit.[110]

Apart from the investor's consent, the provision itself does not specify further details or requirements for the dealer in securities' right of use. The preparatory works only state that the provision allows the dealer a right of use of the securities, for example on the basis of a securities lending arrangement, but do not describe further to what extent and under what conditions the dealer can use the securities in its custody. Also, the requirement set out in Article 3b(1)(1) of the FBA, which states that a dealer has to take measures in order to safeguard the proprietary claim of the investor, provide little guidance in this matter.

If, however, an investor consents to a dealer's right to disposal of securities in its custody, the investor impliedly also agrees to be left with a contractual claim against the dealer for redelivery of equivalent assets. By consenting to this replaceability of his securities, the investor therefore also agrees to transfer his right of ownership to the dealer in securities in exchange for a contractual redelivery claim.[111] It must therefore be concluded that the custody should essentially be characterised as a *depositum irregulare*, and that consent to a right of disposal essentially entails a transfer of title.

2.2.2.2 Omnibus accounts

A '*samle depot*' – according to Article 3b(3) of the FBA – is an omnibus customer deposit[112], where an investor's securities are held on deposit together with the securities of other investors.[113] *Dematerialised securities* registered with the VP and part of a *samle depot* are held on a nominee basis. The nominee structure means that the investor appoints a nominee whose name, instead of the investor's, appears in the VP System.[114] The nominee *de facto* replaces the owner of securities to the outside

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insolvency – can be proven by way of precise account documentation received from the dealer. See Erik Werlauff: *Boers- og Kapitalmarkedsret* (2000), p. 112, and Kruger Andersen & Jul Clausen: *Boersretten* (2003), p. 88f.

[109] The person amending the securities register should be authorised to do so on the basis of the applicable account agreement ('*register legitimation*'). See Article 36 of the Book-Entry Executive Order and Jul Clausen: *Sikkerhed i fordringer* (2002), p. 122.

[110] See the corresponding provision in the second indent of Article 10 of the Investment Services Directive (cf. footnotes 6 and 8 above) and Jul Clausen and Kruger Andersen: *Boersretten* (2003), p. 88.

[111] Cf. the discussions supra on the irregular usufruct and irregular pledge.

[112] Or omnibus customer account, if the securities are dematerialised and kept with the VP.

[113] The dealer can only place an investor's securities in a *samle depot*, if the custodian informs the investor of the legal effects of doing so and if the investor has consented. The dealer has to segregate its own securities holding from its clients' securities. The Danish Financial Authority (*Finanstilsynet*) can, under special circumstances, allow a dealer in securities to place its own securities holding in a *samle depot* with the securities of other investors. See Article 3b(3) of the FBA.

[114] See Article 72(2) of the STA.

world.[115] This means that the nominee is technically able – albeit not permitted[116] – to dispose of the securities. The nominee can therefore pass on good title in respect of the securities to a bona fide purchaser. *Physical securities* are not held and registered by the VP. A *samle depot* consisting of physical securities is held and registered by individual Danish dealers in securities.

In respect of physical (bearer) securities as well as dematerialised securities, Article 3b(1)(1) of the FBA requires dealers to take satisfactory measures to safeguard the proprietary claim of investors. Dealers must keep a register, which clearly specifies the ownership rights of individual clients in respect of the securities registered in the omnibus account.[117] The inventory makes it possible to determine exactly which and how many of the securities in the omnibus account are attributable to each investor. The investor therefore has a traceable and enforceable right in respect of individual securities in the event of the dealer's insolvency.[118] If the dealer fails to keep a record, and unless the investor is able to prove the identity of the securities by some other means, the investor is left with an unsecured claim and is therefore unable to enforce a proprietary claim if the dealer becomes insolvent.[119]

Because Article 3b(3) of the FBA requires dealers in securities to keep an inventory, the securities are held on a *non-fungible* basis and the dealer's obligation to redeliver the securities is *in specie*. In principle, therefore, the *samle depot* is a *depositum regulare*.[120]

As with the individual deposit, the omnibus deposit does not allow the dealer in securities a right of disposal, unless the investor expressly consents to such.[121] The investor in this case also impliedly agrees to the transfer of ownership of the securities in exchange for a contractual claim for redelivery of equivalent assets.

2.3 Conclusion to the client-custodian relationship

The Danish position on the right of a custodian to dispose of its clients' securities is dependent on the custody relationship, i.e. on whether there is a securities holding with the Danish CSD, the Vaerdipapircentralen, (of dematerialised securities) or with a dealer in securities (of either dematerialised securities or immobilised physical securities). The Danish CSD currently has no right of disposal, while the securities in the custody of a dealer can made be available for the dealer's own purposes. The right of the dealer in securities to use the securities in its custody is, however, dependent on

[115] The nominee handles the investor's economic interests. The nominee may, for example in the case of equities, receive dividends and other payments, along with shareholder information. Should the investor wish to grant the nominee administrative powers, this requires a separate contract between the parties. In the event of the nominee's insolvency, the investor is in principle protected from the creditors of the nominee, because they do not have a better right to the securities than the nominee. The nominee is just a middleman, and the actual ownership right is with the investor.
[116] In principle, a disposal by the nominee is a breach of the contract between the nominee and the investor, and an infringement of the property interest of the investor, who is the actual owner.
[117] See Article 3b(3) of the FBA, and Jul Clausen & Kruger Andersen: *Boersretten* (2003), p. 89.
[118] See Article 3b(4) of the FBA and Jul Clausen & Kruger Andersen: *Boersretten* (2003), p. 90.
[119] See Erik Werlauff: *Boers- og Kapitalmarkedsret* (2000), p. 112.
[120] Cf. section 2.1 above.
[121] See Article 3b(2) of the FBA.

the client's express consent. This follows from Article 3b(2) of the FBA, which implements Article 10 of the Financial Services Directive in Danish law.

The custodian's right of disposal on the basis of consent implies that the client gives up its proprietary claim in respect of the assets deposited individually or in a *samle depot*, in return for a contractual claim for redelivery of generic assets. Article 3b(2) of the FBA therefore entails an 'irregular custody' structure. Because the client has consented to disposals by the dealer in securities, he loses his ownership rights to the deposited securities. The client will, as a consequence, run an insolvency risk in relation to the custodian.

2. DUTCH AND GERMAN LAW*

The right of use based on a security interest as envisaged in the Collateral Directive

Introduction

This chapter explores whether a right of use based on a security interest is compatible with the Dutch and German systems of property law. In particular it is examined if the right of use set out in Article 5 of the European Collateral Directive ('CD')[122] should not actually be qualified as a transfer of ownership. Also it investigates whether the provision on proprietary substitution set out in the Collateral Directive can be reconciled with Dutch and German property law.[123]

General right of disposal

On the basis of Article 5 of the CD a collateral provider can give a collateral taker a right of use. This right of use means that a pledgee has the right to dispose of the pledged assets in his own name. He can sell the assets to a third party or encumber them with a security interest. A pledge under Dutch and German law is a security right. Under current law, a pledgee only has a right to dispose of pledged assets if an event takes place that justifies enforcement of his security right. The right of use implies a pledgee's general right of disposal and is therefore a remarkable development in security law.

Proprietary substitution

A second theme addressed in Article 5 of the CD is that of proprietary substitution.[124] Under Article 5 of the CD, if the collateral taker executes his right of use, a collateral provider is left with a contractual claim until the moment that the collateral taker transfers equivalent assets. These assets must be transferred at the latest at the end of the transaction. As soon as the collateral taker receives these equivalent assets, the Collateral Directive proposes proprietary substitution. This means that the collateral provider is the owner of the equivalent assets transferred, and is deemed to have been the owner as from the moment the original collateral was first provided. Under current Dutch and German law such proprietary substitution is only possible under very limited conditions. A fundamental change is also required in property law to deal with this issue.

Current market practice

At present, collateral market participants in Germany and in The Netherlands provide collateral by way of a transfer of ownership. Collateral in repurchase agreements is usually transferred on the basis of a sale/re-sale, whereas collateral in securities

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* The author is grateful to Professor Leenen and colleagues at the Free University of Berlin for the research facilities provided and for the exchange of thoughts. Professor Flessner is thanked too, for the stimulating talks at the Humboldt University in Berlin.

[122] See footnote 4 above.

[123] For the current proposals for implementation, see: the Dutch draft Law on Financial Collateral Agreements, TK, 2002-2003, 28874, nr. 1-2 (proposed Article 7:53 of the Dutch Civil Code), and the Explanatory Comments ('*Memorie van Toelichting*') thereto (TK, 2002-2003, 28874, nr. 3); the *Diskussionsentwurf des Bundesministerium der Justitz; Entwurf eines Gesetzes zur Änderung der Insolvenzverordnung, des Bürgerlichen Gesetzbuches und anderer Gesetze*, p. 18-19 (available on www.bmj.bund.de, search for 'finanzsicherheiten').

[124] Cf. section 2 of the introduction to this report.

lending is transferred on the basis of a loan of fungibles (‘*verbruiklening*’, ‘*Darlehen*’). This practice is sanctioned in Article 6 of the CD concerning the recognition of title transfer arrangements.

Outline
The sections on ‘execution’, ‘re-pledge’, ‘proprietary representation’ and ‘perishable goods’ mainly focus on the circumstances under which a pledgor is – or is not – entitled to dispose of the pledged assets under current law. In the section on ‘usable goods’, the theory of irregular pledge, usufruct and custody is considered. The focus of the section on ‘proprietary substitution’ is on the limits of such substitution under current Dutch and German law.

This chapter examines the right of use from a legal point of view. The question of the tax, regulatory and accounting treatment of a security interest combined with a right of use will not be examined.

1. Execution

The most important example of a pledgee being entitled to dispose of pledged assets in his own name is execution. Only if the obligation in relation to which the right of pledge is vested is not fulfilled, is the pledgee entitled to enforce his security interest. Note that the right of use under the Collateral Directive goes further, as it entails a right to dispose under ‘normal circumstances’. Because execution is not that wide in scope, it cannot serve as a basis for implementing the right of use.

2. Re-pledge

On the basis of Article 3:242 of the Dutch Civil Code, a pledgor can give a pledgee the right to establish a further right of pledge over the pledged asset for the benefit of a third party. This further right of pledge is established later, but ranks above the initially established right of pledge. In Dutch legal literature the device of re-pledge has been criticised. The argument is that a pledgee cannot dispose of assets that are not his own, and therefore should not be able to establish a further right of pledge for the benefit of a third party.[125]

This approach in Dutch legal literature is exactly the same approach as that taken by the drafters of the German Civil Code. Under German law, a pledgee cannot establish a right of pledge over the pledged asset for the benefit of a third party. He only has

[125] See on the re-pledge generally: *Asser-Serie 3-III* (2003), nr. 38-39; M.A. Koopal, ‘De herverpanding van artikel 3:242 BW: Een Monstrum?’, *WPNR* 6202 (1995), p. 775-777, with reaction of C.M. Stokkermans, *WPNR* 6226 (1996), p. 418-419; H.A.G. Fikkers, ‘Herverpanding heroverwogen’, *WPNR* 6313 (1998), p. 301-307, with reaction of N.E.D. Faber, *WPNR* 6333 (1998), p. 686-688; J.J. van Hees, ‘Gedachten over herverpanding’, in: J.C. van Apeldoorn, e.a. (ed.), *Onzekere Zekerheid; Insolad Jaarboek 2001*, Kluwer, Deventer, 2001, p. 227-238; K. Breken, ‘Herverpanding, geen standaard ‘nemo plus’ situatie’, in: S.C.J.J. Kortmann, e.a. (ed.), *Onderneming en tien jaar nieuw burgerlijk recht*, Kluwer, Deventer, 2002, Serie Onderneming en Recht (24), p. 365-387. And critically: W.J. Zwalve, ‘Enige opmerkingen over art. 3:242 BW’, in: T. Hartlief, e.a. (ed.), *CJHB (Brunner-Bundel)*, Kluwer, Deventer, 1994, p. 441-450.

the right to pledge the right he has towards the original pledgor for which the original right of pledge was established.[126]

The right of re-pledge is envisaged in the Dutch Civil Code, but comes in for criticism. Under German law, such a right does not exist. In addition, a right of re-pledge can never entail that a pledgee has a right to transfer ownership of pledged assets. The right of use under the Collateral Directive, on the contrary, does entail a right to pledge and to transfer. The right of re-pledge cannot therefore be a satisfactory explanation for the right of use.

3. Proprietary representation

The concept of proprietary representation ('*machtiging*', '*Ermächtigung*') means that someone who is not the owner of an asset is given the right to dispose of the asset in his own name. Proprietary representation has not explicitly been codified in the Dutch Civil Code. In German law proprietary representation does have an explicit legal basis.[127] Important applications of the doctrine of proprietary representation under both Dutch and German law are 1) the disposal by an agent in the case of a sale on commission (e.g. the Dutch '*lastgeving*') and 2) the consignment sale and other retention of title arrangements (e.g. the Dutch '*eigendomsvoorbehoud*' and the German '*Eigentumsvorbehalt*').[128]

The *sale on commission* cannot serve as a basis for implementation of the right of use. In the case of a sale on commission, the agent in one way or another always represents the interest of the principal. In the case of the right of use, the only interest of the 'pledgee' is to obtain as much profit as possible for his own benefit.

The right of use is probably more similar to a *consignment sale*. It is generally accepted by German legal scholars, and argued for by Dutch scholars, that the consignee should in the case of a consignment sale be able to dispose of assets in the normal course of business. It is argued that the consignee has this right of disposal on the basis of the concept of proprietary representation. However, the structure of a consignment sale differs from that of a security interest combined with a right of use:

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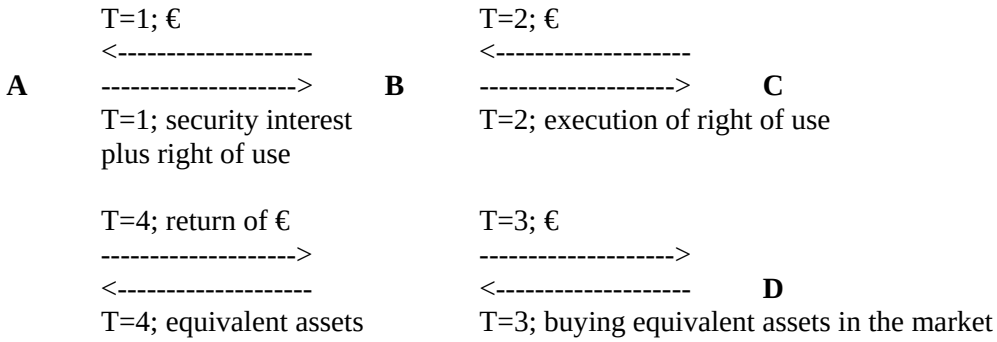
[126] See for the approach of the so-called '*Pandektisten*': H. Dernburg, *Das Pfandrecht nach den Grundsatzen des heutigen römischen Rechts*, Verlag von S. Hirzel, Leipzig, 1860, part 1, § 61; Windscheid/Kipp, *Lehrbuch des Pandektenrechtes*, Scientia Verlag, Aalen, 1984, 2nd print of the 1906 Frankfurt am Main edition, part 1, § 227. The German legislator has followed this approach: R. Johow, *Die Vorentwürfe der Redaktoren zum BGB; Sachenrecht; Teil 2*, Walter de Gruyter & Co., Berlin – New York, 1982, p. 803-809 (in particular p. 804).

