

**INDIRECT HOLDING SYSTEM,  
SECURITIES PLEDGE AND REPLEDGE IN PANAMA**

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## INDIRECT HOLDING SYSTEM, SECURITIES PLEDGE AND REPLEGDE IN PANAMA

### I. Overview

The main objective of Title XI of Decree Law 1 of July 8, 1999 (hereinafter referred to as Decree Law 1/99) is the following:

- (1) To create a securities system based on account annotations.
- (2) To create and operate an indirect holding system of financial assets through securities accounts in conformity with standards that increase the level of efficiency in securities trading, and facilitate the integration of the Panamanian Securities Market with international systems of holding, clearance and liquidation of securities.

Chapter II of Title XI defines the term "Dematerialized Securities" and deals with the registration and trading of this uncertificated type of securities. Subsequently, Chapter III sets forth the indirect holding system rules.

The major difference between both systems is the type of relationship between the beneficial owners of securities with the issuer of the securities. Whereas the indirect system is characterized by the intervention of securities intermediaries (such as broker-dealers, depositories, clearing corporations), the direct system entails a more direct relationship with the issuer.

Chapter III creates a completely new personal property regime in Panama. The present work explores this chapter in light of the provisions by which it is oriented, i.e. Part 5 of Revised UCC Article 8.

### II. Basic Definitions

As Grant Gilmore once commented on the UCC structure, Decree Law 1/99 appears to have been written in its own shorthand.<sup>1</sup> The key to deciphering that shorthand may be frequently found in the definitions to the Decree Law 1/99. Some of these definitions are:

**A. Financial assets (*activos financieros*):**<sup>2</sup> Includes securities, cash and any other immovable property that an intermediary holds in a securities account in favor of a person, if the intermediary and that person have agreed to credit that property as a financial asset, subject to Title XI.

Official Comment 9 to Revised UCC § 8-102 states that "the definition of "financial asset," in conjunction with the definition of "securities account" in § 8-501, sets the scope of the indirect holding system rules of Part 5 of Revised Article 8.

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<sup>1</sup> See Emily H. Boss's Foreword to Sandra M. Rocks & Carl S. Bjerre, *The ABC's of the UCC Article 8: Investment Securities*.

<sup>2</sup> Decree Law 1/99, Article 1.

Accordingly, since the indirect holding system of Decree Law 1/99 is based on this Part of Revised Article 8, these concepts delineate likewise the scope of the indirect holding system under the rules of Title XI.

**B. Indirect Holder (*tenedor indirecto*):**<sup>3</sup> Any person to whom an intermediary has credited a security entitlement over financial assets in a securities account through annotation in the account.

A person shall be considered an indirect holder over financial assets in a securities account even if she has not been annotated as so in the account, from the moment in which an intermediary perform one of the following acts:<sup>4</sup>

- (1) Credits a financial asset in favor of that person by annotation in the securities account.
- (2) Receives from that person, or a third person, a financial asset and accepts to credit it in the securities account of that person.
- (3) Is compelled by another law or regulation to credit a financial asset in the securities account of that person.

In any of the preceding circumstances, the indirect holder acquires a security entitlement, even if the intermediary has not acquired title or right over the financial asset, or does not have at that moment sufficient financial assets of the same class to satisfy all security entitlements credited by him in securities accounts in favor of indirect holders with respect to financial assets of that class.

The financial assets that are transferred to an intermediary to be credited in securities accounts shall be issued to the name and order of the intermediary, or endorsed in blank, or by special endorsement in favor or to the order of the intermediary, or assigned to the intermediary or annotated in the account on his favor, so the intermediary may transfer, encumber or dispose of those financial assets freely, without requiring any consent or act from third parties. If an intermediary holds a financial asset in favor of another person and that financial asset has been issued, annotated, endorsed or assigned in favor of that person or to his order, such asset shall not be subject to the indirect holding regime contemplated herein.

**C. Direction Powers (*Poder de Dirección*):**<sup>5</sup> A person obtains direction powers with respect to a security entitlement in any of the following circumstances:

- (1) If that person has acquired the quality of legitimate person. (See section II)
- (2) If the intermediary has agreed to comply with the instructions of that person concerning the transfer, disposition or encumbrance of that security entitlement without the indirect holder's consent.

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<sup>3</sup> *Id.*

<sup>4</sup> Decree Law 1/99, Article 182.

<sup>5</sup> Decree Law 1/99, Article 162 (2).

If the indirect holder has transferred security entitlements over financial assets to the intermediary with whom he holds those financial assets, it is presumed that the intermediary has direction powers over them.

A person complying with the requirement (2) has direction powers over a security entitlement even if the indirect holder retains certain rights, such as substituting the security entitlement for another, giving instructions to the intermediary, or negotiating that security entitlement. In order to agree upon these terms, a securities intermediary need express authority from the indirect holder. Such type of authority, for instance, may derive from discretionary powers granted by the indirect holder to the securities intermediary. However, the intermediary is not obligated to make this type of agreement even if the indirect holder requests him to do so. Finally, a securities intermediary that has entered into such an agreement is not required to confirm the existence of the agreement to another party unless requested to do so by the registered owner or entitlement holder.<sup>6</sup>

**D. Legitimate person (*persona legitimada*):**<sup>7</sup> The indirect holder that appears in the securities account. If this person is deceased or lacks capacity, then legitimates person are the indirect holder's heirs, the personal representative acting for the estate of the decedent (*albacea*), guardian or other similar representative.<sup>8</sup>

**E. Security (*valor*):**<sup>9</sup> A bond, negotiable commercial security or other title of debt, share (including treasury securities), security entitlement credited in a securities account, participation share, certificate of participation, certificate of title, fiduciary certificate, certificate of deposit, mortgage certificate, options and any other title, instrument or right commonly recognized as security, or that has been determined as a security by the Commission.

This term does not include the following instruments:

- (1) Non-negotiable certificates or titles containing obligations issued by banks or its clients as part of usual banking services offered by banks, such as non-negotiable deposit certificates. This exception does not include negotiable banking acceptances and negotiable commercial securities issued by banking institutions.
- (2) Insurance policies, capitalization certificates and similar obligations issued by insurance companies.
- (3) Any other instrument, title or right that has been determined as a security by the Commission.

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<sup>6</sup> See Revised UCC § 8-106 (d), (e), (f) and (g).

<sup>7</sup> Decree Law 1/99, Article 160.

<sup>8</sup> See Revised UCC § 8-107 (a) (3), (4) and (5).

<sup>9</sup> Decree Law 1/99, Article 1.

**F. Securities Account (*cuenta de custodia*):**<sup>10</sup> An account managed by an intermediary with the aim of crediting and debiting financial assets by virtue of a contract by which the intermediary has agreed to settle that account in favor of an indirect holder, in order to submit the account and financial assets to be credited on it to the indirect holding system established in Title XI.

