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# **Intermediated securities**

## **Call for evidence**

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**August 2019**

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**Law  
Commission**  
Reforming the law

# **Intermediated securities Call for evidence**



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# THE LAW COMMISSION – HOW WE CONSULT

**About the Law Commission:** The Law Commission was set up by section 1 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law. The Law Commissioners are: The Rt Hon Lord Justice Green, Chair, Professor Nicholas Hopkins, Stephen Lewis, Professor David Ormerod QC, Nicholas Paines QC. The Chief Executive is Phillip Golding.

**Topic of this call for evidence:** Intermediated securities. This call for evidence seeks consultees' views about, and evidence of, their experience of the intermediated securities system.

**Team working on the project:** The following members of the Commercial and Common Law team have contributed to this call for evidence: Laura Burgoyne (team manager); Siobhan McKeering (team lawyer); Theodora Papadopoulou (research assistant).

**Geographical scope:** This call for evidence considers the law of England and Wales.

**Availability of materials:** The call for evidence is available on our website at <https://www.lawcom.gov.uk/project/intermediated-securities/>.

**Duration:** We invite responses from 27 August 2019 to 5 November 2019.

## Comments may be sent:

Using an online form at <https://consult.justice.gov.uk/law-commission/intermediated-securities> (where possible, it would be helpful if this form was used).

## Alternatively, comments may be sent:

By email to [int-sec@lawcommission.gov.uk](mailto:int-sec@lawcommission.gov.uk).

By post to Commercial and Common Law Team, Law Commission, 1st Floor, Tower, 52 Queen Anne's Gate, London, SW1H 9AG.

(If you send your comments by post, it would be helpful if, whenever possible, you could also send them electronically.)

**After the call for evidence:** We will use the views and evidence received during this call for evidence to assist us in formulating our scoping study, which will be published in autumn 2020.

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## GLOSSARY

Term	Definition
<i>Bonds</i>	A type of debt security (see also “debt securities”).
<i>Central securities depository (“CSD”)</i>	an electronic register on which securities are registered.
<i>CREST</i>	The central securities depository in the United Kingdom.
<i>Debt securities</i>	Investment securities which embody an obligation on the issuing company to repay a debt to the holder of the security.
<i>Dematerialisation</i>	The issue of securities by companies without paper certificates to evidence title. A dematerialised security is represented by an entry in an electronic register.
<i>Equity securities</i>	Investment securities which give the legal owner of the security economic and corporate rights in relation to the company.
<i>Headcount test</i>	The requirement under section 899 of the Companies Act 2006 that a scheme of arrangement must be approved by a majority in number of the creditors or members (or class of creditors or members) who vote on the compromise or arrangement.
<i>Investment platform</i>	An online tool or service that facilitates the purchase and sale of securities.
<i>Intermediary</i>	An individual or, more commonly, an organisation which holds an interest in investment securities on trust for another, who may be another intermediary or the ultimate investor.
<i>Issuing company</i>	The company which issues the investment securities.
<i>Majority in number requirement</i>	See “headcount test”.
<i>Majority in value requirement</i>	The requirement under section 899 of the Companies Act 2006 that a scheme of arrangement must be approved by a majority of creditors or members (or class of creditors or members) representing 75% in value of the creditors or members (or class of creditors or members) who vote on the compromise or arrangement.
<i>No look through principle</i>	The principle that an ultimate investor may only bring an action against its immediate intermediary and not against the issuing company or intermediaries higher in the chain.