[127] See Article 185 of the German Civil Code.

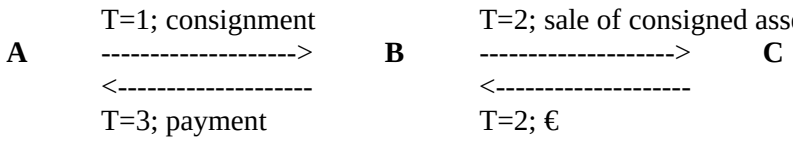
[128] See Asser-Kortmann, *Bijzondere overeenkomsten; Deel III*, W.E.J. Tjeenk Willink, Zwolle, 1994, nr. 154 and nr. 168 *et seq.*; L. Groefsema, *Bevoegd beschikken over andermans recht*, diss. RUG, 1993; S.Y.T. Meijer, *Middelijke Vertegenwoordiging*, diss. VU, 1999, section 5.4; Pitlo-Reehuis, *Het Nederlands burgerlijk recht; Deel 3; Goederenrecht*, Gouda Quint, Deventer, 2001, 11th edition, nr. 141.

Security interest combined with a right of use



At T=1, A borrows euros from B and vests a security interest combined with a right of use in return. At T=2 B executes his right of use and sells A's assets to C. Because of its obligation to transfer equivalent assets to A at T=4, B buys equivalent assets in the market from D at T=3.

Consignment sale



At T=1, A gives B assets in consignment, which means that A retains title to the assets until B sells them in the normal course of business. At T=2, B sells the assets to C and receives euros in return. At T=3, B pays A for the assets.

The structure of a security interest combined with a right of use is essentially different from that of a consignment sale. Without being exhaustive, a number of crucial differences are:

1) In the right of use scenario, A already receives a counter-performance at T=1; in the consignment sale, A receives payment only at T=3;
2) In the consignment sale, there is no obligation to deliver equivalent assets at the end of a transaction, but only an obligation to pay for the consigned assets; if a right of use has been granted, equivalent assets must be transferred;
3) In the consignment sale, A is the secured party wishing to retain his ownership interest in any case until B has lawfully disposed of the assets in the ordinary course of business; in the right of use structure, both A and B are secured in the sense that their risk is covered by a counter-performance that is available for set-off[129].

The consignment sale deviates so much from the right of use structure under the Collateral Directive that it cannot be used as a basis for implementing the right of use.[130] It will be shown below that the structure of a security interest combined with a right of use is essentially the same as that of an irregular pledge.

[129] Such set-off is enforceable under the regime of the Collateral Directive.
[130] Also note that in the case of a consignment sale no proprietary substitution is possible under Dutch or German law. After a sale by the consignee the consignor is left with a contractual claim.

4. Perishable goods

In the case of perishable goods, German law provides for a pledgee's right to sell these goods, if necessary. After the sale, proprietary substitution takes place, i.e. the pledgor has an ownership right in respect of the replacement goods. Here you see both a right of disposal and a proprietary substitution arrangement in order to preserve the pledgor's security right.[131]

The provision on perishable goods cannot help accommodate the right of use, however. This is so for two reasons. First, securities are not necessarily 'perishable goods'. They can only be considered to be so in the case of extreme price fluctuations on the market. The right of use under the Collateral Directive aims at tradeability under all circumstances. The second argument relates to the two functions of collateral. Collateral in the sense of the Collateral Directive is provided for recovery purposes and for entering into further trades.[132] The German arrangement in respect of perishable goods protects the pledgor's security interest, and therefore only serves the recovery function of collateral. The right of use under the Collateral Directive, on the other hand, stresses the second function of collateral, i.e. trading with the pledged assets. For these reasons, the regulation on perishable goods cannot serve as a satisfactory basis for integrating the right of use in the Dutch and German systems of property law.

5. Usable goods; Replaceability entails an outright transfer

Usable goods are goods the main characteristic of which is that they can be consumed or sold. Securities are usable goods in the sense that one of their main features is that they are traded. How should a right of pledge, a right of usufruct or custody in respect of such usable goods be characterised? In Dutch and German doctrine, it is argued that in all these cases a transfer of ownership takes place, if the assets are made 'replaceable'. Replaceable means that the pledgee, usufructuary or custodian is allowed to dispose of the assets, while being under an obligation to transfer back equivalent assets. In this case the doctrine speaks of 'irregular pledge', 'irregular usufruct' and 'irregular custody' respectively.[133,134]

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[131] The chapter on the right of pledge under the Dutch Civil Code contains no provision on perishable goods. Also in the literature on Article 3:229 of the Dutch Civil Code, which contains a rule of proprietary substitution, perishable goods do not feature. See section 6 below.

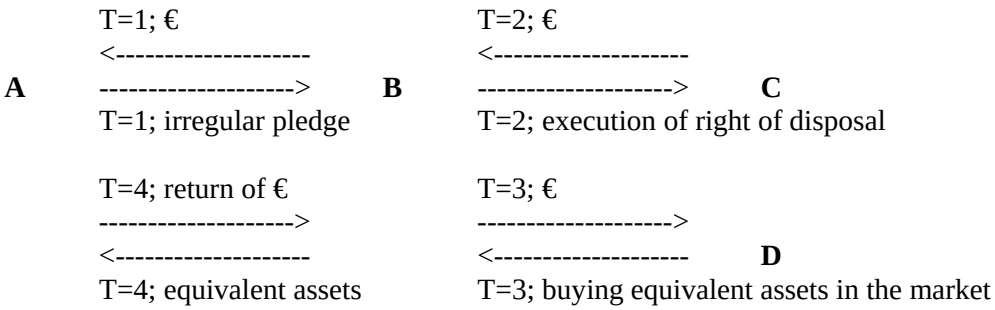
[132] See on the two functions of collateral section 2 of the introduction to this report.

[133] See on Dutch law: A. Hammerstein, *Eigenlijke en oneigenlijke zaaksvervanging*, diss. KUN, W.E.J. Tjeenk Willink, Zwolle, 1977, chapter 4; Houwing, in: G. Van Hall, Ph.A.N. Houwing, *Het afscheiden en individualiseren van vermogensbestanddelen ten behoeve van bepaalde crediteuren of groepen van crediteuren*, Prae-advies Broederschap der Notarissen, 1952, p. 165-228; M.S. van Gaalen, *Vruchtgebruik*, Kluwer, Deventer, 2001, Ars Notariatus XCI, nrs. 022 and 153; W. Meijer, *Effectenbewaring*, diss. KUN, 1974, p. 3-27. See on the German irregular pledge: Staudinger, (Neubearbeitung 2002), § 1204, nr. 52-60. The irregular usufruct has been codified in § 1067 of the German Civil Code.

[134] Note that – contrary to doctrine – the Dutch legislator has recently enacted proprietary substitution in case of a right of usufruct. This choice, however, leads to dogmatic problems, particularly if substituting claims or immovable property are registered in the name of the usufructuary. It has therefore been argued in literature that the doctrine of irregular usufruct – entailing a transfer of ownership – should be re-established. See Van Galen (2001), in particular sections 5.4, 5.5, 5.8 and chapter 7 (section 175).

Taking into account that Article 5 of the CD relates to security interests, the focus of attention will be on the irregular pledge. The structure of an irregular pledge is essentially as follows.

Irregular pledge



This structure is exactly the same as the structure of a security interest combined with a right of use as envisaged in the Collateral Directive.[135] Such a security interest combined with a right of use is therefore essentially an irregular pledge. In line with the doctrine on irregular pledge, usufruct and custody, the conclusion must therefore be drawn that the right of use under the Collateral Directive entails a transfer of ownership.[136]

Note that it is usually argued by Dutch legal scholars that the transfer of ownership takes place at the moment the parties intend to establish the irregular pledge, usufruct or custody arrangement.[137] This is also the starting point in respect of the irregular pledge under German law.[138] Also in the case of an irregular right of usufruct (codified in § 1067 of the German Civil Code), a transfer of ownership takes place at the moment the irregular usufruct is vested. The fact that you make assets replaceable automatically triggers a transfer of ownership.[139]

The Collateral Directive – in deviation from this theory – envisages that the collateral provider loses his ownership only at the moment that the collateral taker exercises his right of use.[140] In this respect the Collateral Directive is – somewhat inconsistently – not in line with the theory on 'irregular' structures, but follows the principles relating

[135] Cf. section 3 above.
[136] The irregular pledge has been suggested in German literature as a way of implementing Article 5 of the CD. See K. Löber, 'Der Entwurf einer Richtlinie für Finanzsicherheiten', *Zeitschrift für Bank- und Kapitalmarktrecht ('BKR')* 3/2001, p. 118-124; C. Keller, 'Die Wertpapiersicherheit im Gemeinschaftsrecht', *BKR* 8/2002, p. 347-354; K. Löber, 'Die EG-Richtlinie über Finanzsicherheiten', *BKR* 14/2002, p. 601-602; C. Keller, 'Umsetzung der Richtlinie zu Finanzsicherheiten', *BKR* 12/2003, p. 481-483. Cf. the discussion paper issued by the German Ministry of Justice, mentioned in footnote 123 above.
[137] See in this sense Meijer 1974, p. 27 (section 4); Hammerstein 1977, chapter IV, § 2. Houwing 1952, p. 170-171, stresses the importance of the relationship between the parties.
[138] Staudinger, (Neubearbeitung 2002), § 1204, nr. 54 stresses the will of the parties as an important factor, but takes the moment the irregular arrangement is entered into as a starting point.
[139] A difference between the consignment sale and the irregular pledge therefore concerns the moment when the consignor or pledgor loses his ownership right (in the case of a consignment sale at the moment the assets are sold by the consignee, in the case of the irregular pledge at the moment the irregular pledge is established).
[140] Cf. Article 5(2) of the CD.

to the consignment sale. The consignor loses his ownership interest at the moment a lawful disposal is made by the consignee.

6. Proprietary substitution

Note that besides the introduction of the notion of dispositions by a secured party (which can only be accommodated in a satisfactory way by codifying the irregular pledge), the Collateral Directive also introduces a rule of proprietary substitution (see Article 5(3) of the CD).

As was demonstrated in section 4 above, proprietary substitution can take place in the case of perishable goods. Assets that replace perishable goods are subject to exactly the same proprietary constellation as the original goods. Generally speaking, the concept of proprietary substitution is applied only in a very limited number of cases under Dutch and German law. Besides perishable goods, two other categories spring to mind: insurance money, or claims for damages that replace the original assets and are subject to the same proprietary constellation as the original assets.[141] For example, a pledge on a car that is stolen can be transformed into a pledge on insurance money paid to replace the car. Note that the concept of proprietary substitution is limited to cases where the secured party's security interest deserves protection, because there is an external factor affecting the value of the encumbered goods (perishable goods, insurance, damages). Under current Dutch or German proprietary law, proprietary substitution does not apply if the parties agree that the pledgee is allowed to dispose of assets in order to earn money. In the case of an agreement between the parties there is no external factor justifying application of proprietary substitution. Note in this respect that neither the consignment sale nor the irregular pledge know a rule of proprietary substitution.

Article 5 of the Collateral Directive does, however, introduce a rule of proprietary substitution when a collateral taker starts trading with the encumbered assets. In order to accommodate the proprietary substitution rule of the Collateral Directive, the scope of application of the notion of proprietary substitution therefore needs widening considerably. This will inevitably lead to changes to Dutch and German law.

Concluding remarks

The pledge concept is incompatible with a pledgee's general right of disposal. The pledge is a security interest, which means that dispositions can take place when there is an event of default. On the basis of the right of use under the Collateral Directive it is, however, possible to give the 'pledgee' a right to dispose under all circumstances.

A pledgee's general right of disposal is incompatible with a number of characteristics of a right of pledge. Under current law, a pledgor can redeem his assets at the moment

[141] Article 3:229 of the Dutch Civil Code contains a rule on proprietary substitution. Basically, this substitution rule applies to damages or insurance money due or paid. See *Parlementaire Geschiedenis; Boek 3, Vermogensrecht in het algemeen*, p. 734-736; *Asser-Serie 3-III* (2003), in particular nrs. 25, 63, 179. Cf. J.H. Nieuwenhuis, e.a. (ed.), *Burgerlijk Wetboek; Tekst & Commentaar*, Kluwer, Deventer, 1998, commentary to Article 3:229 of the Dutch Civil Code.

he fulfils his obligations. Under current law, a pledgee has a duty of good care in respect of the pledged assets (which in any case means that he will not sell them to a third party) and is not allowed to appropriate assets. The right of use would render these principles void. A pledge is a security interest intended as a safeguard in an event of default, and not a general right of disposal.

The theories of execution and re-pledge, and the concepts of the sale on commission and the consignment sale cannot serve as a basis for implementing the right of use into Dutch and German proprietary law. Also the German theory on perishable goods, which envisages both a right of disposal and a rule of proprietary substitution, cannot serve as a basis to implement the right of use. Securities are not perishable, but are usable goods.

The theory of irregular pledge, irregular usufruct and irregular custody best illustrates what the right of use is all about. If assets are made replaceable, i.e. if the beneficiary has the right to dispose of them in exchange for a contractual obligation to redeliver equivalent assets, a transfer of ownership takes place. This transfer of ownership takes place at the moment the parties establish the irregular pledge, usufruct or custody arrangement. Note that Article 5 of the Collateral Directive envisages a transfer of ownership at the moment that the 'pledgee' exercises its right of use. At this point the Collateral Directive deviates from the theory on irregular structures.[142]

Everything points towards a transfer of ownership: the general right for the pledgee to dispose of the pledges assets, as well as the contractual obligation to deliver equivalent assets. If the pledgee does not fulfil his obligation, the pledgor has no proprietary action of revendication. The only remedy he has if the pledgee cannot fulfil his obligations is a right of set-off. Contractual arrangements regarding set-off are enforceable under the Collateral Directive. However, if the prices of the securities concerned go up, and in the absence of proper margin mechanisms, the pledgor is left with an unsecured contractual claim. He will in this case have to compete with other ordinary creditors on a *pari passu* basis.

The proprietary substitution arrangement proposed in Article 5 of the Collateral Directive is also incompatible with current Dutch and German law. In the case of a consignment sale, no proprietary substitution takes place if assets are disposed of in the normal course of business. Also the doctrines of irregular pledge, irregular usufruct and irregular custody do not envisage proprietary substitution. Under current law, proprietary substitution is only possible in a limited number of cases (e.g. perishable goods, insurance, damages).