Official Comment 1 to Revised UCC § 8-501 states: “A securities account is a consensual arrangement in which the intermediary undertakes to treat the customer as entitled to exercise the rights that comprise the financial asset”. The consensual aspect is covered by the requirement that the account be established pursuant to agreement. There is no requirement that a formal or written agreement be signed.

**G. Security Entitlement (*derechos bursátiles*):**<sup>11</sup> Set of personal property rights, including property and pledge rights, held by an indirect holder with respect to financial assets.

According to Revised UCC § 8-102 (a) (17), a security entitlement describes a property interest rather than property rights, of a person who holds a security or other financial asset through a securities intermediary.

A security entitlement acquired by a indirect holder with respect to a financial asset is a title of property over the rights in that financial asset held by the securities intermediary, regardless of the moment in which the indirect holder acquired that security entitlement, or in which the securities intermediary acquired that title over that financial asset. This provision reflects the principle established by Revised UCC § 8-503, in the sense that a security entitlement is a right over the property held by the securities intermediary.

**H. Intermediary (*intermediario*):**<sup>12</sup> A securities center (such as a stock exchange), participant in a securities center (such as a stockbroker), bank or securities custodians, as well as any person authorized by the Commission to hold securities in custody.

Correspondingly, Revised UCC § 8-103 uses the term “Securities intermediary” to refer to those who hold securities for others in the indirect holding system. It covers clearing corporations, banks acting as securities custodians, and brokers holding securities for their customers. Therefore, under Revised UCC Article 8, a securities intermediary is not involved in direct holding of securities.

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<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

Instead of defining the term “intermediary”, other investment securities laws such as the Mexican Investment Securities Law, refer to and define the concept of “intermediation”. Thus, under the Mexican law, intermediation means “carrying out in an habitual manner the following acts:

- (1) Brokerage operations, commissions or other activities intended to put in contact the offer and acceptance of securities.
- (2) Operations with own accounts, with securities issued or guaranteed by third parties upon which a public offer has been made.
- (3) Administration and management of portfolios of securities owned by third parties.

### **III. Judicial Interpretation**<sup>13</sup>

Judicial interpretation of the indirect holding system rules shall be made in accordance with the following rule:

For the purpose of judicial interpretation, the provisions contemplated by this Title shall be interpreted in a manner that allows achieving the objectives described in the previous article, and may be supplemented by the regulations adopted by the Commission on the subject matter, the rules of self-regulated institutions and usages of trade generally observed in the local and international securities markets. Likewise, the provisions contemplated in the Commercial Code, Civil Code and any other law relating to matters covered in this Title shall be supplementary applied only to the extent they are not incompatible with the provisions and objectives of this Title, and shall be judicially interpreted in the manner that allows best to achieve the objectives described in the previous article.

Similarly, Revised UCC § 8-102 states the fundamental principle of interpretation that the Code provisions should be construed and applied to promote their underlying purposes and policies.

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<sup>13</sup> Decree Law 1/99, Article 152.

#### **IV. Indirect Holding System**

Chapter III of Title XI of Decree Law 1/99 creates a securities system inspired by Part 5 of Revised UCC Article 8. This securities system is organized under an “electronic book-entry” structure. This structure takes into account that the principal mechanism through which securities trades are settled today is not delivery of certificates or registration of transfers on the issuer's books, but netted settlement arrangements and accounting entries on the books of a multi-tiered pyramid of securities intermediaries.<sup>14</sup> In the United States, securities are registered in the name of, and immobilized with, clearing corporations such as The Depository Trust Company (for most publicly traded corporate equity securities, corporate debt securities, and municipal debt securities), Participants Trust Company (for certain mortgage-backed securities), and other depositories that hold securities for the benefit of their participants (such as brokerage corporations and custodian banks). As one author has observed, the “book-entry” system of holding securities constitutes the most significant innovation in Revised Article 8.<sup>15</sup>

Decree Law 1/99 creates a new set of property rights over financial assets held by a securities intermediary in a securities account. This system is known as “Indirect Holding System”, and the property rights stemming from it are known as “security entitlements”.<sup>16</sup>

To illustrate the basic features of this new property regime, consider a simple example of one investor. John owns 1000 shares of Techno Panama, Inc. (TP), a publicly traded company. John does not have a certificate representing his 1000 shares and is not registered on TP’s stock books as a holder of record. He enjoys the economic and corporate benefits of ownership but does so through his broker and any other intermediaries in the chain back to the issuer. John’s right in TP’s common stock is described under Chapter III of Title XI as a “security entitlement”. Thus, if John grants a security interest (pledge) in his investment position, the collateral would be described as a “security entitlement”.

#### **V. Effects of Account Annotations<sup>17</sup>**

Annotations in a securities account (*anotaciones en cuenta*) produce the effect of either constituting or extinguishing property rights on the securities held in that account, including property and pledge rights. Annotations must indicate the extension and scope of the rights conferred or extinguished.

Using our previous example, if John purchases additional securities through his broker from another publicly traded corporation, say 1000 shares of Investment

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<sup>14</sup> See Prefatory Note, UCC Article 8 1994 Revision.

<sup>15</sup> Curtis Reitz, *Investment Securities: The New UCC Article 8 For Delaware*, 1 Del. L. Rev. 47 (1998), at 51.

<sup>16</sup> Decree Law 1/99, article 177.

<sup>17</sup> Decree Law 1/99, Article 165.

Panama, Inc. (IP), such a purchase must be annotated by his broker in John's securities account and, as a result of such annotation, John will obtain a "security entitlement" to those securities held by his broker in his securities account. The same type of procedure, though with a completely different effect, will operate if John decides to sell those securities through his broker.

## **VI. Acquisition of Securities Entitlement<sup>18</sup>**

A person acquires a security entitlement from the moment in which an intermediary performs any of the following acts:<sup>19</sup>

- (1) Credits a financial asset in favor of that person through annotation in a securities account.<sup>20</sup>
- (2) Receives either from that person, or a third party, a financial asset and accepts to credit it in the securities account of the former.<sup>21</sup>
- (3) Is compelled by other law or regulation to credit a financial asset in the securities account of that person.<sup>22</sup>

If one of the foregoing conditions is met, the indirect holder acquires a security entitlement, even though the intermediary had not acquired rights over that financial asset, or did not have at that moment sufficient financial assets of the same class to satisfy all security entitlements acknowledged by the intermediary in securities accounts in favor of indirect holder with respect to financial assets of the same class.<sup>23</sup>

The financial assets that have been transferred to an intermediary to be credited in a securities account shall be issued in the name of, to the order of, indorsed in blank, or specially indorsed to, assigned or annotated in a securities account to the order of the securities intermediary, so the securities intermediary be able to transfer, encumber or dispose of those financial assets in accordance with the indirect holder's instructions. If an intermediary holds financial assets for another person, and they have been issued, indorsed, assigned or annotated to the order of that person, then those financial assets are not subject to the indirect holding regime.<sup>24</sup>

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<sup>18</sup> Decree Law 1/99, Article 182.

