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## **TRANSFERRING DEMATERIALIZED SHARES IN GERMANY, AUSTRIA AND IN THE UNITED STATES OF AMERICA**

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**Abstract.** *The present article is aimed at briefly reviewing the historical development of dematerialized shares in Germany, Austria, and in the United States of America (the USA). A brief comparison is made between the dematerialized shares in the United Kingdom and those in Germany and Austria. Further, described are the reasons, which have led to the development of the depository services, on the basis of which the German and Austrian markets built a new system for transferring securities around the fundamental legal analysis, where there is a Central Securities Depository, which keeps in custody the certificates for most of the securities listed on the market.*

*There is a comparison made between the intermediaries and the investors in the German and Austrian law, on the one hand, and in the English law, on the other.*

*Discussed is the reason the securities certificates in Germany and Austria were removed from the transferring process by taking them out of circulation (immobilization), and not through abolishing them (dematerialization).*

*Presented is the development of the most active and liquid capital market in the world — that of the United States Department of the Treasury. There is a brief description made of the System of the conventional paper certificates and the system of the dematerialized securities known as direct holding system, as well as of the System for immobilization and possessing through intermediaries, known as indirect holding system. The Depository Trust Company is specified, as well as its functions. There is a description provided of the concepts “materialized security” and “dematerialized security” pursuant to the Uniform Commercial Code of the USA.*

*In conclusion, there is a short presentation of the currently valid legal status quo related to transferring dematerialized shares in the three countries.*

**Keywords:** *dematerialized shares; securities; paper certificates; dematerialization; Central Securities Depository; direct and indirect holding.*

## Transferring dematerialized shares in Germany and Austria

### *Historical development*

Germany and Austria felt the need to abolish the paper form of transferring securities in the 1930s. Until then, the German and Austrian securities were transferred through physical provision of paper certificates. However, the circumstances in the 1930s prompted the reduction of the need to move around the paper certificates.

Nevertheless, the authors of the reform from the 1930s could have used a law, which was enacted in 1910 and provided the possibility to issue and hold the government bonds as dematerialized securities, the reform did not make use of that model. Instead, it was carried out in line with the legal regulations, which had been existing by then. Prior to the reform, securities were considered tangible assets, while the securities owned through intermediaries, were analyzed under the Property Act for property deposited in custody. The authors of the reform did not change the principle of that analysis; they rather modified the act for depositing property in custody in order to regulate the securities held as common property, which is not distributed individually to a particular person. Securities continued to be classified as tangible assets. The analysis was left untouched, irrespective of the fact that the individual certificates were replaced by global certificates, but it was further extended in order to include the government bonds for which there were no certificates existing.

All the three jurisdictions — of England, Germany and Austria, abolished the need to physically move the paper certificates in the process of transferring. The time when that happened was determined by circumstances beyond the law. However, the law — and in particular, the legal doctrine regulating securities before the reform — determined the way in which that reform was implemented.

Prior to the dematerialization, securities were classified as intangible assets, where after the dematerialization the former principles of analysis were still applied. Securities were still classified as intangible assets, and the procedure for transferring, regulating the dematerialized securities, replaced the procedure existing before that. Dematerialization had no impact either on the securities held through intermediaries. The analysis prior to the dematerialization was that the intermediaries kept the securities in custody in favor of the investors, and that analysis was applied nevertheless whether the securities were held in a materialized or dematerialized form<sup>1</sup>.

<sup>1</sup> Micheler E. *Property Securities. A Comparative Study*. Cambridge University Press, 2007, p. 227–228 (hereinafter only Micheler, E. *Property ...*).

The analysis in the German and Austrian law used to be focused on the securities of a bearer, since the majority of the German companies issued them. However, that was changed over the recent years.

Irrespective of the different doctrinal approach dominant in England, on the one hand, and in Germany and Austria, on the other, there is one important similarity. All the three jurisdictions have found the way to abolish the paper form from the process of transferring securities.