The right of use is a deviation from the current practice in The Netherlands and Germany under which collateral is provided by way of a transfer of ownership. National legislators shall have to implement the right of use, a concept that is incompatible with pledge law and actually boils down to an outright transfer. The most elegant solution is to opt for the device of the irregular pledge, because it has 'pledge' in its name but is actually a transfer of ownership. When implementing the

[142] Van Setten suggests that the right of use of Article 5 of the CD should be implemented in Dutch law as a loan of fungible assets ('*verbruiklening*'). Also such a loan entails a transfer of ownership, which takes place at the moment the loan is entered into. See J.H. Dalhuisen, L.D. van Setten, *Zekerheid in roerende zaken en rechten*, Kluwer, 2003, Preadvies van de Vereeniging 'Handelsrecht', p. 140-141.

irregular pledge, it should be taken into account that the Collateral Directive deviates from the approach in legal theory as far as the moment of the transfer of ownership is concerned. Besides, the Dutch and German legislators will need to accommodate the liberal rule of proprietary substitution set out in the Collateral Directive.

3. A CUSTODIAN'S RIGHT OF USE UNDER DUTCH LAW?

Introduction

This chapter deals with the right of use in a client – custodian relationship under Dutch law. First, the Dutch statutory system of custody of securities, the Securities Giro Transfer Act, will be dealt with. Second, the non-statutory system will be described briefly. Finally, the question will be addressed, whether a right of use, as envisaged in the Collateral Directive[143], is compatible with the investor – custodian relationship in The Netherlands.

1. The Securities Giro Transfer Act

Like most other European jurisdictions, the proprietary aspects of custody of securities are regulated in a specific act, the Securities Giro Transfer Act ('SGTA' or the 'Act')[144]. The aims of the Act are twofold.[145] The first is to provide a legal basis for the transfer of securities by way of book-entries. The second is to protect investors' property rights. For this reason, the SGTA is based on the notion of co-ownership. Two types of deposits must be distinguished: a collective deposit ('*verzameldepot*') and a giro deposit ('*girodepot*'). Giro deposits are administered by Euroclear Netherlands[146], the Dutch CSD. Collective deposits are administered by admitted institutions ('*aangesloten instellingen*').[147] Investors hold an account with an admitted institution. All assets within a collective deposit are co-owned by the investors.[148] An admitted institution holds an account with Euroclear Netherlands. As with the collective deposit, a giro deposit is subject to a right of co-ownership. Although the account with Euroclear Netherlands is registered in the name of the admitted institution, the co-ownership right forms part of the collective deposit.[149] The investors therefore have a right of co-ownership in a collective deposit, which includes, *inter alia*, a right of co-ownership in the relevant giro deposit. Assets held under the SGTA do not belong to the custodians. As a result, creditors of custodians have no recourse to these assets in the event of insolvency. Furthermore, investors are entitled to exercise such rights as the right to dispose, the right to vote, the right to income payments etc.[150] Only in so far as this can be deemed necessary for the administration of the assets can a custodian exercise any investors' rights vis-à-vis third parties.[151]

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[143] See footnote 4 above.
[144] The *Wet giraal effectenverkeer* was enacted on 8th of June 1977, published in *Staatsblad* 1977, 333. The latest revision took place on 2 November 2000, published in *Staatsblad* 2000, 485.
[145] *Kamerstukken II*, 1975/76, 13780, nrs. 1-4, p. 1, 13 and 16-19.
[146] Euroclear Netherlands is the trade name of *Nederlands Centraal Instituut voor Giraal Effectenverkeer BV (Necigef)*.
[147] An admitted institution is admitted as such by Euroclear Netherlands.
[148] See Articles 10 and 12(1) of the SGTA. An admitted institution can of course be one of the co-owners.
[149] See Articles 38(1) and 10(c) of the SGTA.
[150] *Kamerstukken II*, 1975/76, 13780, nrs. 1-4, p. 18.
[151] See Articles 11 and 36 of the SGTA. Note that a custodian is explicitly excluded from exercising the right to vote.

2. Non-statutory custody of securities

The SGTA is not applicable to all types of securities. Most notably, non-Dutch securities generally fall outside the scope of the SGTA. Where such securities are held by a custodian on a fungible basis – which is most often the case –, the custodian becomes their owner.[152] As such, the custodian is in principle free to dispose of the securities as he deems fit. However, the custody contract usually provides that the custodian shall not dispose of the securities nor use any rights derived from the securities other than for the investors' benefit and on their instructions. In contrast to the position under the SGTA, investors' rights are not based on the rules of property, but on a contractual claim against the custodian. In the event of the custodian's defaulting, investors cannot exercise any proprietary claims against the custodian, its trustees in bankruptcy or third parties.

Where securities are not held on a fungible but on an individual basis, the investor has a property right. A custodian's right of use must be based on a transfer of property, or be granted via a right of re-pledge, for example.

3. A right of use?

It inevitably follows from the foregoing that a custodian does not have a right to use investors' assets for his own business purposes. This is one of the specific aims of the SGTA. Other than by means of a transfer, the only way a custodian can obtain specific rights over the investor's right is if the investor grants them to it, for example through a right of re-pledge or a proxy to use the right to vote. In this context the question arises whether a general right of use granted through a security interest, such as envisaged in the Collateral Directive, is compatible with the nature of the legal relationship between a custodian and its client? Indeed it should be stressed that the relationship between a custodian and an investor is a fiduciary relationship, yet in the author's opinion this does not necessarily render a right of use incompatible with this relationship *per se*. The fiduciary nature of the relationship means that the custodian should always act in the best interest of its clients. Furthermore, a custodian must provide its clients with such information as information they require.[153] Whenever an investor pledges assets to his custodian, he does not expect to lose his rights to them as a result of a right of use. It is therefore submitted that a right of use contained in general terms and conditions[154], or comparable standard agreements, is contrary to the fiduciary nature of the investor – custodian relationship. This does not mean, however, that a right of use as such is inherently incompatible with the investor – custodian relationship. It merely means that a custodian, when stipulating a right of use, should ensure, first, that the investor fully realises the legal implications of a right of use and, second, that the investor has given his full consent.

[152] *Hoge Raad* 12th January 1986, *Nederlandse Jurisprudentie* 1986, 274 (*Teixeira de Mattos*).
[153] See Article 2 of the General Banking Terms and Conditions ('*Algemene Bankvoorwaarden*').
[154] For instance the General Banking Terms and Conditions.

Conclusion

The Dutch SGTA makes it very clear that a custodian does not have a right of use with regard to investors' assets. In fact it is one of the goals of the Act. The only way for a custodian to obtain a right of use is through a transfer of ownership or being granted such a right by an investor, such as for example a right of re-pledge or a proxy to vote. Where securities become property of the custodian by virtue of a custody agreement, the custody agreement grants the investors use of the securities. A general right of use as envisaged by the Collateral Directive is not necessarily contrary to the fiduciary nature of the custodian – investor relationship, provided the investor fully realises the legal consequences of such a right and has given his full consent to it.

4. THE IRREGULAR PLEDGE UNDER ITALIAN LAW

Introduction

This chapter deals with the irregular pledge under Italian law and focuses in particular on the following issues:

1) The legal status of a security interest combined with a right of disposal;
2) Whether a pledge can qualify as 'irregular' with respect to securities held on an individual basis, as well as to securities held with a depository on a non-dematerialised or dematerialised basis; and
3) If and under what conditions a depository and a financial intermediary can dispose of investors' assets.

1. Definition of irregular pledge

Articles 2784 ff. of the Italian Civil Code govern pledges. These articles contain no specific provision concerning the irregular pledge. However, Article 1851 of the Italian Civil Code, concerning '*anticipazione bancaria*' contracts (i.e. bank advances secured by deposits in money, chattels or securities), expressly refers to the irregular pledge. According to this provision, if monies, chattels or securities – which are not identified – are deposited as a guarantee for one or more bank advances, or if the bank has been granted a special power of use thereof, the pledge qualifies as irregular. In this case the bank, in its capacity as secured creditor, is only obliged to return the sum, chattels or securities exceeding the amount of the secured claims to the pledgor.

The meaning and the scope of the irregular pledge have been outlined in more general terms by scholars and by the Italian courts. Indeed, irregular pledges can also be used to secure claims other than those deriving from the bank advances mentioned above, and also with respect to claims towards non-banking institutions. A pledge qualifies as 'irregular' provided that a) the pledge concerns monies, chattels or securities, and b) the parties consider that such assets belong to a *genus*. In this case, the pledgee can dispose of the pledged collateral and is only obliged to return the '*tantundem eiusdem generis et quantitatis*' (same amount of the same kind and quantity) to the pledgor. On the contrary, a pledge is 'regular' if the assets pledged have to be returned *in specie* (e.g. a pledge is created over cash, but the individual notes pledged are identified by their serial number).

2. Transfer of ownership

The creation of an irregular pledge essentially entails a transfer of ownership for security purposes (*trasferimento della proprietà a scopo di garanzia*).[155] The transfer of ownership occurs as soon as the pledged assets are delivered to the pledgee. Thereafter, the pledgor loses his rights to dispose of the pledged assets and only has

[155] Gorla/Zanelli, *Commentario del Codice Civile*, Scialoja/Branca, *Pegno Ipoteca*, Zanichelli, 1992, Art. 2784, 37; *Corte di Cassazione*, 13.04.1977, No. 1380, *Banca, borsa, titoli di credito*, 1978, II, 421; *Corte di Cassazione* 25.11.1977, No. 5136, *Banca, borsa, titoli di credito*, 1978, II, 429.

the right to obtain restitution of the *tantumdem eiusdem generis et quantitatis* as soon as the secured obligations have been paid.

3. Pledgee's right of disposal: security interest or outright transfer?

As seen above under section 2), it is generally held that the creation of an irregular pledge entails an outright transfer and not a mere security interest with a right of use. Accordingly, the pledgee may dispose of the pledged assets in his own interest and for his own benefit, i.e. he has no fiduciary duties with respect to the pledgor. The pledgee is only bound to return to the pledgor the *tantumdem eiusdem generis* in full or in part when the debt is settled either fully or partially, as the case may be.

Italian scholars consider that where an irregular pledge over money is created, the transfer of money to the secured creditor amounts to an anticipatory satisfaction of the secured claim.[156] This conclusion does not, however, alter the principle expressed above whereby the pledgee is only bound to return to the pledgor the *tantumdem eiusdem generis.* On the contrary, it accords with the idea that the creation of an irregular pledge entails an outright transfer.

Moreover, the pledgor may exercise all rights pertaining to the pledged assets (e.g. option rights, distribution of profits and interests).

4. Pledgor's rights

According to the aforementioned principles, it appears that the irregular pledge operates differently from the regular one. The irregular pledge does not serve to guarantee the success of enforcement proceedings, since the transfer of ownership satisfies the creditor's interests directly. This is particularly true because the creation of an irregular pledge amounts to an anticipatory satisfaction of the creditor's claim.

In the case of an irregular pledge, if the pledgee becomes insolvent the pledgor may not exercise any action of revendication, since the ownership of the collateral has already been transferred to the pledgee on creation of the pledge. As mentioned above, the pledgor's debt vis-à-vis the pledgee is considered extinguished, in full or in part, when the pledged collateral is delivered to the pledgee. On insolvency of the pledgee, therefore, the pledgor is exempted from paying his debt to the insolvency up to an amount corresponding to the pledged collateral. If the pledgor pays his debt vis-à-vis the insolvent pledgee in full or in part, since he is barred from revendicating the pledged collateral, his claim will be satisfied according to the *pari passu* principle, i.e. the pledgor will have to file a claim with the Insolvency Court for restitution of an amount of money equal to the value of the pledged collateral.[157]

[156] E.g. a cautionary deposit of 10 guarantees a claim of 30; on creation of such deposit with the creditor, the latter definitively acquires the said sum which shall be deducted from the total credit leaving the creditor with an outstanding claim for 20.
[157] Gorla/Zanelli, cit., Art. 2784, 40.

5. Irregular pledge over securities[158]

Under Italian law the level of (de-)materialisation of securities is an important factor in determining whether the irregular pledge concept can be applied or not.

Securities held on an individual basis
In principle, the rules concerning the irregular pledge also apply to securities in as far as they qualify as 'replaceable' securities. However, a distinction should be made between bearer securities (*'titoli al portatore'*), order securities (*'titoli all'ordine'*) and registered securities (*'titoli nominativi'*). In order to create a valid pledge over all the abovementioned types of securities, it is necessary, *inter alia*, to grant the secured creditor/s (or a third party appointed as custodian) a right of possession over the pledged securities. In addition, if such securities qualify as order or registered ones, it is necessary to execute a registration entry on the order securities' certificates. If the securities are registered ones, it is necessary to execute double registration entries on both the registered securities' certificates and on the relevant registers held by the issuer. These formalities might imply the specific identification of the securities and, consequently, the pledge thereby created would not qualify as 'irregular'. However, in a case[159] concerning order securities, an *obiter dictum* of the Italian Supreme Court stated that, notwithstanding the identification of the pledged collateral, the relevant pledge qualifies as irregular if the right of disposal of the pledged collateral is granted to the secured creditor.

Securities admitted to a central securities depository system
A further relevant issue is whether securities are held by a central securities depository on a non-dematerialised or on a dematerialised basis. The creation of central depository systems[160] and the dematerialisation of securities lead to the introduction of specific technical rules[161] relating to the admission, dematerialisation and creation of charges over such securities. In particular, the relevant question is whether intermediaries' registration obligations in relation to such pledged securities identify the securities *in re*, so as to substantially preclude the existence of an irregular pledge. It could be argued that in the case of dematerialised securities and/or non-dematerialised securities admitted to the central securities depository system it is impossible, in any case, to qualify the pledge created over them as 'irregular'. Although this position seems to be indirectly held by different scholars[162] on the basis of several assumptions, their conclusions are neither fully substantiated nor do they seem to take into consideration all possible eventualities.

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[158] In the present work the term 'securities' refers to the Italian law notions of *'titoli di credito'* (documents of credits) and *'strumenti finanziari'* (financial instruments).
[159] *Corte di Cassazione*, 25.11.77, No. 5136.
[160] In Italy this function is currently exercised by Monte Titoli S.p.A.
[161] Legislative Decree No. 58 of February 1998; Legislative Decree No. 213 of June 1998; Consob Regulation No. 11768 of 23 December 1998.
[162] Ferrarini/Giudici, *Le garanzie su strumenti finanziari nel diritto comunitario: orientamenti e prospettive*, *Il Fallimento*, 9/2002, 1002. Sonia Carmignani, *La gestione accentrata di strumenti finanziari*, in *Intermediari finanziari mercati e società quotate*, a cura di A. P. Griffi, M. Sandulli, V. Santoro. E. Gabrielli, *Il pegno anomalo*, 1990, p. 185.