<sup>19</sup> See Revised UCC § 8-501 (b).

<sup>20</sup> See Revised UCC § 8-501 (b) (1).

<sup>21</sup> See Revised UCC § 8-501 (b) (2).

<sup>22</sup> See Revised UCC § 8-501 (b) (3).

<sup>23</sup> See Revised UCC § 8-501 (c).

<sup>24</sup> See Revised UCC § 8-501 (d).

## VII. Fiduciary Duty of Securities Intermediaries<sup>25</sup>

The right of a securities intermediary to hold and trade with financial assets in securities accounts are subject to a set of fiduciary duties. More precisely, to the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset in a securities account, the rights of the securities intermediary are subject to the following rules:

- (1) It shall be understood that they have been acquired by the securities intermediary as a trustee on behalf and benefit of the indirect holders to whom the securities intermediary have credited security entitlements over that financial asset/
- (2) It shall be understood that they are not part of the personal properties of the securities intermediary.<sup>26</sup>
- (3) They cannot be seized or encumbered, or by any means subject to claims of creditors of the securities intermediary, or be part of the properties of the securities intermediary in insolvency and bankruptcy proceedings, liquidation, reorganization or any other similar proceeding, except for the case contemplated in article 192. This exception will be addressed later on as part of the analysis of the priorities over financial assets in securities accounts held by a securities intermediary.

The fiduciary duties of a securities intermediary operate *ipso iure*. Accordingly, the securities intermediary and indirect holder cannot eliminate these legal duties imposed on the securities intermediary by means of a trust agreement. As a result, the provisions of the Panamanian Trust Law (Law 1 of 1984) do not apply to the special fiduciary relationship between an indirect holder and a securities intermediary. Moreover, a securities intermediary does not require a fiduciary license to operate in the securities market pursuant the provisions of Decree Law 1/99.

## VIII. Rights of the Indirect Holder Against Securities Intermediaries<sup>27</sup>

An indirect holder can only exercise directly his rights in a financial asset against a purchaser of that financial asset or right therein, if all the following circumstances are present:<sup>28</sup>

- (1) The securities intermediary enters into an involuntary liquidation process, insolvency or bankruptcy proceedings.<sup>29</sup>

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<sup>25</sup> Decree Law 1/99, Article 179.

<sup>26</sup> See Revised UCC § 8-503 (a).

<sup>27</sup> Decree Law 1/99, Article 181.

<sup>28</sup> See Revised UCC § 8-503 (d).

<sup>29</sup> See Revised UCC § 8-503 (d) (1).

- (2) The securities intermediary does not have sufficient financial assets to satisfy the security entitlements that he credited over the same to all of his indirect holders.<sup>30</sup>
- (3) The securities intermediary has violated the obligation contemplated in article 185 of Decree Law 1/99.<sup>31</sup> (See section XII)
- (4) The third person does not have the right to claim the protection established in the next paragraph.<sup>32</sup>

The indirect holder of a financial asset cannot assert any action against a person who, in exchange of value, has obtained that financial asset from a securities intermediary, or has acquired a property right over that financial asset, as long as that person has acquired direction powers over the financial asset and has not been an accomplice of the intermediary in the violation of the latter's obligation described in section XII.<sup>33</sup> This provision creates an important protection in favor of *bona fide* purchasers who obtain securities from a securities intermediary. However, such a protection will apply only if three requirements are met:

- (1) The purchaser has obtained the securities or financial assets for value.
- (2) The purchaser has acquired direction powers. (See section I (C))
- (3) The purchaser has not acted in complicity with the securities intermediary in violation of the securities intermediary's obligations under article 185. (See section XII)

## **IX. Duty of the Securities Intermediary to Maintain Sufficient Financial Assets<sup>34</sup>**

A securities intermediary has the obligation to obtain and maintain sufficient financial assets in order to back up and satisfy all security entitlements credited in favor of indirect holders with respect to those financial assets. The intermediaries may maintain those financial assets directly or through one or more other securities intermediaries.<sup>35</sup>

It is presumed that the securities intermediary has performed this obligation if:<sup>36</sup>

- (1) The securities intermediary acts as agreed upon with the indirect holder.<sup>37</sup>
- (2) In the absence of agreement, the securities acts diligently in accordance with usages of trade generally observed in the local market to obtain and maintain those financial assets.<sup>38</sup>

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<sup>30</sup> See Revised UCC § 8-503 (d) (2).

<sup>31</sup> See Revised UCC § 8-503 (d) (3).

<sup>32</sup> See Revised UCC § 8-503 (d) (4).

<sup>33</sup> See Revised UCC § 8-503 (e).

<sup>34</sup> Decree Law 1/99, Article 185.

<sup>35</sup> See Revised UCC § 8-504 (a).

<sup>36</sup> See Revised UCC § 8-504 (c).

<sup>37</sup> See Revised UCC § 8-504 (c) (1).

## **X. Convertibility of Financial Assets<sup>39</sup>**

When a financial asset is issued, endorsed, assigned or annotated in an account in favor of a securities intermediary with the object of submitting it to the indirect holding system, that financial asset will become fungible property and, thereby, the indirect holder will not have anymore a security entitlement in a particular property, but instead will acquire security entitlements over financial assets of the same class and with equal characteristics that have been credited in the securities account.

On the basis of Revised UCC § 8-504, this provision recognizes the reality that as the securities business is conducted today, it is not possible to identify particular securities as belonging to customers as distinguished from other particular securities that are the firm's own property. As noted by Official Comment 1 to Revised UCC § 8-504, securities firms typically keep all securities in fungible form, and may maintain their inventory of a particular security in various locations and forms, including physical securities held in vaults or in transit to transfer agents, and book entry positions at one or more clearing corporations.

## **XI. Indirect Holder Acquires Security Entitlements Free of Adverse Claims<sup>40</sup>**

A person who acquires a security entitlement in a financial asset, pursuant to article 182 of Decree Law 1/99 (see Section XI), do so free of any adverse claim by means of which another person reclaims rights in that financial asset, unless the acquirer had knowledge of such adverse claim.<sup>41</sup>

At this instance, two requirements must be satisfied:

- (1) The person acquires the security entitlement for value.
- (2) The person acquires the security entitlement without knowledge of the adverse claim.

Notwithstanding the foregoing provision, any person (such as legitimate indirect holder) who has been deprived of his rights with respect to a security entitlement in a securities account can assert an action against those who have illegitimately done so.