<b>Term</b>	<b>Definition</b>
<i>Pooled or omnibus accounts</i>	Accounts which are used to hold the securities of more than one investor in one place (in contrast to “segregated or designated accounts”). <sup>1</sup>
<i>Proxy advisor</i>	An organisation hired by investors (such as institutional investors) to give advice or recommendations to investors on how to vote.
<i>Proxy agent</i>	An organisation hired by investors (such as institutional investors) to manage the voting process and pass votes to the custodian or registrar.
<i>Right to set off</i>	Where there have been mutual dealings between A and B, A has a right to rely on debts due to B as a form of security covering B’s debts to A. For example, A has a money claim against the company, and the company has a money claim against A, one claim can be set off against the other. <sup>2</sup>
<i>Scheme of arrangement</i>	A binding compromise or arrangement between a company and its creditors or members approved by a meeting of creditors or members and sanctioned by the court under section 899 of the Companies Act 2006.
<i>Segregated or designated accounts</i>	Accounts which only hold the assets of a particular investor (in contrast to pooled or omnibus accounts). <sup>3</sup>
<i>Shares</i>	A type of equity security (see also “equity securities”).
<i>Shortfall</i>	In the context of this paper, a shortfall occurs when an intermediary does not have sufficient securities in a pooled or omnibus account to satisfy claims made by its account holders.
<i>Ultimate investor</i>	The person with the ultimate economic interest in investment securities, at the end of an intermediated securities chain. An ultimate investor may be an individual, an institution holding securities on its own behalf, or a fund which manages investments on behalf of individuals or corporate bodies.

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<sup>1</sup> BIS, “Exploring the intermediated shareholding model” (2016), p 10, [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/489357/bis-16-20-intermediated-shareholding-model.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/489357/bis-16-20-intermediated-shareholding-model.pdf).

<sup>2</sup> I Fletcher, *The Law of Insolvency* (5th ed 2017) para 23-021. See also *Bailey & Groves: Corporate Insolvency – Law & Practice* (5th ed 2017) para 26.45.

<sup>3</sup> BIS, “Exploring the intermediated shareholding model” (2016) p 12.

# Chapter 1: Introduction and background

## ABOUT OUR WORK ON INTERMEDIATED SECURITIES

- 1.1 Shares and bonds are increasingly held through a system of “dematerialisation” and “intermediation”. In other words, while an investor traditionally held paper certificates directly from the issuing company, it is now more common for investors to “own” their interest in securities through computerised credit entries held through a chain of intermediaries. In this model, the ultimate investor is not the legal owner of the securities.
- 1.2 This system has made trading quicker, cheaper and more convenient. However, it has been the subject of criticism over issues of corporate governance and transparency. There is also uncertainty as to the legal redress available to investors in certain situations.
- 1.3 In June 2019, the Department for Business, Energy & Industrial Strategy (“BEIS”) asked the Law Commission to undertake a one-year scoping study into the intermediated system. Our full terms of reference are set out in Appendix 1.
- 1.4 The scoping study will provide an accessible account of the law. It will also identify the corporate governance and other legal issues associated with intermediated securities, with an assessment of whether these issues cause difficulties in practice. We will consider the effect of intermediated securities on both retail investors and institutional investors. Our project is intended to inform public debate, develop a broad understanding of potential options for reform and seek a consensus about issues to be addressed in the future. It will not offer formal recommendations for reform.
- 1.5 We understand that the Government is bringing forward plans to transpose Chapter 1a of the revised EU Shareholder Rights Directive II (“SRD II”)<sup>4</sup> by the deadline of 3 September 2020. SRD II applies to companies with voting shares being traded on EU-regulated markets. Chapter 1a and our scoping study consider similar issues, including the identification of shareholders, transmission of information and facilitation of shareholder rights. However, our work will be carried forward separately from the Government’s immediate work on the transposition. SRD II defines “shareholders” in accordance with the law of the member state in which the company has its registered office. In the UK, this means the member on the register of members of a UK company (not the ultimate investor). We have been advised that the UK transposition will be carried out on this basis.

### Previous work on intermediated securities

- 1.6 This is not the first time that intermediated securities have been subjected to formal scrutiny with a view to reform. In 2004, the Financial Markets Law Committee published a report which included detailed proposals for legislation addressing

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<sup>4</sup> Shareholder Rights Directive II 2017/828/EU, Official Journal L 132 of 20.05.2017 p 1.

intermediated securities.<sup>5</sup> Subsequently, between 2006 and 2008 the Law Commission analysed the UNIDROIT Convention on Substantive Rules for Intermediated Securities and provided a series of advices to HM Treasury on the issues raised by the Convention.<sup>6</sup>