Non-dematerialised securities
In a decision concerning State bonds[163], the Turin Court recognised the possibility of creating an irregular pledge over non-dematerialised securities admitted to a central depository system.

Dematerialised securities
Italian scholars seem to exclude the possibility of a pledge over dematerialised securities (i.e. securities listed on Italian regulated markets) qualifying as irregular for the following reasons: no certificate is issued with respect to dematerialised securities; their circulation as well as the creation of charges over them occur through *ad hoc* registration entries in the accounts held with the financial intermediaries with which the securities are registered. On the basis of this assumption, scholars tend to categorise a pledge over dematerialised securities as a pledge over the receivables owed to the pledgor by the financial intermediary. An irregular pledge may be created over money, securities and chattels, but not over receivables. The irregular pledge concept is therefore not viable if receivables are the object of the pledge.

6. Irregular deposits and dispositions by a financial intermediary

Irregular deposit
In the case of an irregular deposit, a transfer of ownership occurs from the depositor to the depository. Here the depository acquires the right to dispose of the securities/moneys. The depositor only has a contractual claim on the depository for the restitution of equivalent securities/moneys (*tantundem eiusdem generis et quantitatis*).

With respect to an irregular deposit it is the subject of discussion whether a depositor can create an irregular pledge for the benefit of a third party. Italian scholars[164] argue that such a pledge should be qualified as a pledge over receivables rather than an irregular one. The issue is disputed.[165]

Dispositions by financial intermediaries
If there is no irregular deposit, financial intermediaries can also dispose of their clients' securities subject to certain conditions. In the case of financial instruments, and pursuant to the regulation issued by the Bank of Italy's Governor on 1st July 1998,[166] financial intermediaries (i.e. banks, investment undertakings and other entities indicated therein) may not dispose of clients' financial instruments, unless they have first obtained their clients' written consent. In order to obtain such consent, the financial intermediaries must enter into a specific agreement with their clients. Such agreements must specify, *inter alia*, the transaction authorised, the counterparty/ies and the guarantees offered. Furthermore, each transaction must be communicated to the clients.

[163] *Tribunale di Torino* (Turin Court), 31.03.1992, *BBTC*, 1993, II, 336.
[164] Luminoso, *Deposito cauzionale presso il terzo e depositi irregolari a scopo di garanzia*, in *Giur. Comm*., 1981, I, 425. Gorla/Zanelli, cit., Art. 2784, 44.
[165] Please refer to the remark on receivables in the preceding section.
[166] Implementing the Investment Services Directive (see footnotes 6 and 8 above).

Conclusions

Under Italian law if a pledge qualifies as irregular, the pledgee only has a contractual obligation to return to the pledgor equivalent assets (*tantundem eiusdem generis et quantitatis*) and also has the right to dispose of the pledged assets. An irregular pledge entails a transfer of ownership.

An irregular pledge could be considered as an existing instrument implementing the right of use under Article 5 of the European Collateral Directive[167]. However, some Italian scholars seem to rule this possibility out in the belief that the irregular pledge concept is not applicable to dematerialised securities.[168] Notwithstanding this contrary opinion, if the Italian legislator chooses the irregular pledge as the instrument to implement the requirements of the Collateral Directive, it might still be necessary to amend the regulatory provisions in force[169] establishing the procedures and formalities to follow in order to create security interests over dematerialised securities.

If, on the contrary, the irregular pledge principles are held to be incompatible with the current Italian law on dematerialisation, a more extensive modification of the existing law[170] could be required to implement the Collateral Directive.

As far as dematerialised securities are concerned, the so-called *'riporto'* could be an alternative instrument for implementing the Collateral Directive. A *riporto* is a contract under which one party transfers to another the ownership of a certain type of securities for a specified price while the other party assumes the duty of transferring to the former the ownership of an equal number of securities of the same type at the expiration of an established term in return for reimbursement of the price.

[167] See footnote 4 above.
[168] In a recent Communication (Communication No. DME/3046592 of July 14, 2003, addressed to the Italian Banking Association), Consob (the Italian Regulatory Authority for the securities market) clarified certain technical issues as to the formalities to be complied with in order to create an irregular pledge over dematerialised securities; however, Consob refused to clarify whether from a civil law perspective an irregular pledge over dematerialised securities is admissible, as this would have been outside the scope of its powers.
[169] Consob Regulation No. 11768 of 23 December 1998.
[170] Legislative Decree No. 58 of February 1998; Legislative Decree No. 213 of June 1998.

5. RIGHT OF USE UNDER ENGLISH LAW*

Introduction

The English law analysis adds value for two reasons. First, it shows that it is not necessarily the case in common law jurisdictions that a collateral taker can be granted a right of disposal on the basis of a security interest. Under American law, the beneficiary of a security interest can be granted a general right of disposal in certain financial (notably derivatives) transactions.[171] However, granting a general right of disposal to such a beneficiary is alien to English law.[172] Second, the reason for prohibiting a right of disposal on the basis of a security interest is slightly different from that given under Dutch and German law, for example. Whereas Dutch and German lawyers would emphasize that a security interest implies an obligation to exercise 'due care' in respect of the encumbered asset and, in particular, a prohibition on its appropriation, an English lawyer would probably focus on the equity of redemption as an inherent characteristic of security interests. Of course this is merely a matter of different focus, as these three approaches of security interests are essentially fully compatible and all of them exclude dispositions by the secured party.

1. The client – custodian relationship

Traditionally the relationship between client and custodian has been characterised as a bailment. There are good grounds for arguing, however, that this relationship should be characterised as a trust. This is based on the view that a bailment relates to tangible goods, whereas the indirect securities holding system relates to intangible goods. A trust is therefore a better way to characterise the relationship between client and custodian under English law. The custodian is the trustee and therefore the legal owner of the assets. The client is the beneficiary of the trust, and has a beneficial interest in the trust property.[173]

In England a custodian holds assets for clients on a segregated basis, i.e. on an account separate from the account on which its own assets are held. This ensures that the assets held on the client account are inaccessible to the custodian's general creditors in the event of its insolvency. Clients' assets are usually held on a commingled basis.[174]

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* The author is grateful to Dr. Joanna Benjamin for her critical comments in respect of this chapter.

[171] Note that the ISDA Margin Provisions (New York law) leave no room for any proprietary claim of the collateral provider whatsoever. It is therefore arguable that the structure envisaged in these Margin Provisions actually entails an outright transfer. Cf. section 3 of the introduction to this report.

[172] Benjamin uses the term 're-hypothecation' to indicate this general right of disposal (i.e. the right to vest a security interest in respect of an asset or to transfer it outright). Because 're-hypothecation' or 're-pledge' may be understood to relate to a right to vest a security interest only, these terms are not used in this chapter to refer to a general right of disposal. Cf. Benjamin (2000), cit. (footnote 29), chapter 5.C.

[173] See Benjamin (2000), chapter 2; A.O. Austen-Peters, *Custody of Investments: Law and Practice*, Oxford University Press, 2000, 2.25-2.32.

[174] See Benjamin (2000), section 2.73-74.

Starting point: the beneficiary's interest
A custodian cannot dispose of its clients' assets in the course of its own business, because it acts in the capacity of a trustee. It would be incompatible with its fiduciary duty towards the client/beneficiary for a custodian to dispose of its clients' assets and to pocket the profits. Any dispositions should be for the benefit of the clients.[175]

A third party purchaser may face actions by clients if a custodian disposes of clients' assets wrongfully. If, broadly speaking, the purchaser knew or should have known that a disposition was illegal, he may face the prospect of tracing and/or constructive trusteeship.[176] Such actions are, however, an exception in the securities markets, because a heavy duty to investigate does not benefit the smooth functioning of these markets.[177]

Basis for a right of disposal: outright transfer, not a security interest
Of course a client is free to transfer his beneficial interest in book-entry securities to its custodian outright.[178] In this case all rights (i.e. legal interest and beneficial interest) lie with the custodian who can then dispose of them freely. Under English law, however, a client cannot grant a custodian a general right of disposal on the basis of a security interest (i.e. for example a right to encumber the client's interest in securities with a security interest or to transfer it outright to a third party). Such a right of disposal is incompatible with the key features of a security interest, such as the right of redemption.[179] A general right of disposal is only compatible with the characteristics of an outright transfer, and a security interest comprising such a right should be re-characterised as an outright transfer.[180]

Market practice
It is current practice that custodians reserve a right of use as a matter of routine. They often do so on the basis of securities lending agreements. Note that securities lending agreements are usually structured as an outright transfer.[181] An outright transfer as a matter of fact entails a general right of disposal.

Prime brokerage
Prime brokerage is a bundle of services offered by financial institutions (including custodians) to their hedge funds clients. A prime broker often has the right to transfer securities out of its client's custody account into its own account, subject to an obligation to deliver equivalent assets to the client. This enables the prime broker to dispose of its clients' assets. This 'right of use' (i.e. the prime broker's right to sell or encumber its clients' assets) is in many cases based on a security interest.[182] Under

[175] Of course the custodian-trustee may ask for a reasonable fee for its services. See J.E. Martin, *Hanbury and Martin; Modern Equity*, Sweet & Maxwell Ltd., London, 2001, 16th edition, p. 601-606.
[176] Cf. Benjamin (2000), section 2.52-65.
[177] Cf. on this policy issue Benjamin (2000), sections 2.52-65; and the UCC (2002 edition), cit. (footnote 14), p. 767-769. Cf. footnote 38 above.
[178] As the trustee is the legal owner, the only thing a beneficiary/investor can dispose of is his equitable interest.
[179] See Benjamin (2000), section 5.46-70.
[180] Cf. Benjamin (2000), p. 117 (footnote 101).
[181] The 2000 Global Master Securities Lending Agreement, but also for example the earlier 1995 Overseas Securities Lender's Agreement, are based on the outright transfer technique.
[182] It is believed that this is largely because prime brokers have modelled their documentation on US documentation. US law permits a right of use (cf. section 3 of the introduction to this report).

English law this construction runs the risk to be characterised as an outright transfer. Because of this, the prime brokerage documentation itself regularly envisages a conversion of the security interest into an outright transfer arrangement at the moment of actual use.[183] This conversion reflects the fact that a general right of disposal is incompatible with the concept of a security interest (and with the notion of equity of redemption in particular).[184]

Conclusion
Both legal theory and market practice lead to the conclusion that the only way under current English law to give a custodian the right to dispose of a client's assets for its own business purposes is for the client to transfer its beneficial interest to the custodian outright.

2. The collateral provider – collateral taker relationship

What applies to the client-custodian relationship also holds good for the relationship between a collateral provider and collateral taker generally (i.e. even if they are not engaged in a trust relationship). A collateral provider can only grant a collateral taker a right to dispose of his assets by way of an outright transfer of his own interest in securities (whether it be a legal interest in non-dematerialised securities or a beneficial interest in securities held by an intermediary). As stated above, a right of disposal cannot be granted on the basis of a security interest under current English law.

ISDA Margin Provisions
It should be noted that the 2002 ISDA Margin Provisions also only envisage an outright transfer of collateral under English law. A right of use and a security interest are mutually exclusive concepts.[185]

3. Arguments for change?

Benjamin advances two arguments for introducing a right of use on the basis of a security interest. Neither of these arguments seems convincing and they are refuted below.

1. First, Benjamin argues that whereas the outright transfer method and insolvency set-off are generally enforceable under English law, this may not be the

[183] In the case of the insolvency of the prime broker, and also if the hedge fund's assets have not yet been 'used' by the prime broker, there is a considerable risk that under current law a judge will re-characterise a security interest combined with a right of use as an outright transfer, irrespective of the terms of the prime brokerage documentation. In this case the hedge fund is left with an unsecured contractual claim only.
[184] See Benjamin (2000), sections 10.49-10.59; J. Benjamin, M. Yates, G. Montagu, *The Law of Global Custody; Legal Risk Management in Securities Investment and Collateral*, Butterworths Lexis Nexis, 2002, sections 4.8, 4.33, 4.34. Cf. the section on margin lending in section 3 of the introduction to this report.
[185] The 1995 Deed subject to English law (one of the Credit Support Documents preceding the 2001 Margin Provisions) also made it possible to vest a security interest. However, no right of use could be established in connection with the security interest. See Paragraph 6(d) of the 1995 UK Deed.

case in foreign jurisdictions. In this scenario an outright transfer is not appropriate. The alternative proposed by Benjamin is a security interest combined with a right of use in order to reach the same economic result.[186]

The argument concerning outright transfer and set-off is, however, no longer valid for transactions covered by the law of a Member State of the European Union after the implementation of the Collateral Directive[187]. The Collateral Directive recognises the outright transfer method and insolvency set-off in the case of collateralised transactions. Also it is submitted that whereas the economic purpose of the outright transfer and the right of use structures is identical, their legal characterisation (and their treatment for tax, accounting and capital adequacy purposes, for example) should also be the same. A security interest combined with a right of use is essentially an outright transfer.

2. Benjamin's second argument in favour of a right of use is as follows. A *legal* interest can be delivered in respect of securities not held by an intermediary. If a third party 'C' obtains a legal interest in these securities from a collateral taker 'B', this interest is protected against the original collateral provider 'A's equity of redemption, if 'C' is acting in good faith. However, if 'C' acquires an interest in securities that are held by an intermediary, this interest is not legal but *equitable*, and is subject to 'A's equity of redemption. Because of the increasingly important role played by intermediaries, the tendency is therefore that the position of third parties acquiring securities worsens (because legal interests are replaced by equitable ones).[188]

It is, however, too simple to argue – as would be the result if a right of use on the basis of a security interest were introduced – that the equity of redemption, the duty of due care in respect of encumbered assets and the prohibition of appropriation can simply be set aside. These characteristics of a security interest guarantee that the interests of a collateral provider and a collateral taker are balanced. A security interest without these characteristics, such as a security interest combined with a right of use as envisaged in the Collateral Directive, is essentially an outright transfer.

If, as in Benjamin's example, party 'A' grants a security interest combined with a right of use in respect of interests in securities (held by an intermediary) to party 'B', this essentially entails an outright transfer of 'A's equitable interest to 'B'. Party 'C' cannot therefore, after having acquired this equitable interest from party 'B', be faced with an equity of redemption invoked by 'A'. A has no equity of redemption, because an outright transfer has taken place.

Conclusion

Under English law, a custodian has no right to dispose of its clients' assets for the benefit of its own business. This is incompatible with the rights of a beneficiary of a trust. In accordance with its fiduciary duties, the custodian must take the interests of clients into account and cannot dispose of them freely.

[186] See Benjamin (2000), section 5.67. Cf. in particular Articles 6 and 7 of the CD.
[187] See footnote 4 above.
[188] See Benjamin (2000), sections 5.68-69.

Generally speaking, the only way a collateral provider can grant a ‘right of use’ to a collateral taker under current English law is a transfer of ownership. A right of disposal cannot be granted on the basis of a security interest, in particular because it is incompatible with the equity of redemption. Such a structure should be re-characterised as an outright transfer. These considerations also apply to the special relationship between a client and its custodian. Only if a client transfers his rights to a custodian outright does the latter have the right to dispose of the transferred assets. Under English law, a custodian cannot dispose of assets on the basis of a security interest.