Let us now turn to an example to illustrate the previous paragraph. John steals bearer bonds from TP, and delivers the bonds to his broker for credit to John's securities account, thereby acquiring a security entitlement. Under the law, TP has an adverse claim against that security entitlement as the traceable product of the bonds that John misappropriated. Because John was himself the wrongdoer, John

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<sup>38</sup> See Revised UCC § 8-504 (c) (2).

<sup>39</sup> Decree Law 1/99, Article 183.

<sup>40</sup> Decree Law 1/99, Article 184.

<sup>41</sup> See Revised UCC § 8-502.

obviously had knowledge of TP's adverse claim. Accordingly, article 184 does not preclude TP from asserting an adverse claim against John.

Assume now that John acquired bonds from a securities intermediary holding them in a securities account for Peter. The securities intermediary, however, transferred the bonds in violation of a Peter's express prohibition to transfer. John gave value and did not have knowledge of Peter's adverse claim. In this case, regardless of Peter's ability to trace those bonds and show that they ended up in John's securities account, article 184 precludes any action against John, provided that John acquired the security entitlement for value and without knowledge of Peter's adverse claim.

## **XII. Prohibition to Grant Securities Interests in Financial Assets<sup>42</sup>**

Unless otherwise agreed upon with its indirect holder, a securities intermediary may not grant any securities interest (such as a pledge) in a financial asset it is obligated to maintain pursuant to article 185 of Decree Law 1/99.<sup>43</sup>

According to Official Comment 2 to Revised UCC § 8-504, "margin accounts" are common examples of arrangements in which an entitlement holder (indirect holder under Decree Law 1/99), authorizes the securities intermediary to grant security interests in the positions held for the entitlement holder". The entire lending process by virtue of which an indirect holder authorizes the securities intermediary to use a security entitlement in a securities account as collateral is commonly known as "margin lending".

## **XIII. Duty of Securities Intermediaries to Obtain Economic Rights<sup>44</sup>**

The securities intermediary has the duty to take adequate measures in order to obtain payments and distributions (which generally includes any and all dividends) made by the issuer of a financial asset.<sup>45</sup> These rights are known under Decree Law 1/99 as "economic rights". Such a denomination is perhaps based on the fact that these rights are, as stated by Official Comment 1 to Revised UCC § 8-505, the principal economic benefit of ownership of the financial asset. Indeed, the same Comment provides that "one of the main reasons that investors make use of securities intermediaries is to obtain the services of a professional in performing the record-keeping and other functions necessary to ensure that payments and other distributions are received.

It is presumed that the securities intermediary satisfies this duty if:

(1) The securities intermediary acts as agreed upon with the indirect holder.<sup>46</sup>

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<sup>42</sup> Decree Law 1/99, Article 186.

<sup>43</sup> See Revised UCC § 8-504 (b).

<sup>44</sup> Decree Law 1/99, Article 187.

<sup>45</sup> See Revised UCC § 8-505 (a).

<sup>46</sup> See Revised UCC § 8-505 (a) (1).

- (2) In the absence of agreement, the securities intermediary acts diligently in accordance with usages of trade generally observed in the local market to obtain payments and distributions.<sup>47</sup>

As part of this duty, the securities intermediary is obligated to its indirect holder for payments and distributions made by the issuer with respect to a financial asset credited in the securities account of the indirect holder.<sup>48</sup>

#### **XIV. Duty of Securities Intermediary to Exercise Corporate and Other Rights<sup>49</sup>**

As a consequence of the indirect holding system, the securities intermediary is entitled to exercise the corporate and other rights, including voting rights, arising from the securities holding, and in accordance with the instructions provided by the indirect holder.

It is presumed that the securities intermediary satisfy its duty if:<sup>50</sup>

- (1) The securities intermediary acts as agreed upon with the indirect holder.<sup>51</sup>
- (2) In the absence of agreement, the securities intermediary does what is necessary so the indirect holder may be able to exercise the rights directly, or acts diligently in accordance with usages of trade generally observed in the local market to follow the instructions of the indirect holder.<sup>52</sup>

The duty established in paragraph (2) conveys a broader obligation on the securities intermediary, namely, to place the indirect holder in a position to exercise the rights directly. This provision takes into account the fact that some of the rights attendant upon ownership of the security, such as rights to bring derivative and other litigation, are far removed from the matters that intermediaries are expected to perform.<sup>53</sup>

#### **XV. Duty of the Securities Intermediary to Act as Directed by the Indirect Holder<sup>54</sup>**

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<sup>47</sup> See Revised UCC § 8-505 (a) (2).

<sup>48</sup> See Revised UCC § 8-505 (b).

<sup>49</sup> Decree Law 1/99, Article 188.

<sup>50</sup> See Revised UCC § 8-506.

<sup>51</sup> See Revised UCC § 8-506 (1).

<sup>52</sup> See Revised UCC § 8-506 (2).

<sup>53</sup> See Official Comment (2) to Revised UCC § 8-506.

<sup>54</sup> Decree Law 1/99, Article 189.

The securities intermediary has the duty to follow the instructions of the indirect holder regarding the transfer, disposition and encumbrance of a financial asset provided by a legitimate person in writing, or by any other means agreed upon by them, so long as the securities intermediary has reasonable assurance that the instructions are legitimate and duly authorized.<sup>55</sup> The general rule is that an intermediary's duty with respect to instructions runs only to the indirect holder with whom the intermediary has established a relationship. Thus, in the usual case, a legitimate person is the indirect holder.

It is presumed that the intermediary satisfies its duty if:

- (1) The securities intermediary acts as agreed upon with the indirect holder.<sup>56</sup>
- (2) In the absence of agreement, the securities intermediary acts diligently in accordance with usages of trade generally observed in the local market to follow the instructions of the indirect holder.<sup>57</sup>

A securities intermediary who transfers or disposes of a financial asset or right therein, on the basis of an invalid order, shall reestablish the financial asset or right therein to the indirect holder deprived of it, and pay or credit to his favor any sums or distributions that the indirect holder did not received as a result of the undue transfer.

If the intermediary does not reestablish the financial asset or right therein, it shall respond to the indirect holder for damages (*daños y perjuicios*).<sup>58</sup>

## **XVI. Protection of *Bona Fide* Purchasers<sup>59</sup>**

Decree Law 1/99 provides *bona fide* purchasers of security entitlements with a special protection. This special protection is similar to that established by UCC Article 9 § 1-201 with regard to ordinary course buyers in secured transactions. Thus, a person who acquires a security entitlement from an indirect holder, do so free of any adverse claim by means of which another person reclaims rights in that financial asset if three conditions are met:<sup>60</sup>

- (1) The person acquires the security entitlement for value.
- (2) The person obtains direction powers.
- (3) The person did not have knowledge that his purchase is in violation of a perfected security interest.