### *Current status*

The majority of the securities under German and Austrian law are issued in the form of documents of a bearer, where those documents are considered tangible assets. In the basis of contemporary German law, there is the theory that the certificates for the securities are paper documents of a very special type. The law, which concerns a paper document, is materialized in the document and, therefore, it can be transferred according to the rules regulating the tangible assets. If a paper document is transferred, the buyer will acquire not only the ownership over the paper document, but also the rights related to it. The term in the German language for the German securities is “Wertpapier” and it is used both in German and Austrian law. The word “Wertpapier” literally means “paper for value”, and the term reflects the fact that the document related to a security epitomizes a valuable right. The term is aimed at reflecting also the theory, which lays the foundations of both German and Austrian securities, i.e., that the rights concerned by the securities certificate and the certificate itself merge and become one single tangible asset. As a result of that, securities, their transferring and the indirect ownership over securities are all subject to the rules regulating the tangible assets.

The analysis adopted by contemporary German and Austrian law appeared somewhat later after securities were used for the first time.

The securities depositories in Germany and Austria emerged as the prevailing type of service provider, which was of assistance to the clients wishing to own securities indirectly. The rules concerning the securities and their transferring — in particular, the rule protecting a buyer from counter claims — fostered the development of this type of service provider on the German and Austrian markets. The fact that the securities were governed by the rules concerning the tangible assets encouraged Germany and Austria to abolish the paper form from the transferring process through immobilization, and not through dematerialization.

In order to facilitate the indirect holding of securities, German and Austrian law elaborated a complex doctrine for joint ownership and co-ownership. That particular form of analysis of the doctrine emerged both in Germany and in Austria because securities were classified as tangible moveable property. This legal analysis provided the regulatory framework where the securities market and the legal regulations

supporting it developed. The analysis influenced the way in which the paper form was eliminated from the transferring process, nevertheless Germany had introduced an alternative system for transferring government bonds, which could have been used as a model for creating a transferring system without using a paper carrier<sup>1</sup>.

### *Indirect holding*

The German and Austrian legal doctrine in respect to securities influenced the type of service provider, which emerged on the German and Austrian markets in order to serve investors, who wanted to own shares indirectly. The process, whereby the paper certificates were eliminated from the transferring process, was formed by the legal doctrinal framework, which directly regulated the owned securities.

The fact that the German and Austrian bearer securities were classified as tangible assets brought the advantage that the German and Austrian rules concerning assignment were no longer applied for transferring. Transferring, instead, was subjected to the rules, identical to those regulating the tangible assets. As a result of that, the acquirer was protected against counter claims. The legal doctrine, where the purchaser of securities is offered protection against counter claims, had a huge impact on the development of the institutional framework, prevailing in Germany and Austria.

The bona fide acquirer becomes owner upon acquiring tenancy over the securities. That rule had a substantial influence on the way in which investors held securities certificates in Germany and Austria. Unlike England, where the securities certificates did not need to be deposited in custody, because the owners would not lose their rights if those certificates were stolen and then transferred to a third party, any investor under the German and Austrian law had to keep the securities certificates out of circulation, so that a third party would not be allowed to acquire tenancy over them, and, subsequently — ownership over the bearer securities.

The paper certificates should be kept in a safe place, and that need of depositing in custody facilitated an important development in Germany and Austria. It created a demand for depository services, and that demand was met by the German and Austrian banks, which developed the activity of depositing securities in custody for investors as a separate branch of its commercial activities.

Instead of renting out deposit boxes or safe deposit boxes to individual investors, banks initially took the securities certificates and kept them in custody for the respective clients. The banks kept separate files for every client; the paper documents were not physically held by the investors, nevertheless, they were distributed for each of them. The German, and Austrian depository services for securities are an

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<sup>1</sup> Micheler E. *Property in Securities. A Comparative Study*. Cambridge University Press, 2007, p. 145–147 (hereinafter only Micheler, E. *Property ...*). Regarding the rules regulating securities in contemporary German and Austrian law, see p. 165 and the following.

example how a doctrine can foster the emergence of certain types of infrastructure providers. Similarly, just like the English law on novation facilitated the advent of registrars in England, the German and Austrian doctrine, protecting buyers against counter claims, favored the emergence of depositories in those countries<sup>1</sup>.