No good arguments are available to justify a ‘right of use’ on the basis of a security interest under English law. A ‘right of use’ is incompatible with essential characteristics of a security interest, such as the duty of due care, the prohibition of appropriation and the equity of redemption. The proper approach is to characterise cases of this kind as an outright transfer.

CONCLUSION

Introductory remarks

This report has investigated what interests are involved where a right of use is granted in respect of securities. By a right of use we mean an owner's customary right of disposal (i.e. a right to encumber the securities with a limited right, or to transfer ownership thereof).

Three interests are involved when discussing a right of use. Generally, a right of use enhances the liquidity of the financial markets, which is to the benefit of all players. A closely related, but distinct interest is that of the major financial market participants. The interests of the markets in general and of its major players are benefited by easy access to assets. The focus of this report has been on the interests of collateral providers and clients of custodians.

If a collateral provider vests a *security interest* for the benefit of a collateral taker, he vests a limited right and expects to retain his ownership right. His ownership right is usually protected by mechanisms such as the duty of the collateral taker to take due care, the prohibition of appropriation, and the equity of redemption. These are basic principles of property law, which in one way or another are present in all legal systems discussed in this report. A right of use on the basis of a security interest sets all these principles aside.

A security interest combined with a right of use is currently envisaged in the European Collateral Directive[189]. It does not only apply to commercial transactions generally, for example to the Over-The-Counter market, but also to the relationship between a client and its custodian.

A right of use on the basis of *contractual consent* is even more noteworthy. The question whether a right of use can be granted on the basis of 'consent', i.e. on a contractual basis, has – surprisingly enough – only been brought up in the relationship between a client and its custodian. Understandable, because custodians are under a commercial pressure to use their clients' assets.[190] But surprising, because it is clearly not in the interest of clients that their assets are disposed of (unless they have unequivocally transferred ownership of these assets to the custodian), and because clients are the weaker party in the client-custodian relationship and deserve protection. A consent based right of use is presently envisaged in securities regulations in, for example, Denmark and Italy.

A collateral provider or the client of a custodian does not expect to lose his proprietary interest in securities if he vests a security interest, or on the basis of mere 'consent'. Therefore, the fundamental argument of this report is that the interests of collateral providers and clients of custodians should be taken into account by using the *outright transfer technique*. This is the most adequate and prudent way to grant a right of use, because the interests of all parties involved are appropriately considered.

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[189] See footnote 4 above.
[190] Cf. Benjamin (2000), cit. (footnote 29), section 5.46.

1. The security interest approach

General considerations
Different jurisdictions tend to have a slightly different approach where the protection of the position of the provider of a security interest is concerned. The focus may be on the 'duty of due care' of the collateral taker, on the prohibition of appropriation of the pledged assets by the collateral taker, or on the equity of redemption of the collateral provider. In all cases, however, the same goal is served, i.e. to safeguard the ownership interest of the collateral provider. A right of use on the basis of a security interest, as for example set out in Article 5 of the Collateral Directive, does not do justice to these considerations and only takes the interests of the collateral taker into account.

United States
A general right of disposal for a secured party cannot be derived from Article 9-207 of the UCC, because the secured party should always respect the remaining proprietary interest of the collateral provider. Under certain circumstances a right to dispose can be granted to a secured party on a contractual basis, but the proceeds of the sale are in this case subject to the pre-sale proprietary rights. The ISDA Margin Provisions (New York law) for margin provided under derivatives transactions envisage no such proprietary substitution, or any proprietary interest of the collateral provider whatsoever. The structure envisaged in these Margin Provisions, i.e. a security interest combined with an unlimited right of disposal for the collateral taker, is therefore essentially that of an outright transfer. Note that under American law repos and securities lending transactions are commonly structured as an outright transfer.

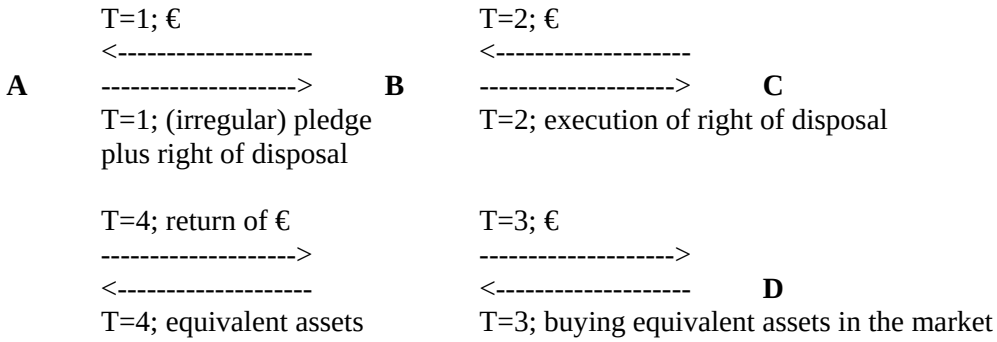
Europe
The right of use on the basis of a security interest as set out in the Collateral Directive is incompatible with the property law systems of Denmark, Germany, The Netherlands, Italy and the United Kingdom.

Danish, Dutch, German and Italian law
In the chapters on Danish, Dutch and German law it was investigated whether a right of use on the basis of a security interest can be explained in a satisfactory way by looking at the theory in relation to 1) the realisation of a security interest, 2) the re-pledge, 3) proprietary representation (i.e. the sale on commission and, in particular, the consignment sale), 4) perishable goods, and 5) the irregular pledge. Because it appeared that the irregular pledge is most appropriate to explain the new concept of a right of use, the former was also investigated in depth in the chapter on Italian law.[191]

The consignment sale and the irregular pledge come closest to what the right of use is about. In both cases a general right of disposal is granted to the counterparty of the original owner. The structure of these two constructions is, however, essentially different. The chapters on Danish, Dutch, German and Italian law show that it is the irregular pledge that matches the structure of the right of use envisaged by the Collateral Directive[192]:

[191] Even though it is uncertain if the irregular pledge concept can relate to dematerialised securities, Italian law also knows the '*riporto*', which - like the irregular pledge - entails a transfer of ownership.
[192] Cf. the drawings and the explanatory comments thereto in chapter 2 on Dutch and German law.

Security interest combined with a right of use / irregular pledge



The irregular pledge and the right of use envisaged in the Collateral Directive coincide on the following points: 1) the security interest is vested to secure a claim of the 'pledgee' towards the 'pledgor'; 2) the parties are under an obligation to transfer equivalent assets at the end of the transaction; 3) both concepts entail a transfer of ownership; and 4) the economic interest of the irregular pledge or the pledge combined with a right of use rests with the 'pledgee', because he can enter into further trades with the 'pledged' assets for his own benefit. Article 5 of the CD should therefore be implemented according to the principles governing the irregular pledge.

The concept of 'replaceability' explains why a transfer of ownership takes place in the case of irregular pledge, usufruct or custody. Replaceability means that 1) the pledgee, usufructuary or custodian can *dispose* of the asset, and 2) is under a *contractual obligation to transfer equivalent assets*. The result of consenting to such replaceability is that a transfer of ownership takes place and that the provider of the right of pledge or usufruct, or the client of the custodian, is left with a contractual claim.[193]

Only as far as the crucial timing issue is concerned, does the Collateral Directive deviate from the irregular pledge theory. As far as the irregular pledge, usufruct and custody are concerned, it is generally accepted that the transfer of ownership takes place at the moment the irregular structure is agreed. The transferor loses his proprietary interest at the moment he consents to replaceability. From that moment on he is left with a contractual claim. This is generally accepted under German and Dutch law, and is also the position in Danish and Italian legal theory. Article 5 of the Collateral Directive, however, is not in line with this theory, because it envisages that the ownership right of the collateral provider is maintained until the moment the collateral taker chooses to dispose of the pledged assets. Only here does the Collateral Directive need to be implemented by referring to the principles governing the consignment sale. In the case of a consignment sale, the consignor loses his ownership right at the moment the assets are sold by the consignee.

English law

Under English law, the only way a collateral provider can grant a 'right of use' to a collateral taker is by way of a transfer of ownership. A general right of disposal

[193] Also in the case of a loan of fungibles – '*verbruiklening*' under Dutch law, '*Darlehen*' under German law – assets are essentially made replaceable. That is why under Dutch and German law also a loan of fungibles leads to a transfer of ownership.

cannot be granted on the basis of a security interest. The main reason for this is that a right of disposal for a collateral taker is incompatible with the characteristics of a security interest, such as the equity of redemption, the duty of due care and the prohibition of appropriation.

Conclusion
The conclusion drawn from an analysis of the position prevailing in different countries is that the right of use of the Collateral Directive is essentially an irregular pledge (i.e. an outright transfer) from the point of view of Danish, German, Dutch and Italian law, whereas it should be re-characterised as an outright transfer under English law. A right of use based on a security interest is therefore nothing more than a transfer of ownership.

The main argument against allowing a pledgee always to dispose of the pledged assets is that a pledgor expects to remain the owner of them until an event of default takes place. Essentially, however, he is left with a contractual claim for the redelivery of equivalent assets. In the event of the collateral taker's insolvency, his only remedy is to set this claim off against the money received from the collateral taker. However, if the prices of the securities provided to the collateral taker go up (and in the absence of proper margin arrangements), the collateral provider runs an unsecured credit risk in respect of the collateral taker. In the event of the collateral taker's insolvency, his contractual claim will have to compete with the claims of other unsecured creditors on the basis of the *pari passu* principle. Because collateral takers are usually powerful banks, and collateral providers can – according to the Collateral Directive – also be small and medium sized enterprises, this scenario is unacceptable.[194]

It is submitted that the right of use under the Collateral Directive should be implemented in the laws of the EU Member States as an outright transfer of ownership. In for example Denmark, The Netherlands, Germany and Italy this could be done by using the device of the *pignus irregolare* (basically a transfer of ownership).[195]

The structure of the irregular pledge exactly reflects that of the right of use under the Collateral Directive. Only as far as the timing is concerned does the structure envisaged in the Collateral Directive deviate from that of the irregular pledge. Under an irregular pledge, ownership passes at the moment the parties agree to the irregular pledge. Under the Collateral Directive, ownership passes at the (usually) later moment when the collateral taker chooses to dispose of the pledged asset.

Note that the Collateral Directive poses the additional problem of proprietary substitution. Under Danish, Dutch and German law the device of proprietary substitution is only allowed in a limited number of situations. In the case of perishable goods, insurance payments, damages and appropriation by the government,

[194] Note that the rule of proprietary substitution does not help the collateral provider. Proprietary substitution will usually take place at the end of a transaction. In the course of the transaction the collateral provider has an unsecured exposure in respect of the collateral taker. Cf. footnote 17 above.
[195] If the irregular pledge concept is not available, such as may be the case of Italian fully dematerialised securities, comparable concepts of civil law that also entail an outright transfer (such as a loan of fungible assets - '*verbruiklening*' under Dutch law or '*Darlehen*' under German law –, or the Italian *riporto* arrangement) can be applied to implement the right of use under the Collateral Directive.

proprietary substitution is possible. This protects the pledgee, because his security interest continues to exist. In the case of the consignment sale or the irregular pledge, for example, no proprietary substitution takes place, because under current law substitution is not meant to protect trading arrangements. The proprietary substitution rule under the Collateral Directive therefore goes further than is currently possible. This novelty should be taken into account when implementing the Collateral Directive.

2. The client – custodian relationship

American and English law
Under English and American law, a custodian does not have the right to dispose of its clients' assets for the benefit of its own business. Under English law, this is incompatible with the rights of a beneficiary of a trust. Under American law, Article 8 of the UCC requires a custodian always to have sufficient assets in place to fulfil the demands of its clients (the 'perfect match system'). A custodian must therefore take the interests of clients into account and cannot dispose of the assets freely.

Under both American and English law, a custodian has the right to dispose of its clients' assets freely only if an unambiguous transfer of proprietary interests (legal and/or beneficial) has taken place. In the American derivatives markets, a right of use can also be granted on the basis of a security interest, even though this structure is very much similar to an outright transfer. Under English law, a custodian cannot be given a general right of disposal on the basis of a security interest.

Under English law, it is sometimes argued that a prime broker (a financial institution providing a bundle of financial services to hedge funds) can dispose of its clients' assets on the basis of a security interest. This construction, however, should also be characterised as an outright transfer.

Replaceability leads to outright transfer
An irregular deposit – as understood by the Danish, Dutch, German and Italian systems – is a deposit of replaceable assets with a custodian. Replaceability means, as in the case of the irregular pledge and the irregular usufruct (see above), that the custodian can dispose of the deposited assets in exchange for a contractual delivery obligation of equivalent assets. An irregular deposit entails a transfer of ownership.

Dutch law
At present, a custodian's right of use is not possible under Dutch law, unless a transfer of ownership takes place. An unlimited right of disposal cannot be granted on the basis of a security interest or on the basis of a contractual arrangement. Present practice is therefore based on outright transfers (notably securities lending arrangements). Only a limited right of use can be granted on the basis of, for example, a re-pledge.

In the Dutch chapter on the client-custodian relationship, it has been suggested that a right of use on the basis of a security interest as envisaged in the Collateral Directive does not conflict with the fiduciary client-custodian relationship, if 1) the investor

realises the legal implications of a right of use to their full extent, and 2) the investor has given his consent. This view is controversial.

It is of course the custodian who should explain the *legal implications* of a right of use to its clients. It should explain that a pledge with a right of use is something essentially different from a traditional right of pledge, and that there is no prohibition of appropriation, no duty of due care and no right of redemption in order to protect the client's ownership interest. It is somewhat naive to rely fully on the ability and willingness of commercial banks to explain to their clients what the implications of a right of use actually are (i.e. the client loses its ownership right and is left with a contractual claim). Commercial banks are under a strong economic pressure to use the assets of their clients.[196]

In addition, it is argued that the investor should give full *consent*. As was demonstrated above, consenting to dispositions by a custodian in exchange for a contractual obligation to transfer equivalent assets makes assets replaceable, which implies a transfer of ownership from a civil law point of view.

The proper approach is therefore that a right of use should be possible on an outright transfer basis only. If the outright transfer method is used, no complicated explanations about the deformed right of pledge are necessary; every investor should understand that he loses his ownership rights in this case. From an investor protection point of view, the outright transfer method is therefore preferable over a right of use on the basis of a security interest. These considerations are particularly important if the client is not a major financial institution, but for example a small or medium-sized enterprise.

Danish and Italian law

Following the implementation of the second indent of Article 10 of the Investment Services Directive ('ISD')[197] in Danish law, dealers in securities can dispose of their clients' assets on the basis of mere consent. Even though the legislative history does not make entirely clear how the relevant provision should be interpreted, it is argued in the Danish chapter that the consent-based formula is nothing more than an irregular deposit (cf. the remarks on replaceability above). Therefore, if consent is given, the custodian becomes the owner of the assets and the client has a contractual claim for the redelivery of equivalent assets.