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<sup>55</sup> See Revised UCC § 8-507 (a).

<sup>56</sup> See Revised UCC § 8-507 (a) (1).

<sup>57</sup> See Revised UCC § 8-507 (a) (2).

<sup>58</sup> See Revised UCC § 8-507 (b).

<sup>59</sup> Decree Law 1/99, Article 191.

<sup>60</sup> See Revised UCC § 8-510 (a).

If an adverse claim could not have been asserted against an indirect holder pursuant to article 170, the adverse claim cannot be asserted against a person who acquires security entitlements from the indirect holder, either for value or not.<sup>61</sup>

Some important considerations ought to be made before exploring the foregoing paragraph incorporated in article 191 of Decree Law 1/99. First, since article 170 is outside the context of the indirect holding system rules, it seems to us that referral to this provision is inaccurate. Instead, the Panamanian Legislature should have made reference to article 184, which not only uses an identical wording and has the same end, but also is part of the indirect holding system rules in Chapter III of Title XI.<sup>62</sup> Second, Revised UCC § 8-510 (b), in which article 191 is based, refers to § 8-502, the equivalent of article 184 in the UCC indirect holding system rules. At last but not least, article 184, as described earlier, sets forth the general “shelter principle” that investors in the indirect holding system are provided with a protection against adverse claims by specifying that no adverse claim can be asserted against a person who acquires a security entitlement under article 182 for value and without knowledge of the existence of an adverse claim.

Let us now create a hypothetical scenario with the help of our subject characters. Consider John steals a bearer bond certificate from PT. John delivers the certificate to First Securities, Inc. (FS) for credit to John’s securities account. FS, in turn, forwards the certificate to LatinClear, a clearing corporation, for credit to FS’s account. Later, John instructs FS to sell the positions in the bonds. FS sells to Second Securities, Inc. (SS), acting as a broker for Mark. The trade is settled by annotations in the accounts of FS and SS at LatinClear, and in the accounts of John and Mark at FS and SS, respectively. PT may be able to reconstruct the trade records to show that settlement occurred in such fashion that the same “bonds” that were carried in John’s account at FS are traceable into Mark’s account at SS. Mark later decides to donate the bonds to the University of Panama (UP) and executes an assignment of its rights as indirect holder with a security entitlement to the UP. Under article 184, Mark was protected against John’s adverse claim since Mark acquired for value and did not have knowledge of the existence of TP’s adverse claim. UP, however, was not protected by article 184, because UP did not give value. Thus, by virtue of article 191, TP is also precluded from asserting an adverse claim against UP, since UP acquired a security entitlement from an indirect holder (Mark).

## **XVII. Pledging Security Entitlements<sup>63</sup>**

An indirect holder may obtain a loan using security entitlements as collateral. In this connection, Decree Law 1/99 provides that an indirect holder can choose to provide as collateral either certain or all security entitlements in a securities

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<sup>61</sup> See Revised UCC § 8-510 (b).

<sup>62</sup> See Revised UCC § 8-510 (b) referring to § 8-502.

<sup>63</sup> Decree Law 1/99, Article 194.

account (See section XVII). This transaction is known as a “Securities Pledge” under Panamanian Investment Securities Law.

In order to be valid and enforceable, a pledge over security entitlements shall be made in writing, unless it is used to secure a credit with a securities intermediary. (See Section XVIII). Pledged rights or assets shall be identified in the agreement or identifiable under parameters included therein. The identification of the rights or assets, however, does not require being specific. It shall suffice only to describe their class or category, their quantity or any other formula or mathematical procedure that allows identifying objectively the pledged rights or assets.

According to Decree Law 1/99, the pledge can be used to secure present and future obligations. It also may be constituted over existing or after acquired rights or assets. Furthermore, the pledge will have date certain (*fecha cierta*) from the moment of its perfection, and it does not have to be notarized.

### **XVIII. Separability of Security Entitlements**

Under the principle of separability adopted by Decree Law 1/99, security entitlements with respect to financial assets held in securities accounts may be separated. Thus, it is presumed that if a pledge is constituted and perfected over a securities account then the pledge covers all security entitlements that an indirect holder may have with respect to the financial assets in that account. Likewise, if a pledge is constituted and perfected over security entitlements the indirect holder has with respect to specific financial assets in a securities account, the pledge will not cover the remaining security entitlements in that account.

### **XIX. Securities Intermediaries as Secured Creditors**

Decree Law 1/99 creates a special pledge in favor of securities intermediaries who become secured creditors of their own indirect holders, i.e. securities intermediaries who provide loans to their indirect holders by annotating security entitlements in the indirect holders’ accounts. As discussed earlier, this lending process is commonly referred to as “margin lending”.

As one commentator has observed, margin lending is “the making of a loan by the broker to its customer, representing a portion of the cost of purchasing or carrying securities held by the broker for the customer’s account. Margin loans typically are secured by the customer’s pledge to the broker of those securities (often called “margin securities” in this context)”.<sup>64</sup>

Unlike all other forms of securities pledge, this special pledge does not require being in writing. Once the securities intermediary credits the financial asset in the securities account it will be automatically perfected, and unless the securities intermediary expressly agrees to subordinate its claim, the rights of a securities

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<sup>64</sup> Kenneth C. Kettering, *Repledge Deconstructed*, 61 U. Pitt. L. Rev. 45 (1999), at 51.

intermediary over the pledged assets has priority over any other right granted by the indirect holder to another secured party, pre-existing or otherwise. Furthermore, the right of a securities intermediary who is a secured creditor to its own indirect holders extend to the proceeds of those financial assets. This special type of pledge, however, generates uncertainty among secured parties who either have not acquired the status of indirect holder with a security entitlement, or have not obtain control over the security entitlement.<sup>65</sup> In the absence of a subordination agreement by the securities intermediary, a secured party who has a prior claim to its borrower's securities in the hands of a broker could find itself subject to a later-granted security interest in the same securities, securing the broker's margin claim against the borrower. However, only if a secured creditor of the securities intermediary acquire the status of indirect holder with a security entitlement or obtains control of such financial assets, the claims of the securities intermediary's secured creditor to the assets in question will take priority over claims of the entitlement holder, unless control was obtained through fraud or collusion with the securities intermediary. That was the result in the *Drage* case, discussed later in this paper.

## **XX. Perfection of Securities Pledges**

By and large, rules related to pledges on personal property provide perfection against third parties from the moment in which the debtor delivers possession of the collateral to a lender or appointed third party. Consequently, the debtor does not retain actual possession of the collateral. Following the guidelines of Revised UCC Article 8, Decree Law 1/99 devises a non-possessory type of pledge. In other words, the pledgor (secured debtor) retains possession of the collateral (security entitlements over financial assets) along with other existing rights therein. Accordingly, as long as the pledgor does not default on its obligation to pay the price as agreed upon with the pledgee (secured creditor), the pledgor will enjoy all economic benefits (such as payments and distributions), as well as corporate rights (such as voting rights) which are inherent to the security entitlement.