The German and Austrian rules, safeguarding buyers against counter demands, issuing from unlawful transferring, prompted the need for investors to prevent any disappearance of their documents. That led to a demand for depository services on the German and Austrian markets. That demand was met by the German and Austrian banks, which elaborated specialized depository services. The doctrinal framework, regulating the paper transferring of securities, influenced the way in which the paper certificates were removed from the transferring in Germany and Austria. The legal doctrine, which provides the ground for securities in both jurisdictions, is based on the normative presumption that the special rules regulating securities transferring are applied because securities are tangible assets. Hence, the legal experts drew the conclusion that if securities were not classified as tangible, those specific rules could not be applied. Securities transferring, instead, should have been governed by the laws for assignment. In order to prevent that, it was possible to elaborate a special regime, which was to be applied for securities transferring, nevertheless how they were classified. Besides, it would have been possible both for the German and Austrian law to refer to the rules, which had existed for the government bonds, for which there were no paper certificates.

That option, however, was not the preferred one. The securities certificates, instead, were eliminated from the transferring process by taking them out of circulation (immobilization), and not through abolishing them (dematerialization). The prevailing point of view was that it was essentially important that the legal analysis governing the paper certificates be further applied, even though in an environment, where paper certificates no longer fulfilled their original function for transferring the rights embodied in them. As a result of that, the German and Austrian markets introduced the central securities depositories<sup>2</sup>.

Unlike England, which chose to transfer dematerialized securities, Germany and Austria preferred their immobilization. The relationship between intermediaries and investors is followed in respect to depositing property in custody according to the German and Austrian law. Investors are considered co-owners of the indirectly held papers; moreover, they jointly possess the securities certificates deposited with the Central Securities Depository. That is opposite to the position adopted in the

<sup>1</sup> Micheler E. Op. cit. p. 182–183.

<sup>2</sup> Ibid. P. 192. For more details about the process, which led to taking securities out of circulation (their immobilization) in Germany and Austria and the legal analysis of that process, see pp. 193–215.

English law, where the relations with the investors, who hold securities indirectly, is governed by the Custody Act.

The co-ownership interest in indirectly owned securities is transferred through registration in the books of the intermediary, who keeps the securities. That registration is classified by law as including transferring the tenancy over the securities certificates from the seller to the buyer.

The buyers of indirectly owned securities are protected against counter claims issuing from unlawful transferring, on the basis of the same rules, which protect the buyers of directly held securities in the German and Austrian law. Irrespective of the fact that the investors have a co-ownership interest within the total amount of securities, kept at the Central Securities Depository, a bona fide buyer can rely on the rules protecting a buyer of a tangible asset against unlawful transferring. The situation in the English law is less clear. The rules regulating materialized securities were not forbidden when dematerialized securities were introduced in England. It is still unclear, however, whether and to what extent the rules protecting the buyers of materialized securities provide protection to the buyers of dematerialized securities.

At the same time, none of the jurisdictions did create a completely new legal regime, which would facilitate securities transferring carried out without the need of moving the paper certificates. Instead of that, the rules existing in all the three jurisdictions governing transferring through the use of a paper carrier were modified in order to address transferring without the use of a paper carrier. Furthermore, the legal norms regulating transferring through the use of a paper carrier had a major impact on the institutional formation used in order to regulate transferring in a dematerialized form.

The analysis in the German and Austrian law is focused on the securities of a bearer, since most of the German companies used to issue them. This, however, started to change over the recent years. Some big companies, listed on the stock exchange in Germany, have replaced the bearer stocks with registered ones, where that change has been prompted by the globalization. The reason for that change was that the companies in question wanted to be able to get registered directly on the **New York Stock Exchange — NYSE**. NYSE, however, lists only registered stocks. In order to be able to issue the same type of stocks to the investors in the USA, as well as to the German investors, the German issuers decided to issue registered shares, instead of shares of a bearer both on the US and on the German stock markets. The German legislation supported that change by reforming the legal regulations for the registered shares, which have been traditionally represented in the German Companies Act (*Aktiengesetz*).