- 1.7 In 2014 we also published a report on the *Fiduciary Duties of Investment Intermediaries*, in which we referred to some of the issues arising in relation to intermediated securities chains.<sup>7</sup>
- 1.8 More recently, in 2016, the then Department for Business, Innovation & Skills (“BIS”) published a research paper on *Exploring the Intermediated Shareholding Model*.<sup>8</sup> This research paper provided a review of intermediated securities chains, considering in particular ownership and voting. It also identified weak links in these chains.
- 1.9 Alongside these official papers, we have also paid particular regard to the work of the Commercial Law Centre at the University of Oxford, which, through a series of academic workshops, has produced a collection of articles on *Intermediation and Beyond*.<sup>9</sup>

## ABOUT THIS CALL FOR EVIDENCE

- 1.10 This call for evidence is the first step in the intermediated securities scoping study. Its primary function is to seek views about, and evidence of, stakeholders’ experiences of the intermediated securities system.
- 1.11 In this introductory chapter, we set out the background to intermediated securities: what they are and how they are held and recorded, as well as their advantages. We explain what we are seeking to achieve from this call for evidence and how the information obtained will be useful in our scoping study.
- 1.12 In Chapter 2, we discuss specific issues arising in relation to intermediated securities. We invite observations and evidence as to whether these issues create problems in practice, and thoughts as to potential solutions. We ask consultees for their views on the role that technology could play in the future operation of the investment securities

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<sup>5</sup> Financial Markets Law Committee, “Issue 3 – Property interests in investment securities” (July 2004), [https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc\\_report.pdf](https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf). All websites and electronically available materials referenced in this document were last accessed on 16 August 2019.

<sup>6</sup> Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Interim Advice* (October 2006); Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Updated Advice to HM Treasury* (May 2007); and Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008). This Convention has been ratified only by Bangladesh and is not yet in force.

<sup>7</sup> *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350 paras 11.105 onwards. We also touched on these issues in a further report, *Pension Funds and Social Investment* (2017) Law Com No 374.

<sup>8</sup> BIS, “Exploring the intermediated shareholding model” (2016).

<sup>9</sup> L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) and L Gullifer and J Payne (eds), *Intermediated Securities: Legal Problems and Practical Issues* (2010). These books each comprise a series of articles written by different authors. To avoid repetition, when we refer to these articles in this call for evidence, we do not refer to the name of the article each time.

markets. We also ask whether there are other jurisdictions that provide examples of good practice and whether there are particular considerations in relation to the UK's devolved jurisdictions.

- 1.13 Finally, we ask consultees whether there are additional issues or problems which we should consider in the scoping study, and ask for estimations as to the benefits and costs of any possible changes.

## NEXT STEPS

- 1.14 Prior to publication of this call for evidence, we spoke to a small number of stakeholders representing a range of interests in the intermediated securities system. We look forward to engaging further with stakeholders as the project progresses.
- 1.15 This call for evidence runs until 5 November 2019. We will analyse responses from consultees and use these to inform our scoping study which will be published in autumn 2020.

## AN INTRODUCTION TO INTERMEDIATED SECURITIES

- 1.16 Intermediated securities are investment securities which are held through a chain of intermediaries between the company issuing them and the person who has the ultimate economic interest in the securities.

### Terminology

- 1.17 In this paper, we call the person with the ultimate economic interest in the securities the “ultimate investor”. An ultimate investor may be an individual (such as a retail investor), an institution holding securities on its own behalf, or a fund (such as a pension fund) which manages investments on behalf of individuals or corporate bodies.<sup>10</sup> While there may be some differences in policy considerations depending on the type of ultimate investor, their legal position is the same in respect of the securities and there is unlikely to be a reason to distinguish between them in the context of any future reform. We consider that our summary of legal issues, set out below, applies to all types of ultimate investor, and intend that our scoping study will be of general application.

- 1.18 Throughout this paper, we refer to the issuer of investment securities as “the company”.<sup>11</sup>

### What are investment securities and how are they held?

- 1.19 Investment securities (which we refer to simply as “securities” in this paper) play an important role in corporate finance. They can be divided into two categories:<sup>12</sup>

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<sup>10</sup> L Gullifer and J Payne, “Introduction” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 10.