A pledge over security entitlements is perfected and enforceable with respect to third parties from the moment in which the pledgee acquires direction powers over the pledged rights or assets. Hence, a pledgee acquires direction powers if he is one of the following persons:

- (1) A legitimate person, namely, the indirect holder that appears in the securities account (known as "entitlement holder" under Revised UCC Article 8).
- (2) A person negotiating with a securities intermediary who holds security entitlements in a securities account for an indirect holder. In this case the

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<sup>65</sup> See generally Joseph B. C. Klutz *et al*, *How To Be Secure When Your Collateral Is A Security: A Guide To The Creation And Perfection Of Security Interests In Investment Property Under The 1994 Revisions To The Uniform Commercial Code*, 4 N.C. Banking Inst. 183 (2000), at 191.

intermediary will not require express authority if it has been given discretionary powers to manage the securities account. However, in the absence of those powers, the indirect holder will require express authority from the indirect holder.

Let us now turn to an example of paragraph (1): John acquires 1000 shares from TP for value. John delivers the stock certificate to FS, for credit in John's securities account. Later on, John borrows from Bank granting a security interest in the security entitlement. To acquire a securities entitlement and thus become an indirect holder, the bank should have a separate securities account (also known as securities pledge account) to which FS would credit John's securities.

An example in the context of paragraph (2) can be illustrated with the same facts, however; in this case, the Bank does not become an indirect holder. Therefore, the Bank can obtain direction powers by virtue of an agreement in which FS agrees to comply with the Bank's instructions.

A recent decision of the United States District Court for the Eastern District of Pennsylvania dealt with the issue of whether a borrowing bank that has given notice to the securities intermediary of a securities pledge agreement concluded between the bank and the indirect holder acquires direction powers over the pledged securities.<sup>66</sup>

First National Bank of Palmerton (Bank), the pledgee, entered into two security agreements with Pankesh, Kadam and Alka Patel (Patel), the pledgor and indirect holder. After the first security agreement was concluded, the bank sent a letter to Donaldson, Lufkin & Jenrette Securities Corporation (DLJ), the securities intermediary, explaining that Patel had "pledged the marketable securities" and "she agreed to have the bank perfect its interest in the stocks". In the letter, the bank requested that DLJ either "forward the stock certificates or an agreement from [DLJ] that the securities will remain in the account until notification from the bank". At the end of the letter, Patel had signed an acceptance and acknowledgment whereby she "consented to the stock certificates being forwarded to The First National Bank of Palmerton." DLJ forwarded the stock certificates to the bank. DLJ, however, never responded to this letter.

Later on, Patel signed a second security agreement and a collateral pledge agreement which granted the bank an assignment and security interest in the account. Again, after the agreement was concluded, the bank requested that DLJ sign and return an acknowledgment form whereby it would agree that the bank, as the secured party, would have the sole right to make withdrawals from the collateral. DLJ, however, did not sign the form or return it to the bank.

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<sup>66</sup> *First National Bank of Palmerton v. Donaldson, Lufkin & Jenrette Securities Corporation*, 1999 U.S. Dist. LEXIS 3275.

Patel defaulted on its obligations under both agreements. When the bank tried to liquidate the securities in the collateral brokerage account in order to apply the funds toward the borrowers' outstanding debt, it learned that Patel had liquidated the account. In an effort to recover its loss, the bank brought a suit against DLJ claiming that by allowing Patel to liquidate the brokerage account, DLJ was negligent, breached its fiduciary duty, and committed fraud.

With respect to the relationship between the bank and DLJ arising from the agreements concluded by the bank and Patel, the court went on to say:

In the instant case, Patel granted to the bank a security interest in her security entitlements. In and of itself, this transaction did not establish a duty between DLJ, the securities intermediary, and the bank, the secured party. Although Pennsylvania courts do not appear to have considered this issue yet, the drafters of the Uniform Commercial Code have stated that a "securities intermediary owes no duties to the secured party, unless the intermediary has entered into a 'control' agreement in which it agrees to act on entitlement orders originated by the secured party". Thus, the legal duty owed by DLJ to the bank that is necessary to support claims of negligence and breach of fiduciary duty, could arise only if the bank, Patel, and DLJ all agreed that the bank had the power "to have the securities sold or transferred without further action by [Patel]".<sup>67</sup>

Remember that the terms "entitlement holder" and "control" provided by Revised UCC Article 8 are known, respectively, as "indirect holder" and "direction power" under Decree Law 1/99. In the present case, the court addressed the issue of control in a very straightforward manner:

Control of a security entitlement can be achieved in one of two ways: through a control agreement or by having the secured party become the entitlement holder. See section 8-106 (d). To acquire a securities entitlement and thus become the entitlement holder, the bank would have needed to establish a separate securities account to which DLJ would credit Patel's securities. See *id.* § 8-501 (b). Plaintiff does not allege that this

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<sup>67</sup> *Id.* at 9.

occurred and, thus, it cannot claim to be the entitlement holder. This leaves a control agreement as the sole means by which the bank could have perfected its security interest.<sup>68</sup>

Finally the court concluded that simple notice to the intermediary is not enough to obtain control. By contrast, it is essential that the intermediary be actual party to the control agreement. Thus, the court held:

To obtain control through an agreement in conformance with section 8-106 (d)(2), a secured party cannot simply notify the intermediary of the secured party's interest and the debtor's willingness to allow entitlement orders to issue from the secured party -- "it is essential that the . . . securities intermediary . . . actually be a party to the agreement." As no agreement existed, no duty arose between DLJ and the bank. Because the bank cannot allege the existence of a duty, I must dismiss plaintiff's negligence and breach of fiduciary duty claims.

Control provisions of Revised UCC Article 8 introduced important changes on the subject of perfection of security interests in investment securities. In fact, before the enactment of Revised UCC Article 8, a secured party was able to perfect its security interest by simply giving notice to the securities intermediary holding securities for the secured debtor or not. For instance, a decision of the Court of Appeal of Florida (Second District) resolved this particular issue in 1994.<sup>69</sup> In this case, Precision Agricultural Products, Inc. (Precision) borrowed \$ 200,000.00 from The First Bank of Immokalee (First Bank) on July 30, 1990. To secure this obligation, Precision signed a security agreement listing 50,000 shares of ATNN Inc. and 118,000 shares of Non-Invasive Monitoring Systems, Inc., as collateral. Because the stock was in the possession of Precision's broker, F.N. Wolf & Co., Inc. (F.N. Wolf), First Bank wrote to F.N. Wolf and advised that Precision had assigned these shares of stock as collateral for the loan. The letter enclosed a copy of the promissory note and the security agreement. A few days later, F.N. Wolf sent a reply, refusing to hold the securities in trust for anyone other than Precision, but offering to assist in a physical transfer of stock certification if that was the desire of Precision. First Bank did not respond to this letter.