Under Italian law a depository can dispose of the assets of its clients after a transfer of ownership. An irregular deposit entails a transfer of ownership. As under Danish law, the implementation of the Investment Services Directive has lead to the appearance of a consent-formula in Italian securities regulations, on the basis of which financial intermediaries can dispose of their clients' assets.[198]

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[196] Cf. Benjamin (2000), section 5.46. Because their interests are therefore diametrically opposed to those of their clients, it is advisable to oblige custodians to inform their clients and to monitor their behaviour in practice.

[197] See footnotes 6 and 8 above.

[198] Article 10 of the ISD relates to 'investment firms'. Article 3(b) of the Danish Financial Business Act – the implementation of the second indent of Article 10 of the ISD – applies to 'dealers in securities'. The relevant Bank of Italy regulation relates to 'financial intermediaries'.

A right of use is incompatible with investment and custody services
On the basis of the second indent of Article 10 of the Investment Services Directive an investment firm can 'use' (for 'use' read 'dispose of') the assets of investors for its own account, provided that the investor has consented to such use. The 'consent' formula also features in Articles 12(8) and 12(9) of the Proposal for a Directive on Financial Instruments Markets.[199]

The meaning of the words 'for its own account' in the second indent of Article 10 of the ISD is not clear. Does 'for its own account' mean 'in the investment firm's own name, but for the benefit of the investor' (the 'best case' scenario) or does it mean 'in the investment firm's own name and for the firm's own benefit' (the 'worst case' scenario)? Usually, 'for its own account' means 'for its own benefit' (this would mean that the worst case scenario applies). But recital 29 of the ISD states: 'this principle [i.e. the protection of investors' ownership rights; TK] does not, however, prevent a firm from doing business in its name but on behalf of the investor, where that is required by the very nature of the transaction and the investor is in agreement, for example stock lending'. The words 'on behalf of the investor' point in the direction of the best case scenario. However, the words 'stock lending' point in the direction of the worst case scenario again, because stock lending usually (for example under the Global Master Securities Lending Agreement) entails an outright transfer of ownership without any limitation.

The core task of an investment firm is to administer its clients' assets safely, and to invest them for the benefit of these clients. Dispositions by an investment firm of its clients' assets for its own benefit are incompatible with this core task. The proper interpretation of the words 'for its own account' in the second indent of Article 10 of the ISD is therefore that they mean 'in the investment firm's own name, but for the benefit of the investor'.

This means that if the investor consents to 'use', as within the meaning of the second indent of Article 10 of the ISD, the investment firm is not entirely free to dispose. Because of the fiduciary nature of the client-investment firm relationship, the firm can only dispose for the benefit of the investor. This situation is similar to that of the sale on commission (cf. section 3 of chapter 2 on German and Dutch law) and a trust relationship (cf. chapter 5 on English law). Like the agent and the trustee, the investment firm is limited when it disposes of the original owner's assets in that it must take his interests into account. Therefore, only if an investor unequivocally transfers all interests (legal and beneficial) to the investment firm, is the investment firm free – in deviation from its core task – to dispose of the investor's assets for its own benefit.

Should the 'worst case' scenario apply (as appears to be the case under Danish law; see above), meaning that the investment firm can dispose of its clients' assets in its own name and for its own benefit, the analysis is as follows. In this case, the client essentially consents to making assets replaceable. This automatically triggers an outright transfer (cf. the remarks on replaceability above). In this case, the client runs an insolvency risk in respect of the investment firm.

[199] Interinstitutional File 2002/0269 (COD), 11150/1/03 REV 1, EF 34, ECOFIN 202, CODEC 947.

Traditionally, custodians have an essentially different function from investment firms.[200] Custodians are designed to keep and administer their clients' assets safely. The ISD has not been written with the client-custodian relationship in mind.[201] In any case – as in the case of investment firms – it is also contrary to a custodian's function to dispose of the assets that it holds in custody for its clients for its own benefit.

In many cases, clients may not realise the consequences of contractual consent to 'use' to their full extent. In particular, clients do not expect investment firms and custodians to dispose of their assets for their own benefit, because such disposals are incompatible with the core task of the institutions (i.e. to keep and administer their clients' assets safely, and to earn money for their clients). Investment firms and custodians should not be able to dispose of their clients' assets for their own benefit. The Proposal for a Directive on Financial Instruments Markets is a good opportunity to clarify the 'consent' formula of the Investment Services Directive and to take the interests of investors into account.

The proposed general right of intermediaries in securities (including investment firms and custodians) to dispose of their clients' assets for their own benefit, as envisaged in the UNIDROIT Second Session Report, should be rejected on the basis of the above argument.

3. The outright transfer method

A right of use enhances the liquidity of the financial markets. A right of use should be granted on the basis of an outright transfer in order to protect the interests of collateral providers and clients of custodians. A collateral provider or the client of a custodian does not expect to be left with a contractual claim only if he vests a security interest or enters into a purely contractual arrangement.

The country reports clearly show that market participants use the outright transfer technique when entering into collateralised transactions. This is the approach of internationally used standard agreements such as the Global Master Repurchase Agreement (repos) and the Global Master Securities Lending Agreement (securities lending). Present practice in Germany and The Netherlands is that repos and securities lending are indeed structured as outright transfers. In the United Kingdom too, collateral is provided on the basis of transfer of title. This is illustrated by the ISDA Margin Provisions (UK law). The outright transfer method is also a perfectly viable way to provide collateral in the U.S., and is the standard in the American repo and securities lending markets. As present practice shows, it is perfectly possible to reach the goal of liquid markets on the basis of the outright transfer approach.

[200] The custody function can be carried out by Central Securities Depositories ('CSD') such as the Vaerdipapircentralen (Denmark) and Monte Titoli S.p.A. (Italy); by International Central Securities Depositories ('ICSD') such as Clearstream or Euroclear; but also by other institutions, such as for example banks.

[201] See Article 3(1) in conjunction with Annex C of the ISD. Cf. on this issue, Benjamin (2002), cit. (footnote 184), section 7.52.

4. Tax

The tax consequences of a re-characterisation of a security interest combined with a right of use into an outright transfer are discussed in the Tax Appendix to this report. The Tax Appendix focuses on possible corporate income tax and withholding tax consequences and also pays some attention to the tax consequences in the case of participations of a certain percentage (e.g. the participation exemption, the fiscal unity regime). A security right combined with a right of use will not have *corporate income tax* consequences for a collateral provider if it is 'derecognised' for tax purposes, i.e. if it is not considered as a full transfer of economic and legal ownership for tax purposes. The right of use does, however, usually have income tax implications for the collateral taker, if – and this will typically be the case – the collateral taker exercises his right of use and transfers the assets to a third party. Subsequent gains and losses due to price fluctuations are relevant for income tax purposes. As far as *withholding tax* is concerned, in most jurisdictions a collateral taker with a right of use will be the party who can claim a refund or a credit of this withholding tax. Where a security interest is vested without a right of use, it would be the collateral provider who could claim the refund or credit. The characterisation of the right of use is also relevant in the context of 1) the beneficial tax treatment of shareholdings of at least 5%, 10% or 25% (the applicable percentage depends on how EU Member States have implemented the *participation exemption*), and 2) the Dutch *fiscal unity regime* that can be elected for if a taxpayer has legal and economic ownership of at least 95% of the shares of a company.

Because the tax treatment of collateralised transactions differs across the Member States of the European Union, harmonisation in this respect is desirable.

Concluding remarks

A 'right of use' on the basis of a security interest (if agreed) or on the basis of mere consent as envisaged in the Collateral Directive and the Investment Services Directive respectively, is in the interest of collateral takers and investment firms (usually major financial institutions). It gives them the right to dispose of their counterparty's assets. It is, however, misleading to collateral providers and investors (who may be small entities and even individuals).

'Use' normally means the act of employing a thing, not to dispose of that thing. A 'security interest' in its current meaning entails a limited right of disposal in the event of default, never a general right of disposal. A basic feature of 'investment services' is the disposal of a client's assets by an investment firm for the benefit of the client, not for the benefit of the investment firm. The term 'custody services' is commonly understood to comprise safekeeping and administration of clients' assets, and not disposals of these assets by the custodian for its own benefit. All this is confusing to unsophisticated collateral providers and investors who may not be experts in the financial markets. Because the normal meaning of the words in question has been distorted, they may not realise that 'consent to use' actually leads to an outright transfer of their proprietary interest, and that as a result they run an insolvency risk in respect of the collateral taker or investment firm.

Proper information about the consequences of consenting to ‘use’ could alleviate the pain, but it is not likely that collateral takers and investment firms will always be able or willing to provide such information, in particular because they are under a strong economic pressure to dispose of their counterparty’s assets.

Current market practice shows that liquid cash and securities markets can perfectly well be reached on the basis of the outright transfer technique. The consequences of this technique are obvious to all parties involved. On the basis of the above, it is submitted that a right of use would benefit the interests of all market participants if it were based on an unambiguous outright transfer.

TAX APPENDIX

Executive summary on tax issues relevant to the right of use granted under the Collateral Directive

1. Introduction

In order to examine any tax effects of a security interest with a right of use, a good understanding of the legal consequences of granting securities collateral is essential. The main issue here is whether a pledge effects an actual transfer of ownership of the underlying assets or not, because most tax jurisdictions take the transfer of legal title as a starting point to determine whether a taxable disposal has taken place. Ordinarily, granting a security interest will not lead to a taxable disposal, whereas an outright transfer will normally be considered as a disposal for tax purposes. In view of the conclusions drawn by the contributors of the report that a security interest together with a right of use is fairly similar to an outright transfer, granting a right of use may have serious tax consequences.

Under Article 5(1) of the European Collateral Directive ('CD')[202], the collateral taker can be granted the right of use of the pledged assets[203] in his own name under the obligation to transfer equivalent collateral to the collateral provider. This right of use gives the possibility to the collateral taker to dispose of the collateral as if he were the owner, whether or not a default event has occurred. It has been suggested that from a property law point of view, a pledge with the right of use granted to the collateral taker is in effect similar to an outright transfer. The question is whether a pledge with a right of use might trigger a disposal for tax purposes in the hands of the collateral provider. Further, one may question whether the collateral taker should take this right of use into account for tax accounting purposes.

This Appendix will give an overview of the tax treatment of collateral arrangements in various Member States of the European Union and the U.S.. It will discuss the following issues:

1) Does the granting of a security interest on securities lead to a taxable disposal for the collateral provider?

2) Does the return of the equivalent collateralised securities by the collateral taker lead to a taxable disposal?

3) Who is entitled to a tax credit / refund in respect of withholding taxes levied on securities that are subject to a security interest with a right of use?

Also some attention will be given to special tax treatment to so-called substantial interests. Many countries apply beneficial tax treatment to income (dividends and sometimes gains) derived from 25% or more shareholdings in other companies.[204]

[202] See footnote 4 above.
[203] This contribution assumes only fungible assets are pledged.
[204] Some Member-States have reduced the threshold of 25% to 10% (Germany) or 5% (The Netherlands).

The report will shortly discuss the effects of the right of use to the granting of such special tax regime.

2. Tax issues

2.1 Transfer for corporate income tax purposes[205]

Generally, corporates subject to corporate income tax are taxable for (i) income derived from securities, such as interest and dividend income, and (ii) gains made on the sale of securities. Losses made on the sale of securities are ordinarily tax-deductible.[206] If securities are transferred under a collateral agreement, it is the question whether a 'sale' has to be considered for corporate tax purposes. If so, the collateral provider may be confronted with adverse tax consequences. In addition, if a sale is considered, does this automatically lead to the assumption that the collateral taker is the new owner of the securities for corporate tax purposes? [207] For the collateral taker, such assumption may result into a taxable disposal at the moment of the retransfer of equivalent securities.

Although the transfer of legal title to securities is usually the starting point to consider a disposal for tax purposes, the countries involved in our report each have their own approach. For instance, in The Netherlands, Spain and France transfer of legal title leads in principle to a taxable disposal. However, if the economic ownership of the securities remains with the collateral provider, a disposal for tax purposes may be derecognised. This derecognition might be effected by recharacterising the collateral transfer as a securities lending transaction, such as in France under certain circumstances, or on the basis of sound business practice in The Netherlands.

In Germany, Luxembourg and the U.S., the basis to decide whether a taxable disposal occurs is the treatment of the transfer for general accounting purposes.[208] Under general accounting purposes, the transfer of 'control' over the asset is decisive for disposal rather than the transfer of economic or legal ownership of the asset. Although having control over an asset has similarities with having the legal ownership of securities, such as having the right to dispose of the collateralised assets, control can also be attributed to the economic owner on a contractual basis without formally transferring legal title. In addition, the control over an asset also implies that the fruits derived from the collateralised assets can be enjoyed, which seems equal to having the economic ownership of an asset. Also in jurisdictions

[205] This report will only focus on corporate income tax issues and not on individual income tax issues.
[206] This is different if a special tax regime applies to substantial shareholdings. Under such regime, dividends are tax-exempt and also the capital gain made on a sale may be exempt from tax. Consequently, a loss made on a sale of a substantial interest is non-deductible for corporate income tax purposes.
[207] It has been recommended by the Giovannini Group in *Cross-Border Clearing and Settlement Arrangements in the European Union*, Brussels, November 2001, and by the BIS-IOSCO report *Recommendations for securities settlement systems*, Recommendation 5, November 2001, that Member States should provide for tax rules which determine that a transfer for security purposes does not lead to a disposal for tax purposes. See also the suggestion of the European Commission in the Communication *Clearing and settlement in the European Union, Main policy issues and future challenges*, for a further research on the tax treatment of secured loans, swaps and repo's.
[208] Such as the treatment under general accounting standards like IAS, GAAP and FASB.

which take ‘control’ as a starting point, a disposal for tax purposes may be derecognised by means of, for instance, a recharacterisation of the transaction into a securities lending transaction.

Generally, most countries have special regulations under which an outright transfer under a collateral agreement can be denied for tax purposes. Subsequently, a return of equivalent assets by the collateral taker does normally not lead to a disposal for tax purposes. Would the first transfer be considered as a disposal for tax purposes, and thus the return of equivalent assets also, the return of the assets will usually not lead to a taxable gain for the collateral taker because the gain on the assets is reduced by a similar loss on the obligation to return the assets. Only if the collateral taker has disposed of the assets during the term of the collateral agreement, a taxable gain or loss may be made upon the return of the assets if the value of the assets after disposal has changed. Basically, after the collateral taker has disposed of the assets to a third party, only the redelivery obligation of equivalent assets to the collateral provider is left. Would the value of the securities decrease, than the collateral taker will realise a taxable gain on the redelivery obligation. If the right of use is granted to the collateral taker, the latter will normally use the securities received under the collateral. As such, a collateral arrangement under which a right of use is granted will generally lead to different tax consequences for the collateral taker than a standard security arrangement.