That act requires from the German companies issuing registered shares to keep a shareholder's registry. At the same time, the act related to that registry was updated, where the changes made included also a change in the German legal

terminology. Prior to the reform, the share registry was called “the book of shares” (Aktienbuch). This term was abandoned in the reform process and was replaced by the term “registry of shares” (Aktienregister). The explanatory notes to the revised legislative act explicitly state that this terminology was chosen to reflect more accurately the English term for a “registered share”.

The German settlement system helped the German companies in the transition from bearer shares to registered shares by introducing an option allowing the small-scale investors to list their names in the share registry, nevertheless whether they own those shares through a chain of intermediaries or not. That development is an example of convergence (alignment). German law has changed to align with the prevailing international standard to enable the German issuers to be competitive on the global market.

It should be pointed out that the reform did not change the already existing legal doctrine. The bearer shares were replaced by registered shares to ensure compliance with the American market practice. The share registry was renamed so that it should reflect the English language use. None of those changes, however, had an impact on the doctrinal analysis of share transferring. The reform was carried out in line with the prevailing doctrine in the German law about ownership and it did not change the legal nature of the German shares. Besides, that reform did not change the analysis of the transferring process. The German registered shares, as well as the German shares of a bearer, are also considered tangible assets. In order to be transferred via the German settlement system, they should be endorsed. That endorsement transforms the registered shares into bearer shares, whereupon their transferring is governed by the same rules, which regulate all the other bearer securities. The certificates for the registered shares are deposited with the Central Securities Depository. Just like with the bearer shares, the rules about the tenancy over those securities certificates determine the time when the buyer becomes owner of the registered shares, and irrespective of the change in the name, listing in the German share registry does not turn the respective holder of a share into an owner of the shares.

### **Conclusion**

Securities are classified as tangible assets both in the German and in the Austrian legal doctrines, while their transferring is governed by the same rules as those for the tangible assets. This analysis is supported by the theory that the paper certificates traditionally issued for securities epitomize the rights related to the certificates. The analysis was developed towards the end of the nineteenth century and became an orthodox theory, predominant in Germany and Austria after the German provinces and Austria adopted the rules protecting the bona fide buyers against unlawful issuing.

According to the German and Austrian law, a buyer should acquire tenancy over the securities certificate in order to become an owner of the certificate and the rights



related to it. A buyer of securities is protected against counter claims resulting from unlawful transferring in the same way as a buyer of tangible moveable property; there is also a rule protecting the buyer against claims resulting from improper issuing.

Both in the German and in the Austrian law, the rule protecting a buyer of securities from unlawful transferring requires that the risk in such transferring should be borne by the securities owner, who would lose his/her rights when a benevolent buyer acquires tenancy over the securities documents against payment of the respective value. As a result of that, there is a need of keeping the documents in custody under the German and Austrian law, which facilitates the emergence of depositories in both jurisdictions.

The theory underlying securities and their transferring in the German, as well as in the Austrian law, had a major impact on the way in which the paper certificates were abolished from securities transferring in both countries.

The theory presents the regulatory principle that the rules protecting the investors from counter claims resulting from unlawful transferring are applied only because the securities are classified as tangible. If securities were classified as intangible, investors would not have been protected against non-permitted transferring. When processing the paper certificates became too cumbersome, it was considered reasonable on the German market not to adopt an entirely new regime; instead, it was decided that the previous legal analysis should remain unchanged. Securities were further classified as tangible assets, however, paper documents, representing the securities, were immobilized. The German and Austrian markets developed a new system of transferring around the fundamental legal analysis.