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<sup>68</sup> *Id.* at 10.

<sup>69</sup> *First Bank of Immokalee v. Rogers NK Seed Company*, 637 So. 2d 11.

At first, the trial court ruled that First Bank's security interest was not perfected because the security agreement had not been filed and because First Bank had failed to take possession of the stock as suggested by F.N. Wolf.<sup>70</sup>

According to the Florida relevant statutory provisions, §§ 678.313(1)(h) and 678.321(1) Fla. Stat. (1989), “a security interest in stock is enforceable and can attach only if the security interest is transferred to the secured party or its designee”, and “the transfer of such a security interest occurs at the time a written notification... (which may be a copy of the security agreement)... is received by a financial intermediary on whose books the interest of the transferor in the security appears.”<sup>71</sup> Accordingly, the court ruled:

A transfer of the security interest in the stock occurred when F.N. Wolf received the written notification. Despite its efforts in the reply, F.N. Wolf had no ability to decline or prevent the transfer that resulted from its receipt of the notification. Thus, the reply from F.N. Wolf did not alter the date upon which First Bank perfected its security interest in this stock.<sup>72</sup>

## **XXI. Priority Among Indirect Holders and Secured Creditors<sup>73</sup>**

The financial assets held by an intermediary in a securities account shall be used in the following order: First, to satisfy its obligations to indirect holders who have security entitlements with respect to those financial assets, and; second, to satisfy its obligations to a creditor concluded on behalf of indirect holders, including those obligations secured through a pledge or other encumbrances over those financial assets.<sup>74</sup>

A claim of a creditor of a securities intermediary who has a security interest in a financial asset held by a securities intermediary has priority over claims of the

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<sup>70</sup> The court refers here to a perfection method provided by UCC Article 9, namely, filing of a financing statement.

See Joseph B. C. Klutz, *supra* note 62, at 192-193. Under Revised Article 8, a secured party may also perfect a security interest in investment property by filing a financing statement. However, while filing is a permissible means of perfection under Article Nine and will prevail against a claim of the trustee in bankruptcy, control is the preferred method of perfection because a secured party that perfects by control has priority over a secured party that perfects by filing, even if the financing statement was filed prior to perfection by control.

However, under Decree Law 1/99, perfection by control is the exclusive means of perfection of pledged security entitlements.

<sup>71</sup> Florida is one of the few states which have not adopted Revised UCC Article 8. By contrast, UCC Article 8, 1977 version is still in force.

<sup>72</sup> *First Bank of Immokalee*, 637 So. 2d 13.

<sup>73</sup> Decree Law 1/99, Article 192.

<sup>74</sup> See Revised UCC § 8-511 (a).

securities intermediary's indirect holders who have security entitlements with respect to that financial asset if the creditor has control over the financial asset.<sup>75</sup>

A threshold question, however, can be raised at this point: Whether a person (other than the creditor of a securities intermediary) who has obtained control and has perfected a security interest over security entitlements in a securities account is free of any adverse claim. The Supreme Court of New York recently resolved this same issue in *Nathan W. Drage v. First Concord Securities, Ltd. et al.* In this case, the law firm of Nathan W. Drage, P.C. (plaintiff), sued First Concord Securities, Ltd. (FCS), a foreign-broker dealer, its principal Joseph Andres Mann (Mann), M&T Bank Corp. (M&T Bank), a bank holding company, and its brokerage subsidiary, M&T Securities Inc. (M&T Securities) to recover damages based on the sale of plaintiff's shares of stock in a company known as GS Telecom, Ltd. (GST).

Plaintiff maintained a brokerage account with FCS for the sole purpose of effecting the sale of its shares of stock in GST. FCS opened a security clearance account with M&T Bank which, through M&T Securities, operated a security clearance department that acted as a custodial agent for customers buying and selling securities through broker-dealers. In connection with the opening of the security clearance account, M&T Bank issued a demand promissory note, titled Secure Grid Note and Pledge Agreement (the Agreement), providing, in part, that M&T Bank may demand payment of, or decrease the amount of, its advances to FCS on demand, and that M&T Bank's advances to FCS were secured by the securities held in FCS's account. Thereafter, FCS bought and sold securities, settling its trades through M&T Bank, and M&T Bank began extending credit to FCS in connection with its trading activities.

Later on, FCS declined to honor plaintiff's demands to sell a portion of its GST shares. In addition, when the amount of credit that M&T Bank had extended to FCS totaled \$ 4.9 million, and FCS failed to comply with M&T Bank's demand that it cease buying additional shares and decrease the amount of its outstanding loan, M&T Bank advised FCS that it was declaring an event of default, would be seizing all of the securities held in FCS's account and would begin liquidating the account. This action ensued when M&T Bank sold all of the GST shares that had been held in FCS's account, including plaintiff's shares, in partial satisfaction of FCS's outstanding debt.

As to M&T Bank's position with respect to the pledged securities, the court concluded:

"Even though FCS violated the terms of [UCC] 8-504(b) by pledging GST shares as collateral without plaintiff's permission, this offense is not dispositive of the issue of whether M&T Bank obtained a perfected security interest which takes priority over plaintiff's claim... Here, it is clear

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<sup>75</sup> See Revised UCC § 8-511 (b). See also the second paragraph of Article 192, Decree Law 1/99.

that M&T Bank obtained "control" of the GST shares held by M&T Bank pursuant to the security clearance agreement and pledged by FCS in the Agreement. Accordingly, the court finds that M&T Bank did have a perfected security interest in the GST shares in FCS's account".<sup>76</sup>

Thus, the court acknowledged that M&T Bank was indeed an indirect holder with a security entitlement over FCS' securities account, including GST shares.

Next, the court moved to examine such a condition in light of Revised UCC § 8-503(d) and (e)<sup>77</sup> and § 8-511<sup>78</sup>, upon plaintiff's allegations that M&T Bank and M&T Securities could not be considered protected purchasers. Accordingly, the court held:

The amended complaint satisfactorily alleges that M&T Bank acted in collusion with FCS to deprive plaintiff of its entitlement holding. Specifically, the amended complaint alleges that M&T Bank and M&T Securities extended credit to FCS far in excess of the amount provided for in the Agreement, knowing that FCS did not have sufficient assets to cover the increased credit, and by artificially inflating the price of the GST shares in order to recover as much as possible of FCS's debit balance. Moreover, it is undisputed that bankruptcy proceedings have been commenced against FCS, presumably because FCS does not have sufficient shares of GST to satisfy plaintiff's claim. Thus, plaintiff has pleaded valid claims to recover damages against the movants [M&T Bank and M&T Securities] based upon M&T sale of plaintiff's GST shares and retention of the proceeds of sale.<sup>79</sup>

Finally, the court concluded that even if a person has acquired the condition of an indirect holder with a security entitlement, and perfected a security interest over a financial asset, the owner deprived of his rights with respect to that financial

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<sup>76</sup> *Nathan W. Drage v. First Concord Securities, Ltd. et al*, 707 N.Y.S.2d 782, at 785-786.