<sup>11</sup> Our project does not cover investment securities issued by governments.

<sup>12</sup> M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-001 and Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 2.1. We are aware that there is discussion as to whether crypto assets should be considered to be investment securities. This project does not consider this

- (1) debt securities, such as bonds, which embody an obligation on the company to repay a debt to the holder of the security; and
- (2) equity securities, such as shares, which give the legal owner of the security economic and corporate rights in relation to the company.

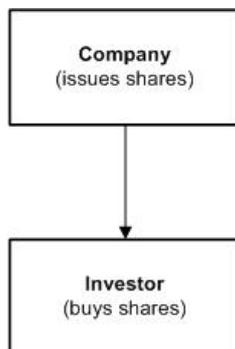
1.20 Traditionally, securities could be held in two ways:<sup>13</sup>

- (1) they could be embodied in a piece of paper (such as in the case of bearer notes) and owned by the holder of the paper; or
- (2) they could be represented by a piece of paper (such as in the case of shares) and registered. The piece of paper would be evidence of legal title but legal ownership would be conferred by the entry in the register.

1.21 Over the last several decades, the way in which securities are held by investors has moved towards dematerialisation, which allows companies to issue securities without a paper certificate to constitute or evidence them.<sup>14</sup> A dematerialised security (also known as an “uncertificated security”) is represented instead by an entry in an electronic register and is transferred by amending the register. As we discuss below, the legal owner is whoever is listed on the register. With dematerialisation has come increasing intermediation.

### What are intermediated securities?

1.22 When an investor buys shares issued by a company, the investor may consider that the relationship would look like the following diagram:



1.23 However, the situation is more complex where dematerialisation and intermediation are involved. As we set out above, dematerialised securities are not issued with a paper certificate. Instead, they exist as entries on an electronic register called a “central securities depository” (“CSD”).

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question. However, further work on intermediated securities should take crypto assets and their features into consideration.

<sup>13</sup> M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-035 and Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 2.2.

<sup>14</sup> See *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350 para 11.107 and The Group of Thirty, *Clearance and Settlement in the World’s Securities Markets* (1989). See also Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 2.6.

- 1.24 CREST is the only CSD in the UK. It settles securities in dematerialised form. Unlike CSDs in most other jurisdictions which operate this system, CREST has no proprietary rights in securities and it is not treated as “holding” securities for the company.<sup>15</sup> Rather, CREST operates a register, which confers legal title on the person or entity named in the register. Each member on the CREST register holds directly from the company, is the legal owner of the securities and is the shareholder (or “member”) for company law purposes.<sup>16</sup>
- 1.25 CREST members are often bodies such as banks, brokers and other financial institutions.<sup>17</sup> It is possible for an individual to have a CREST membership but, in reality, very few individuals are entered on the CREST register.<sup>18</sup>
- 1.26 Securities holdings in the UK are highly intermediated. CREST members are often intermediaries known as “custodians”, and they may pool the securities they hold for various other intermediaries in a single account (we discuss these “pooled”, or “omnibus”, accounts below).<sup>19</sup> CREST account holders may hold some or all of their securities on behalf of their own customers, who form a second tier. These second-tier customers may, in turn, hold on behalf of their own account holders and so on, leading to what may be a long chain of intermediaries between the issuing company and the ultimate investor.
- 1.27 As we discuss below, as the legal owner of the securities, the CREST member alone is entitled to exercise voting, dividend and other rights attaching to the shares and may do so directly against the company. Down the chain, each customer’s relationship is with its own intermediary, not with the CREST member or with the issuing company.

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<sup>15</sup> Most advanced economies rely on a CSD to hold physical and dematerialised securities. Typically, although not in the UK, the CSD is the first holder in a chain. Only the CSD has a direct relationship with the company which issues the securities. The CSD holds on behalf of its “account holders”, who may be banks, corporations or foreign CSDs, who may in turn hold some or all of their securities on behalf of their own customers.