2.2 Withholding tax refunds on dividend and interest paid on cross-border collateralised assets

If dividends are paid on securities, generally dividend withholding tax is levied on those dividends by the source state, i.e. the state of residence of the issuer. Under double tax treaties, this source tax is usually limited to a maximum of 15% in respect of portfolio investments. The reduced amount of 15% is usually available at source, i.e. at the moment the dividend is paid, or by means of a refund afterwards.[209] In the latter case, the domestic withholding tax rate is first withheld at the moment of distribution and afterwards the recipient can ask for a refund of the amount of tax withheld exceeding the applicable treaty rate. The state of residence of the shareholder will take the gross dividend into account for income tax purposes and will give a credit for the foreign 15% tax levied by the source state.

Equal tax treatment applies to interest paid on bonds, albeit that under most double taxation treaties European Member States, if being the source country, are not allowed to levy withholding tax on interest payments if the payment is received by the beneficial owner of the interest. The reduction to a zero rate is granted by way of an exemption at source or a refund afterwards. Because of the zero rate, the state of residence of the recipient does not have to grant a credit for foreign withholding tax.

As far as an exemption or refund of withholding tax is concerned with respect to dividends or interest paid on collateralised securities, the exemption or refund is ordinarily only granted to the ‘beneficial owner’ of the income. The definition of

[209] Within a domestic context, withholding tax is usually an advanced payment of corporate income tax. Therefore, the withholding tax can be credited against the corporate income tax due at the end of the year.

'beneficial owner' has however no clear-cut meaning. Although many countries consider the 'economic owner' as the 'beneficial owner', no general accepted interpretation is available on the meaning of economic ownership. For instance, Germany and Luxembourg grant the tax refund to the person who has the control of the asset, which does not per se require the legal or full economic ownership of the asset. Although Dutch parliamentary history indicates that the economic owner should be regarded as the beneficial owner, Dutch tax law lacks a separate definition of 'economic owner' but only includes an anti-abuse regulation to determine who is not considered as 'beneficial owner'. The U.S. differentiates between domestic and cross-border situations, whereas France has specific anti-abuse regulations in respect of tax refunds regarding income on collateralised securities.

Broadly speaking, it can be derived from the report that the person who is entitled to a tax benefit is ordinarily the person who receives the income and who bears the upward and downward risk on the assets including residual value risk.[210] Granting the right of use of securities to the collateral taker might lead to the situation in which the collateral provider still has an economic interest in certain securities but no longer has the economic ownership of those specific securities. In other words, if the collateral taker has exercised its right of use and has sold the securities to a third party, that third party has both the legal ownership and economic ownership of those securities. After all, that third party is registered as legal owner, is entitled to the fruits and bears the (residual) value risk of those specific securities. Because the relation between the collateral provider and the specific asset has been broken, no tax benefits can be granted to the collateral provider in respect to those assets, even though the collateral provider still has an economic interest in the value of similar assets.

If the collateral taker has the right of use but does not actually sell the securities, the collateral provider can still be regarded as the economic owner of the asset. When income is paid on collateralised securities, it is the question who is entitled to a tax benefit on those securities, the collateral taker or the collateral provider? Many countries have anti-abuse regulations in respect to cross-border securities lending and repo transactions due to the fact that under some double taxation treaties the maximum withholding tax rate is more than 15% in respect of dividends and more than 0% regarding interest. If the double tax treaty between country of residence of the collateral taker and the country of residence of the issuer is more beneficial than the double tax treaty concluded by the country of residence of the collateral provider, a tax benefit may be obtained if the collateral taker should be regarded as the beneficial owner. Whether a collateral transaction with a right of use would be attacked by anti-avoidance regulations remains unclear.

In summary, it can be said that (i) under a standard collateral agreement not qualifying as an outright transfer, the collateral provider will be regarded as the beneficial owner entitled to a tax refund, (ii) if a right of use is granted and exercised by the collateral taker, no tax benefit can be claimed neither by the collateral taker nor by the collateral provider, and (iii) if a right of use is granted but not exercised by the collateral taker, it is questionable whether the collateral taker or collateral provider is entitled to a withholding tax refund. Clarity on this point is a must for a good functioning and liquid European capital market.

[210] Residual value risk means the risk of loss, theft and destruction.

3. Right of use granted to intermediaries

Generally speaking, it is of no relevance for tax purposes that book-entry securities are held through multiple intermediaries. Although the legal ownership is usually the starting point for tax ownership, it is the general view that custodians hold securities for their customers as agent or nominee. The accountholders are therefore considered as owner for tax purposes, even if they do not have legal title to the securities but only a debt claim against their custodian. For that reason, no special attention is given to the position of custodians or pledges to custodians by accountholders in this report.

In principle, if securities are pledged by the accountholder to the custodian combined with a right of use, similar corporate tax issues may arise as described in paragraph 2.1. In respect to the refund of withholding tax, granting the right of use could have adverse tax consequences similar to those described in paragraph 2.2. If a custodian obtains the right of use of securities pledged to him, it can be argued that the custodian no longer acts as a nominee or agent of the accountholder for those securities. As a consequence, withholding tax refunds may no longer be granted to the accountholder, who is the ultimate investor, but rather the custodian might be entitled to a withholding tax credit. If the custodian and the accountholder are not residents of the same country, different withholding tax rates can be applicable due to different double tax treaties. Anti-abuse provisions in respect of withholding tax refunds might therefore be triggered if the custodian is entitled to a more beneficial withholding tax rate.

4. Conclusion

Although the report shows that there are a lot of similarities on how collateral is treated for tax purposes by various countries, differences exist in the approach of issues as who is the owner for corporate income tax purposes and who is entitled to a withholding tax refund. In addition, it can be concluded that some countries have more sophisticated rules with regard to collateral such as France and the U.S., and countries in which unclarities exist and where less sophisticated rules apply such as Spain, The Netherlands and Luxembourg. Especially where countries characterise collateral transactions differently, a possibility for tax arbitrage may arise. However, one should bear in mind that the opposite of tax arbitrage is double taxation. It should therefore be wise to streamline at least the tax treatment of collateral within Europe, also in view of the liberalisation of the EU capital market. In view of the increased attention within the EU for the legal issues of collateral, this would be the moment to have a closer look at harmonisation in the tax field.

A) THE NETHERLANDS

Dutch tax effects of the 'right of use' granted under Article 5 of the Collateral Directive

1. Transfer of legal title – taxable disposal for income tax purposes?

Generally, for Dutch individual income tax purposes a transfer of title to an asset held as investment is not considered a taxable event, i.e. there is no capital gain tax. Under Dutch corporate income tax law, normally a transfer of legal title to assets leads to a taxable disposal of the asset, i.e. the transferor incurs a taxable gain or loss. However, Dutch case law supports that if a transferor can still be considered as the economic owner of the transferred assets, the transfer may be derecognised for Dutch corporate income tax purposes. A taxpayer is considered to be the economic owner of the assets if the transferor still bears the upward and downward risk on the assets including residual value risk.

2. Tax position collateral provider – corporate income tax

2.1 Disposal or not

For a collateral provider the intention of a collateral agreement – whether a pledge or outright transfer – is to provide security to another party and to re-acquire the full ownership of the asset (or similar asset) back in the future. The collateral taker has the obligation to return equivalent collateral, whereby in relation to financial instruments 'equivalent' means financial instruments of the same issuer or debtor forming part of the same issue or class and of the same nominal amount, currency and description.[211] The collateral provider will therefore still have the same economic position in respect to the collateralised financial instruments and thus can he still be regarded as the economic owner of the collateralised assets. Taxation can therefore be deferred.

Irrespective of the construction (a pledge, outright transfer or a pledge including a right of use), all collateral transactions will eventually receive equal corporate tax treatment. No corporate tax will be due on the collateralisation of the assets. The right of use granted to the collateral taker does not change the fact that the collateral provider has an economic interest in the collateralised assets. After all, the collateral taker has the obligation to redeliver equivalent collateral to the collateral provider, who will still bear the upward, downward and residual value risk on the assets. The term 'equivalent collateral' is of vital interest for the application of this derecognition treatment.[212] From Dutch case law it can be derived that an asset may be capitalised on the taxpayer's balance sheet if the asset is transferred under a fungible loan and the counterparty, although not obliged to keep the assets separate from its own other assets, is under the obligation to return assets from the same sort and quality.[213]

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[211] Article 2(1)(i) of the CD.

[212] Please note that for corporate tax purposes, margin arrangements are irrelevant for the determination of tax ownership.

[213] Arnhem Court, 16 February 1961, no. 734/60, *BNB* 1961/307 and Supreme Court, 10 April 1996, no. 30637, *BNB* 1996/274.

Would the collateral taker not return assets from the same kind and quality or no assets at all, a taxable disposal will immediately be considered in respect of the collateral provider. Although Dutch tax law has a concept in which deferral of tax is allowed if assets are replaced with other assets that have the same economic function as the original assets, it is generally assumed that this replacement concept does not apply to different kind of portfolio securities.[214]

2.2 Special tax regimes

There are two situations in which the right of use could have adverse Dutch corporate income tax consequences. In respect to special Dutch tax regimes whereby a traceable relation must exist between the legal owner of the underlying asset and the taxpayer (i.e. the economic owner of the asset), the right of use might lead to the loss of such special tax treatment (for example, the Dutch participation exemption which exempts income and gains on shareholdings of 5% or more from corporate tax). Due to the exercise of the right of use by the collateral taker, the relation between the legal owner (the collateral taker) and economic owner (the collateral provider) of one and the same asset is broken as the third party buyer of the asset will have both economic and legal ownership of the asset. The collateral provider is left with an economic position similar to that asset instead of having an economic ownership right directly enforceable against the legal owner of that asset.

Further, in respect of the fiscal unity regime whereby Dutch resident companies can elect to be treated as one single taxpayer, the right of use may lead to the loss of such tax regime because both legal and economic ownership of 95% of the shares in the group companies are required for election. A pledge including the right of use of shares in a group company granted to a bank in relation to a loan, would bereft the original shareholder, i.e. the taxpayer, from the legal ownership of the shares. This might have great impact on the structuring of acquisition debt.

3. Tax position collateral taker – corporate income tax

Under a collateral agreement – irrespective the right of use – the collateral taker will normally capitalise the received securities as an asset and the obligation to redeliver the assets as a liability on his balance sheet. These two positions are in principle completely matching. As long as the collateral taker does not dispose of the securities, no actual taxable gain will arise because a possible increase of the value of the securities will be neutralised by a corresponding increase in value of the liability. Both the securities and redelivery obligation should be accounted for on a marked-to-market basis, because there is no actual cost price paid by the collateral taker. At the moment of the return of the assets to the collateral provider, no tax will be due because the profit and loss on both positions will neutralise each other.

If the collateral taker, on the basis of the right of use, disposes of the assets, a possible gain on the assets will be neutralised by a corresponding loss on the liability at the time of disposal to a third party. However, if after a disposal by the collateral taker

[214] Supreme Court, 1 November 1989, no. 25 303, *BNB* 1990/92.

the value of the securities decreases, a taxable gain will arise in respect of the liability, i.e. the redelivery obligation (based on a marked-to-market valuation). Deferral of such gain till the moment equivalent assets are eventually repurchased on the market and returned to the collateral provider is unlikely.

4. Dividend withholding tax credits[215]

If dividends are paid on securities, generally dividend withholding tax is levied on those dividends by the source state, i.e. the state of residence of the issuer. According to Dutch tax law, dividend withholding tax is levied from the beneficial owner of the dividend but withheld by the issuer of the securities. The tax is withheld on account of the shareholder, resulting in the receipt of the net dividend by the shareholder. Normally, the legal owner of the shares (or if the dividend coupons are held separately from the shares, the legal owner of the dividend coupons) is considered as beneficial owner. Dutch taxpayers are allowed to credit this dividend tax with their corporate or individual income tax due on the dividend income. In a domestic context, the dividend tax can therefore be considered as an advance levy of income tax. Non-residents may only apply for a refund of part of this dividend tax if a double tax treaty applies and certain conditions are met. A full refund is never granted to non-resident shareholders.[216]

In case of an outright transfer, the collateral taker, rather than the collateral provider is considered as the beneficial owner of the dividend distributed on the collateralised assets, because the collateral taker has legal title to the shares.[217] As a result, the collateral taker should be entitled to a credit or refund of Dutch dividend withholding tax. This is contrary to a standard pledge whereby title to the securities is not transferred and the securities are booked on a collateral account in the name of the collateral provider. If the right of use should indeed be recharacterised as an outright transfer, this would also be of relevance for the determination of ownership for Dutch dividend tax purposes.

Dutch anti-abuse regulations deny a credit or refund of Dutch dividend withholding tax to taxpayers who, in relation to a complex of transactions, pay a compensation for the loss of a dividend to individuals or legal entities that would have been entitled to a less favourable credit or refund than the taxpayer paying the compensation, and these individuals or legal entities remain, directly or indirectly, in the same (long) position in relation to a portfolio of equities that they already held before the transactions took place. As a consequence, if a Dutch taxpayer receives Dutch equities under an outright transfer collateral agreement from a non-resident collateral provider, this Dutch taxpayer is not entitled to a credit or refund of Dutch withholding tax. The same applies if two non-residents are involved whereby the collateral provider is in a less beneficial withholding tax position than the collateral taker. Recharacterisation of a pledge with a right of use into an outright transfer would then have the same

[215] In principle, The Netherlands do not levy withholding tax on interest payments, unless the underlying debt in fact is recharacterised into equity.
[216] Apart form some foreign charitable institutions, foreign pension funds and foreign corporates holding more than 25% of the shares in a company.
[217] I refrain from the specific issue whether the collateral taker is rightly considered as legal owner if it concerns book-entry securities.

consequences. This may have a serious impact on the use of Dutch equities as collateral.

5. Conclusion

The introduction of Article 5 of the CD comprising the right of use of the collateral by the collateral taker does in principle not lead to a difference in Dutch corporate tax treatment of collateral. Nevertheless, one should be aware that in respect of Dutch special beneficial tax regimes such as the participation exemption and group election, the right of use may lead to the loss of this beneficial treatment. Although the transfer of legal title generally leads to a disposal for corporate income tax purposes, Dutch tax law grants the possibility of deferral as long as the transferor bears the economic risk of an asset. The right of use granted to the collateral taker does not affect the economic position of the collateral provider in respect to the collateralised assets. Also, the right of use does not change the tax position of the collateral taker. As long as the collateral taker does not dispose of the assets, there will be no corporate tax consequences for him. Upon disposal of the assets, this tax position will become different as the collateral taker then bears the economic risk of the assets via the redelivery obligation.