<sup>77</sup> See Decree Law 1/99, article 181.

<sup>78</sup> See Decree Law 1/99, article 192.

<sup>79</sup> *Nathan W. Drage*, 707 N.Y.S.2d 782, at 787.

asset conserves the privilege to assert a claim against that person if all the requirements of Revised UCC § 8-503(d) and (e) are met. (See section XI)

## **XXII. Enforcement of Securities Pledges**

If the indirect holder defaults on its payment obligation arising from the securities pledge, the perfected security interest of the intermediary extends to all those rights or assets (proceeds) acquired by the indirect holder which are attributable to that security entitlement. Such a benefit, however, seems to be exclusive to securities intermediaries on the basis of margin loans.

Upon default, the securities intermediary must dispose of the pledged rights or assets in accordance with the securities pledge agreement. Failing such agreement, the securities intermediary is permitted to dispose of those pledged rights or assets in the market, without having to appraise their actual value.

In any other case, that is to say, if the secured party is other than the securities intermediary, upon default, the securities pledge can be enforced from the moment in which the secured party obtains direction powers.

## **XXIII. Priority of Secured Parties**

The general priority rule concerning legal pledges over security entitlements provides that if there are two or more credits over the same pledged securities, all secured creditors have equal priority. However, a securities pledge constituted and perfected in favor of a securities intermediary with whom the indirect holder maintains a securities pledge account (cuenta de prenda) has priority against other secured parties with competing interests.

## **XXIV. Repledging Security Entitlements**

The ability of a securities intermediary to repledge security entitlements is recognized under Decree Law 1/99. According to article 194 (final paragraph), a pledgee (secured creditor) can make use of secured rights or assets, in accordance with the securities pledge agreement. Consequently, unless otherwise agreed upon by the parties to the pledge agreement, a pledgee may grant a security interest over pledged rights or assets to secure its own obligation to a third person.

As one commentator has observed, repledge must not to be confused with the more familiar situation in which the debtor (pledgor) grants a security interest in the same property to two secured parties, securing obligations which the debtor has to each.<sup>80</sup> Thus, for example, in *Nathan W. Drage v. First Concord Securities*, since the plaintiff did not grant FCS a security interest in GST shares of stock (for instance, through a margin loan procured by FCS in favor of plaintiff), FCS did not

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<sup>80</sup> See Kettering, *supra* note 64, at 51.

become repledgor of those securities once it granted a security interested in GST shares of stock to M&T Bank.

In defiance of etymology, repledge is often referred to as rehypothecation.<sup>81</sup> Thus, for example, Official Comment 2 to Revised UCC § 8-504 uses this same term. However, since the Panamanian law provides specifically the concept of “securities pledge”, this paper avoids the use of the term “rehypothecation”.

Not surprisingly, the traditional setting for repledge arises from so-called “margin lending”. Securities firms (such as brokerage companies) commonly obtain the funds they need to provide margin loans to their customers from repledging securities to a third party (which is normally a bank). In order to facilitate such a transaction, agreements between margin customers and their brokers normally authorize the broker to commingle securities of all margin customers for repledge to the lender who provides the financing. However, brokers commonly repledge customer securities having a value somewhat greater than the amount of the loan made to the customer, since the lenders who provide the necessary financing to the broker need some cushion of protection against the risk of decline in the value of repledged securities.

Interestingly, there has been virtually no meaningful reported case law on repledge in the United States since the UCC was promulgated. Such a phenomenon, as pointed out by one commentator, is a consequence of repledge historically being a tool used almost exclusively by stockbrokers.<sup>82</sup> As a practical matter, the legal issues arising from a repledge by a stockbroker or any securities intermediary are likely to be litigated only if the intermediary becomes insolvent. If the intermediary is solvent and hence able to produce the customer’s securities on demand, many customers may not know or care what the intermediary does with the securities in the meantime, and any customer who does know and care is apt simply to move her securities to a different intermediary.<sup>83</sup>

To illustrate a typical repledge scenario consider the following example: John purchases 1000 shares of TP common stock through FS, John’s securities intermediary. FS annotates the transaction in John’s securities account, thereby creating a security entitlement on his favor. FS holds these securities through FS’ clearing corporation account. Later on, based on its contract with John, FS grants a margin loan to John by pledging the 1000 shares of TP common stock. To provide such financing FS borrows from a Bank and repledges the 1000 shares of TP common stock. Pursuant to the security agreement, securities are debited from FS’s account and credited to the Bank’s clearing corporation account (assuming in fact that the Bank also holds its positions in the same clearing corporation). Although the transaction between FS and Bank took the form of an outright transfer on the clearing corporation’s books, as between FS and Bank, FS remains a

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<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at 53.

<sup>83</sup> *Id.*

secured party and the Bank obtains a security interest. The clearing corporation, however, is neither a party to the securities pledge, nor to the securities repledge.

## **XXV. Conclusions**

- (1) The indirect holding system provided by Chapter III, Title XI of Decree Law 1/99 is based on Part 5 of Revised UCC Article 8.
- (2) The indirect holding system establishes an utterly new regime of personal property within Panamanian law.
- (3) The indirect holding system under Decree Law 1/99 accomplishes the principal goal of Revised UCC Article 8, namely, to provide a satisfactory framework for analysis of the indirect holding system in investment securities.
- (4) The indirect holding system rules under Decree Law 1/99, like those of Revised UCC Article 8, regulate the complex relationship between private investors and securities intermediaries (such as brokerage companies and clearing corporations) holding and trading securities on their behalf through securities accounts.
- (5) The indirect holding system operates on the basis of basic concepts such as security, indirect holder, securities, direction powers, legitimate person, among others.
- (6) Decree Law 1/99 also creates completely new types of pledge in Panama.
- (7) The constitution, perfection and enforcement requirements of the Panamanian securities pledge provide perfect tools as demanded by dynamic securities markets.
- (8)** The foregoing requirements are more flexible when a securities intermediary becomes a secured party to a securities pledge agreement. This enhanced flexibility is particularly logical and necessary. Securities intermediaries are a key element to the world securities trading markets. Not only they carry out day-to-day securities trading, but often procure and even provide financing to their customers through securities repledge.