There is the Central Securities Depository, which keeps in custody the securities certificates for most of the German securities listed on the market. Clients usually own the securities through sub-custodians, who have accounts at the Central Securities Depository, while the relationship between the clients and their depositories is analyzed in the light of providing one's property for keeping in custody. It is not considered that the depositories have property rights over the clients' securities; they are only intermediaries in the tenancy between their clients and the securities certificates, which are kept by the Central Securities Depository. The investors are considered co-owners and joint-tenants of the securities held at the Central Securities Depository. The ownership over those securities is to be transferred by registering, which, however, under the doctrine is classified as including transferring of the joint tenancy from the seller to the buyer. The buyer is protected against counter claims, which may result from unlawful transferring or improper issuing<sup>1</sup>.

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<sup>1</sup> *Micheler E. Op. cit. Pp. 216–221.*



## Transferring dematerialized shares in the United States of America

### *Historical development*

On a global scale, dematerialized investment securities appeared much earlier and were related to the process of the so-called dematerialization. The necessity of their introduction was a result of piling heaps of paper in the stock markets in the United States of America (USA) and their difficult processing — a phenomenon called “paper crunch”. Dematerialized securities were officially introduced in the USA with the Uniform Commercial Code (UCC) back in 1977. They are regulated there as uncertificated securities, or those are investment securities for which there is no certificate issued to represent them, and their transferring is done through registration in books kept for this purpose by or at the expense of an issuer. § 8–102 from UCC, definitions (15) and (18).

For more than 30 years the largest, most active and most liquid market in the world, that of the United States Department of the Treasury, was in a process of on-going abolishment of securities’ physical certificates. There are several milestone years illustrating that process:

In 1968 were adopted provisions authorizing the first “book-entry” procedures. The “Book-entry System” is the system for carrying out and registering the issuing and dealing with dematerialized shares;

In 1979, all the new treasury bills were issued only in a dematerialized form;

In 1985, the Federal National Mortgage Association started applying the “book-entry” system;

In 1986, all the new treasury bills and bonds were issued in a dematerialized form;

The market for the most liquid of the instruments on the cash market in the USA — the federal funds emerged since both borrowers and lenders were looking for ways to make use of the opportunities, provided by the trade with reserve funds. The trade with federal funds started in the 1920s and involved only several banks, members of the Federal Reserve, which were based in New York. Nowadays, that market includes more than 14 000 commercial banks and a wide range of non-bank financial institutions. The characteristics of the federal funds, as well as the mechanisms of their purchase and sale, reflect most accurately the needs of the players on the contemporary capital market<sup>1</sup>.

On a global scale, those markets, which are most efficient, will obtain competitive advantage and a dominant position in the actual formation and distribution of the investment products. From a historical perspective, the USA is a leader and innovator

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<sup>1</sup> Donald R. Fraser and Peter S. Rose. *Financial Institutions and Markets in a Changing World*, third edition, BPI, USA, 1987 ..., p. 277. More about the federal fund market. p. 277–284 (hereinafter only Donald R. Fraser and Peter S. Rose., *Financial...*).

in the field of dematerialized securities. Nevertheless, there are other competitors gaining momentum on the market of dematerialized financial instruments. The Euro has created potential for major competition within the European Economic Union, where the links between the separate countries and unions are formed with a head-spinning speed. Furthermore, some later emerging players on the capital market are making quick transition towards securities dematerialization. Among such countries are Australia, the Republic of South Africa and India.

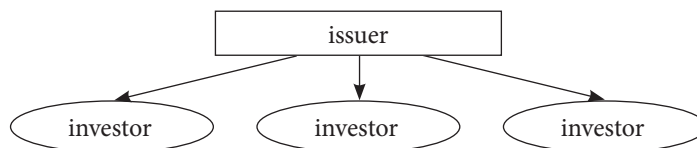
### *Current status*

Transferring dematerialized shares in the USA is governed by Art. 8 of UCC, which regulates ownership and transferring securities and other financial assets. The provisions of Art. 9 of the UCC are related to securing those assets. Art. 8 and Art. 9 are part of the numerous legal norms of the US regulatory basis governing securities and investment assets. Article 8 settles with its content the transactions with securities, the relations between the issuers, investors, intermediaries, and sellers and their buyers. Articles 8 and 9 from the current version of the UCC are adopted by all the fifty states and the District of Columbia. UCC — Art. 3 regulates the ownership and transferring of negotiable instruments (securities), for which there can be established and owned rights over securities through the indirect holding system under Art. 8<sup>1</sup>.