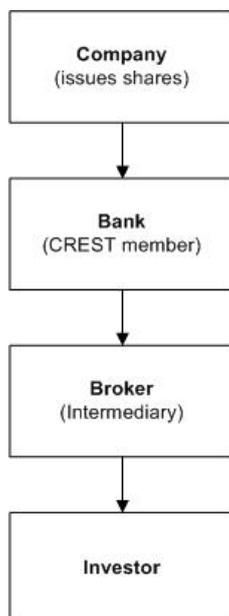
<sup>16</sup> Uncertificated Securities Regulations 2001, SI 2001 No 3755, reg 24.

<sup>17</sup> Trusts cannot be entered on the CREST register: SI 2001 No 3755, reg 23(3).

<sup>18</sup> C Twemlow, “Why are Securities Held in Intermediated Form?” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) pp 86, 87, fn 6. The author says that as of April 2018, the total value of holdings of individuals on the CREST system was £1.3 billion. The value of corporate holdings was approximately £5.3 trillion. The number of individuals holding securities directly through CREST has decreased from approximately 50,000 members in 2003 to 5,400 members in 2018. Even where an individual is a CREST member, some intermediation may be inevitable as they need a broker to access the market: C Twemlow, *Intermediation and Beyond* (2019) p 93.

<sup>19</sup> See paras 1.34 to 1.36 below.

- 1.28 For example, an investor may hold shares in a company through a broker. The broker may have an account with a bank or financial institution, which is the CREST member. The following diagram depicts the chain of interests:



### A series of trusts

- 1.29 In order to understand how ultimate investors are affected by an intermediated securities chain, it is important to consider the legal basis of the relationships between the parties on the chain. We also need to consider the nature of their interest in the securities.
- 1.30 The courts have categorised these arrangements as a “series of trusts and sub-trusts”.<sup>20</sup> As Mr Justice Briggs (as he then was) said in *Re Lehman Brothers International (Europe) (in administration)*:<sup>21</sup>

It is common ground that a trust may exist not merely between legal owner and ultimate beneficial owner, but at each stage of a chain between them, so that, for example, A may hold on trust for X, X on trust for Y and Y on trust for B. The only true trust of the property itself (ie of the legal rights) is that of A for X. At each lower stage in the chain, the intermediate trustee holds on trust only his interest in the property held on trust for him. That is how the holding of intermediated securities works under English law, wherever a proprietary interest is to be conferred on the ultimate investor. In practice, especially in relation to dematerialised securities, there may be several links in that chain.

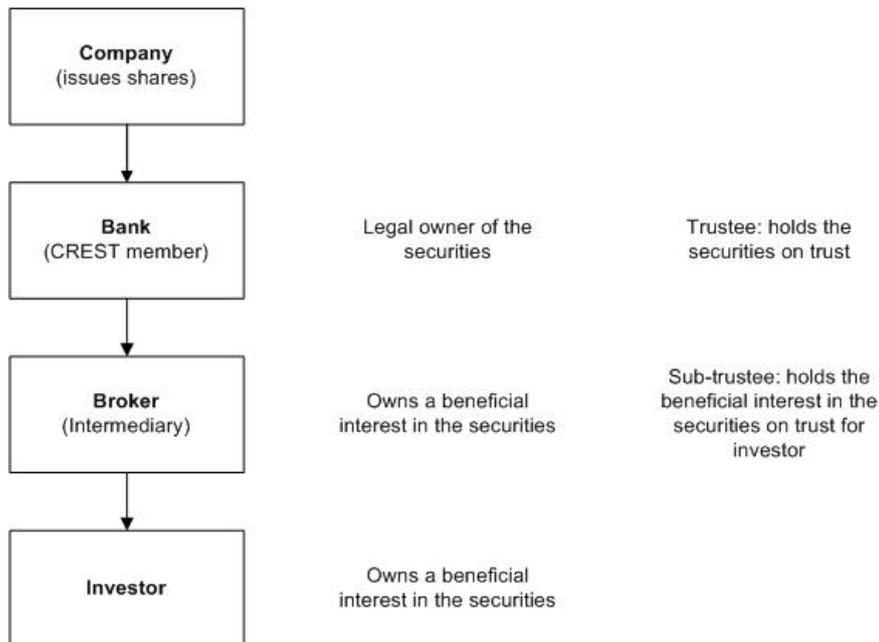
- 1.31 In our example, the CREST member (the bank) has legal title to the securities, which it holds on trust for its account holders, including the broker. The broker in turn is a

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<sup>20</sup> *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 (Ch), [2010] 11 WLUK 494 at [226]; *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2012] 11 WLUK 69 at [163].