If a pledge with the right of use is recharacterised as an outright transfer, parties should be aware of the adverse Dutch anti-abuse regulations which deny withholding tax credits and refunds if the collateral taker has a better dividend withholding position than the collateral provider. In other words, non-residents pledging Dutch equities to a Dutch collateral taker or a foreigner in a better withholding tax position could be confronted with a lower net compensation payment on the collateralised assets.

B) GERMANY

German tax effects of the 'right of use' granted under Article 5 of the Collateral Directive

1. Tax position collateral provider – corporate income tax

If a security agreement constitutes a transfer of the full legal title of an asset to the collateral taker, the collateral provider remains the economic owner of the asset for German tax purposes. Therefore, the transfer of legal ownership of the securities does not trigger capital gains tax in Germany. Nevertheless, if that security agreement provides that the collateral taker may dispose of the collateralised asset, even if the collateral provider fulfils the secured obligations and no credit default occurs, the collateral taker will be regarded as the legal and economic owner of the asset. As a consequence, if a right of use is granted, the transfer of collateral will be regarded as a disposal of the asset. Such a disposal will, in general, trigger a capital gains tax at the level of the collateral provider if

(i) The collateral provider is a company and holds the securities as a business asset (however, in certain cases the transfer of shares may be tax exempt),
(ii) The collateral provider is a private person and the collateral provider holds at least a 1% interest of the shares in a corporation, or
(iii) The collateral provider is a private person and disposes of the securities within a period of one year after acquisition.

If the collateral provider is a company and holds the securities as a business asset, a transfer of the securities for security purposes is not regarded as a taxable disposal. The same is true, if the transaction is structured as a securities lending transaction ('*Wertpapierleihgeschäft*'), in which (i) the collateral taker is obliged to retransfer equivalent assets to the collateral provider after a certain period of time, or (ii) the collateral provider can in its sole discretion claim the asset back at any time.

2. Tax position collateral taker – corporate income tax

In a securities lending transaction the collateral taker will capitalise the transferred asset and an obligation to retransfer the assets on its balance sheet. At the time the assets are returned, the asset and the obligation will be derecognised. In case of a security transfer, the transfer back to the collateral provider does not trigger a capital gains tax.

3. Withholding tax credits

Dividends paid by a German issuer to a non-resident individual or a non-resident corporation are subject to withholding tax, currently at a rate of 20 % plus solidarity surcharge. Within an international context, such a tax rate might be reduced pursuant to the provisions of an applicable double taxation treaty, if any. The amount equal to the spread between the national withholding tax rate and the treaty rate has to be

claimed in a special refund procedure from the Federal Tax Office (‘*Bundesamt für Finanzen*’).

Pursuant to German tax law, dividend income is attributed to the economic owner of the underlying shares, even if the dividends are actually paid by the issuer to a party different from the economic owner.

If the right of use is granted to the collateral taker, and thus the collateral taker is entitled to dispose of the underlying shares, the collateral taker might become the economic owner of the underlying shares. As German withholding tax law looks at the economic owner, the collateral taker will then be entitled to the refund of withholding tax. If the collateral taker, as economic owner, pays a manufactured dividend to the collateral provider, the economic ownership of the collateral taker is not adversely affected. In this case treaty protection will be available for the collateral taker.

With regard to the notion of beneficial ownership as it is included in some German double taxation treaties as a requirement for a withholding tax reduction, the German tax administration will apply German tax law in order to interpret the notion of the beneficial owner. As the notion of beneficial ownership is unknown to German tax law and is only defined in some double taxation treaties (Sweden, Norway, Italy), the tax authorities will most likely regard the economic owner of the underlying shares as the beneficial owner within the meaning of the double taxation treaty. If the economic owner pays a manufactured dividend, such a payment will not infringe its position as economic or beneficial owner of the underlying share.

Pursuant to the provisions of German tax law, the taxpayer is entitled to the foreign tax credit if granted under a treaty. Thus, from a German perspective, the economic owner of the underlying shares is entitled to the foreign withholding tax credit. If the collateral taker is entitled to dispose of the shares, the collateral taker will be regarded as the economic owner and is therefore entitled to the foreign withholding tax credit.

C) FRANCE

French tax effects of the 'right of use' granted under Article 5 of the Collateral Directive

1. Tax position collateral provider – corporate income tax

In France, a pledge is in principle considered as a disposal for tax purposes. However, a special regime applies if the pledge can be considered as a securities lending transaction. In that case, the so-called securities lending tax neutrality system applies which means that a pledge does not result into a taxable disposal. This regime is available if the following requirements are met:

- Asset transfer must result from transactions dealing with OTC derivatives.
- The assets transferred are securities traded on an official securities market in France or in another country, securities traded on a secondary market or on an Over-The-Counter market, debt instruments negotiable on a regulated market and not likely to be listed, or Treasury bills. Subject to subsequent statements from the tax authorities, securities traded on the New Market should also be included. However, securities which, during the term of the transfer, pay a dividend or interest which carry a tax credit, are excluded.
- The assets must be transferred 'in full ownership, to serve as a pledge'. If the agreement governing the asset transfer is ruled by foreign law, the question is to know whether or not the aforementioned condition should be interpreted with regard to the relevant foreign law, or with regard to French law. This second hypothetical situation presents a problem in French law which does not make the distinction, as opposed to Anglo-Saxon legal systems, between legal title and economic title. If the condition is interpreted with regard to the relevant foreign law, which seems logical, the scope of application of the securities lending tax neutrality system will be limited. However, the legislator's intention, as it was brought out in parliamentary debate, is to facilitate the proper functioning of these transactions on financial instruments. The hope is that the tax authorities will adopt a flexible interpretation of the concept of transfers 'in full ownership, to serve as pledges'.
- At least one of the two parties to the collateral agreement is an investment services provider or an institution, company or establishment benefiting from the provisions of Article 25 of the Law of 2 July 1996 (such as insurance and reinsurance companies, mutual investment funds, the French Treasury, Banque de France, French Post etc.), or a non resident establishment with comparable status.
- The transferred securities must not be affected during the term of the transfer by an event changing their characteristics, such as a conversion or exchange of bonds into shares.
- The transferred assets must not be held by the collateral taker for longer than one year.
- The pledged assets are transferred as from the date of entry into force of the Law of 2 July 1996 or 6 July 1996.

If these requirements are not met, the securities transferred under the pledge have to be valued at mark-to-market if they qualify as transaction securities. In this case income tax will be levied from the collateral provider upon the transfer of securities, and from the collateral taker upon the transfer of equivalent securities at the end of the transaction.

2. Tax position collateral taker – corporate income tax

At the return of the assets previously transferred as a pledge, the collateral taker cancels its debt to the collateral provider, this cancellation being counterbalanced by the disappearance of the assets from its balance sheet. In principle, this transaction is neutral for the collateral taker from a tax standpoint, unless it meanwhile sold the assets and has to repurchase them on the market in order to honour its equitable obligation.

3. Withholding tax credits

According to the French tax code, if the entitlement to the coupon and entitlement of repayment of principal is divided between separate corporate entities, or of any treaty having the same effect, and when an entity incorporated or having its registered office outside of France holds all or part of the rights other than the rights to the dividends, the dividend tax credit is only allotted to the beneficiary of the dividends if the stripping or the treaty do not have the effect of granting a tax credit which would not have existed were there is no stripping or treaty.

When the transferred assets consist of securities or negotiable debt instruments, the collateral agreement may provide that the coupons relating to the pledged securities received by the collateral taker are in principle immediately repaid by the latter to the collateral provider. In particular, where share revenue from French companies is involved which entitles the bearer to a tax credit and if the shares are registered in the collateral taker’s share account, only the latter has the capacity of shareholder and subsequently the right to a tax credit. The collateral provider, unless otherwise stipulated in the document, is only repaid the dividend itself, exclusive of the tax credit. It is therefore in a less advantageous tax situation than if it had kept the shares.

When the transferred assets are shares and the collateral provider remains the legal title holder of the shares, one may consider the repayment of dividends (when they are not directly paid into the hands of the collateral provider but to the collateral taker as beneficiary) as a dividend payment because the beneficiary plays the role of collecting agent. The view that the repayment is a dividend must be rejected when the shares are transferred to the collateral taker in full ownership and when this transfer is valid with respect to third parties, such as in case of a pledge with a right of use. The view whereby dividend repayment by the beneficiary to the collateral provider is an indemnity may then be put forward. An indemnity payment is not subject to withholding tax.

D) SPAIN

Spanish tax effects of the 'right of use' granted under Article 5 of the Collateral Directive

1. Tax position collateral provider – corporate income tax

As a general rule, the transfer of legal title of an asset is considered as a disposal of the asset by the collateral provider for corporate tax purposes. If the collateral provider is a Spanish tax resident company, such capital gain/loss would be included in the taxable income at a rate of 35%. However, if the transfer does not lead to a change of legal ownership and the collateral provider also maintains the economic ownership of the securities, no capital gain will be triggered under the Spanish tax law. Subsequently, if one should conclude that a pledge with a right of use is similar to an outright transfer, such a pledge would thus lead to a taxable disposal. Please note that securities lending transactions generate, as a general rule, taxable gains unless these transactions falls within the specific tax-exemption as laid down in the Spanish Tax Act (see paragraph 3 below).

2. Tax position collateral taker – corporate income tax

On the assumption that the original transfer of the asset under a collateral agreement gives rise to a capital gain/loss for the original collateral provider (due to the fact that legal ownership is transferred), the return of the asset by the collateral taker would also generate a taxable gain (or loss) in the hands of the collateral taker.

3. Deferral by recharacterisation into a securities lending transaction

There is no possibility to defer the tax claim, save for the vague provision (subject to further development) regarding the derecognition of a capital gain on a securities lending transaction under specific circumstances.

Under Law 6/2000, a securities lending transaction does not give rise to a capital gain if all the requirements established in the Stock Market Act (L 24/1998) are met. These requirements concern the type of securities that can be used in the lending transaction and other requirements such as, the securities must have belonged to the lender, the lender is entitled to receive the economic benefits of the securities and the securities must be free of charges.

4. Withholding tax credits

Given that the collateral taker would become the legal owner of the securities under a collateral agreement including the right of use, he will be the one entitled to collect the dividends or to claim a refund under the applicable double tax treaty, if any. The fact that the collateral taker pays a manufactured dividend to the collateral provider will have no effect on the tax treatment of the dividend paid on these assets.

Spanish tax law sets forth that a credit for foreign withholding tax is attributed to the taxpayer, i.e., the legal owner (the shareholder) of the securities and who includes the dividend in its taxable income. Therefore the collateral taker (when this is a Spanish resident) is the one who will be entitled to the foreign tax credit.

E) UNITED STATES OF AMERICA

U.S. tax effects of a 'right of use'

1. Tax position collateral provider – corporate income tax

In general, a transfer of title to assets, without a transfer of 'control' (i.e., the ability to exercise an owner's rights), is not a taxable event. However, under a pledge with a right of use, control is effectively transferred over the pledged assets to the collateral taker.[218] Subject to the discussion in paragraph 2 below, such a transfer of title and control generally is a taxable disposition for U.S. federal income tax purposes.

2. Tax position collateral taker – corporate income tax

A return of the securities would constitute a taxable disposition if under the initial transfer the control over the assets was transferred and the transfer did not qualify as a securities lending transaction under Section 1058 of the U.S. Internal Revenue Code ('IRC').

3. Deferral by recharacterisation into a securities lending transaction

To the extent the pledged assets are securities, the transfer may be recharacterised as a securities lending transaction which transfers in principle tax ownership, but does not result in a taxable disposition under Section 1058 of the IRC. To qualify as a Section 1058 of the IRC securities lending transaction, the securities lending agreement generally must (i) be in writing, (ii) provide for the return to the collateral provider of securities identical to the securities transferred (i.e., securities of the same class and issue or equivalent securities in the event of a reorganisation, recapitalisation or merger of the issuer of the securities); (iii) require that payments shall be made to the collateral provider of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the collateral provider and ending with the transfer of identical securities back to the collateral provider; and (iv) not reduce the risk of loss or opportunity for gain of the collateral provider of the securities in the securities transferred. Market participants generally take the position that the posting of collateral is not a taxable disposition for U.S. federal income tax purposes.[219]

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[218] It should be noted that at least one commentator believes that the ability to sell or rehypothecate pledged assets should not result in a taxable disposition until such power is actually exercised. This opinion is not supported, however, by existing case law.

[219] Notwithstanding the foregoing, it should be noted that Proposed Regulations under Section 1058 of the IRC, which were promulgated in 1983 before the explosive growth of the derivatives market, contain a technical requirement that the collateral provider have the right to terminate the securities lending agreement upon 5 business days' notice. The Proposed Regulations have not yet been finalised and are not currently on the regulatory business plan of the U.S. Internal Revenue Service. Moreover, the '5 business day' requirement is clearly out of step with current market practice in the derivatives market. Thus, the Proposed Regulations should not have an impact on the qualification of the transactions contemplated by the Annex under Section 1058 of the IRC.

A pledge with the right of use should be treated as a securities lending transaction. If it were not, the collateral provider would likely recognise gain or loss on the transfer of the collateral provided to the collateral taker under generally applicable tax rules. The gain generally would be treated as capital gain if the collateral were a capital asset in the hands of the collateral provider. Such gain would be a long-term capital gain if the collateral has been held for more than one year prior to the transfer to the collateral taker. If the collateral provided were inventory, accounts or notes receivable, or short-term discount U.S. government obligations, *inter alia*, in the hands of the collateral provider, the gain generally would be treated as ordinary income for U.S. federal income tax purposes.

4. Withholding tax credits

If the right of use is not vested, then the collateral taker is generally viewed as the agent of the collateral provider in collecting any dividends or interest. In respect to cross-border collateral the double tax treaty, if any, concluded between the states in which collateral provider and collateral taker are incorporated, will apply.

If the right of use is transferred to the collateral taker and the pledge is considered a securities lending transaction under Section 1058 of the IRC, then any dividends or interest are beneficially owned by the collateral taker and the collateral taker is entitled to treaty benefits. With respect to substitute dividend and interest payments paid by the collateral taker to the collateral provider under the collateral agreement, the source and, if the payee is a non-U.S. resident, the character of any such payments are determined on a look-through basis for U.S. federal tax purposes. Accordingly, if on a look-through basis such payments are U.S. source, then U.S. withholding tax may apply subject to the portfolio interest exemption, which exempts interest income from U.S. tax, or any applicable treaty benefits (see Treas. Reg. Section 1.864-1(c), which provides that the Interest and Dividends provisions of a double tax treaty will apply to substitute interest or dividends paid to or derived by a foreign person).

If the right of use is transferred to the collateral taker and the pledge is not considered a securities lending transaction under Section 1058 of the IRC, then any dividends and interest are also beneficially owned by the collateral taker and the collateral taker is entitled to treaty benefits. Nevertheless, substitute interest and dividend payments would not be recharacterised or resourced on a look-through basis. The characterisation of such payments for U.S. federal tax purposes is not clear, but they likely would be considered in the nature of a fee for the use of property which fees are exempt from withholding tax.