### *Direct and indirect holding systems*

The system of immobilization and possessing through intermediaries does not entirely replace the system of dematerialized securities, and none of those systems does entirely replace the system of direct holding and the provision of conventional certificates on paper. Article 8 of the UCC contains the legal regulations for all the three systems. The system of the conventional paper certificates and the system of the dematerialized securities are known as *direct holding system*. The system for immobilization and possessing through intermediaries is known as *indirect holding system*.

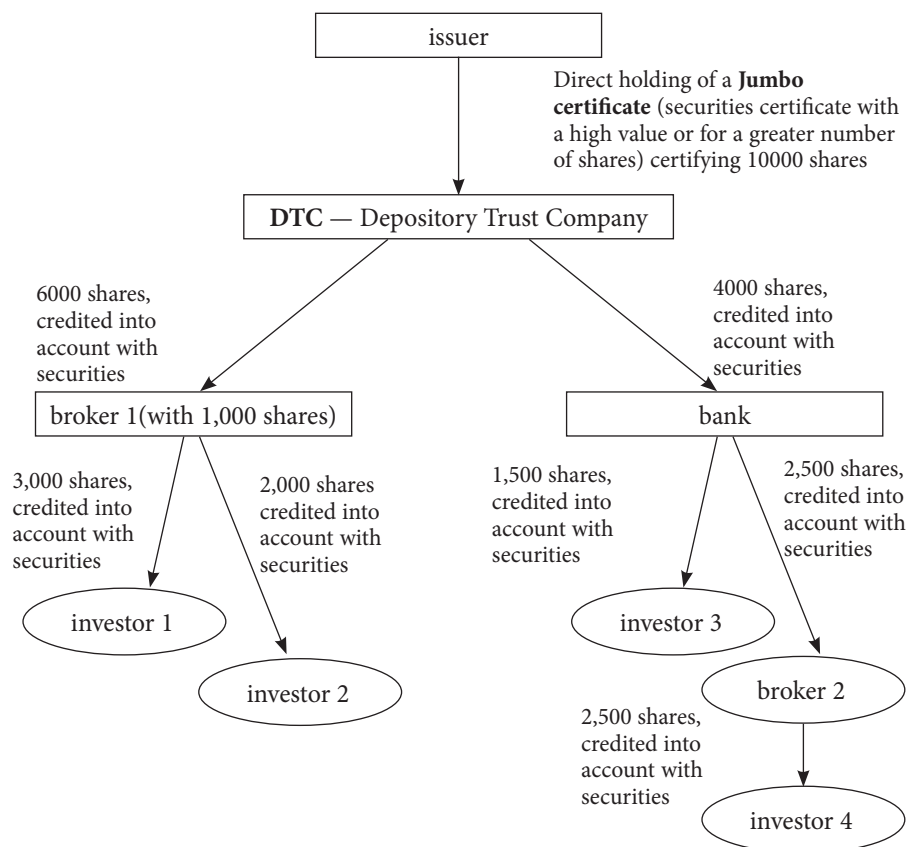
With the direct holding system, each investor is registered as an owner of the security in the issuer's registries, which are often kept by a transferring agent. This can be illustrated by figure 1.



**Figure 1.** *Direct holding system*

<sup>1</sup> Bjerre C. and Rocks S. The ABCs of the UCC. Article 8, Investment securities, 2004, p. 1–4 (hereinafter only Bjerre, C. and Rocks, S. The ABCs ...).

With the indirect holding system, most of the investors have no direct connection and do not communicate directly with the issuer, but they own their investment through intermediaries. The indirect holding system is not entirely independent of the direct holding system: in the case with the securities. The legal entity, which is at the top of the indirect holding chain, communicates with the issuer from the direct holding system. The relation between the two systems, as well as the relationships within the indirect holding system, can be illustrated by figure 2.



*Figure 2. Indirect holding system*

**The Depository Trust Company — DTC**, is the clearing organization for the majority of the publicly traded corporate capital securities, corporate debt securities and municipal debt securities, and its representative is usually Cede & Co. It was established in 1973 with the main goal to reduce the costs on the securities

transactions, as well as to carry out their clearing and settlement by immobilizing securities and transferring securities holding by book entry movement<sup>1</sup>. Some of the services, which that institution offers are:

- custodian services; securities clearing and settlement;
- asset management, including services related to depositing securities and services related to dividend payment.

The securities (or other financial assets) are shares from the capital of a corporation, where investor 1 has the right of collateral for those shares, credited into his/her securities account kept with broker 1. Broker 1, in turn, is in the same relationship with the DTC, which is the registered owner of the shares in the books of the computer corporation.

### *Scope of the two systems*

The direct holding system is applied only for securities, while the indirect holding system has a wider application and comprises securities as well as other financial assets. The definition for a *security*, presented in § 8–102 of the UUC supported by § 8–103 of the UCC differs substantially from the security definition used in the federal securities acts.

It is important to quote part of the provision of § 8–102, namely § 8–102 (1) of the UCC, directly concerning the above discussed question:

"A materialized security," means an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer: which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer; which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and which: is, or is of a type, dealt in or traded on securities exchanges or securities markets; or is a medium for investment".

"Uncertificated (dematerialized) security" means a share, participation or another other interest in an issuer or in property or an enterprise of an issuer, or an obligation of an issuer, which is not represented by a security certificate, where the transfer of which shall be registered upon books maintained for that purpose by or on behalf of the issuer; which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and which: is, or is of a type, dealt in or traded on securities exchanges or securities markets; which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

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<sup>1</sup> [www.dtcc.com/about/subs/dtc.php](http://www.dtcc.com/about/subs/dtc.php)

“A security” may be materialized or dematerialized. If it is materialized, the terms “security” and “materialized security” may mean either an intangible interest, or the document representing that interest, or both, as required by the context. The present article, and not article 3 regulates the written document, which is a materialized security, nevertheless, the document in question meets the requirements of the latter article as well. The present article does not concern money. If a security is detained by or delivered to an issuer or his/her transferring agent due to reasons other than registering of transferring, another temporary purpose, payment, replacement or acquisition by an issuer, such a security shall be treated as a dematerialized security for the purposes of the present article.

A materialized security is in a “registered from” if it nominates a person, who is entitled to the security or to the rights it represents and its transferring may be registered upon books maintained for that purpose by or on behalf of the issuer, or if that is specified in the security.

A materialized security is in a “bearer from” if it belongs to the bearer according to its terms, but not by reason of an additionally registered endorsement.

### *Summary*

The individual shareholders in the USA certify their ownership right in a business company through the shares acquired by them from its capital. The ordinary share capital entitles the holder to take part in the company control having right to one vote for each share listed in the registry, as well as to an interest in the profits in the form of dividends and to participate in the distribution of the net assets in case of a company dissolution upon satisfying the creditors. There are also classes of share capital, such as preferential shares, which are superior to the ordinary shares in respect to dividends and the distribution of the net assets with a company's dissolution.

By exercising their right to vote, the shareholders choose the directors of the business company and thus exert indirect control over its activities. They are entitled to receiving information about the company's activities by reviewing its books. The shareholders can keep their percentage of votes controlling whether the company shall emit any additional amounts of shares from its capital by exercising their right to preferential buyout. They are entitled to prosecute a claim on behalf of the company for damages incurred upon it if, at a request by them, the company refuses to do so<sup>1</sup>.

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<sup>1</sup> Ronald A. Anderson, Ivan Fox and David P. Twomey. *Buseness Law, South — Western publishing CO., USA, 1987*, p. 860–861. For more about share capital, transferring of shares and shareholders' rights and obligations, see pp. 839–863.

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