<sup>21</sup> *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 (Ch), [2010] 11 WLUK 494 at [226].

sub-trustee, holding a beneficial interest (also known as an equitable interest) on trust for the ultimate investors.



1.32 The above diagrams depict a simple chain of intermediated securities where the ultimate investor is a retail investor. The parties on the chain will be different where the ultimate investor is an institutional investor.<sup>22</sup> In that case, for example, there may be an investment or asset manager and a custodian between the ultimate investor and the issuing company.<sup>23</sup>

1.33 The relationships between each of the parties in the chain are regulated by individual contracts entered into between each of the parties.<sup>24</sup> For retail investors and smaller pension funds or institutional investors, the contract will reflect the broker’s standard terms and conditions, rather than a bespoke arrangement according to the ultimate investor’s preferences.

### Pooled, omnibus, segregated and designated accounts

1.34 Pooled, or omnibus, accounts are used to hold the securities of more than one investor in one place.<sup>25</sup> For example, the member on CREST may hold 1 million shares for an intermediary. The intermediary may hold these shares in one account for several ultimate investors, each of which have an account with the intermediary.

<sup>22</sup> BIS, “Exploring the intermediated shareholding model” (2016) p 86 lists the different types of institutional investors, including pension funds, insurance companies, open and closed-ended funds offered to both institutional and retail investors and other investors (including charities, sovereign wealth funds and foundations).

<sup>23</sup> BIS, “Exploring the intermediated shareholding model” (2016) pp 91 and 92.

<sup>24</sup> M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-050.

<sup>25</sup> BIS, “Exploring the intermediated shareholding model” (2016) p 10.

This is an “omnibus” or “pooled” account, holding shares for ultimate investors in accordance with the intermediary’s records.<sup>26</sup>

- 1.35 The opposite of a pooled account is a “segregated” or “designated” account. These are accounts which only hold the assets of a particular investor.<sup>27</sup> The 2016 BIS paper highlighted that very large funds are more likely than smaller funds to hold investment securities in segregated accounts. This means that their identity is known to the companies in which they are investing.<sup>28</sup>
- 1.36 Although intermediaries are obliged to offer investors the option of a segregated account,<sup>29</sup> the majority of investment securities are held in pooled or omnibus accounts, which may occur at multiple levels of an intermediated securities chain. We have been told anecdotally that many brokers will not volunteer the possibility of a segregated account, or explain the potential disadvantages of a pooled account.

### Advantages and disadvantages

- 1.37 The Law Commission’s 2014 report pointed out that intermediation offers practical advantages to both companies and investors. Recording interests in securities electronically in the accounts of an intermediary allows for greater transferability, which in turn enhances liquidity and consequently the value of the securities. It is also administratively convenient. An ultimate investor can hold an entire, diverse, cross-border portfolio through a single intermediary, without having to bear the administrative burden of establishing and maintaining links with companies and intermediaries in a number of other jurisdictions.<sup>30</sup>
- 1.38 However, it is important not to forget that the ultimate investor shoulders the financial risk of the investment,<sup>31</sup> having paid for the securities in the first instance, and that intermediation might also come with disadvantages. Particularly where the ultimate investor is an individual or a smaller fund, they may have had no meaningful choice as to the manner in which they hold their securities. Although the intermediated securities system may offer the practical advantages set out above, certain features of this system can impact adversely on the rights of ultimate investors.
- 1.39 We now turn to consider these issues and invite consultees’ views.

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<sup>26</sup> L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 11 and 12.

<sup>27</sup> BIS, “Exploring the intermediated shareholding model” (2016) p 12.

<sup>28</sup> BIS, “Exploring the intermediated shareholding model” (2016) p 92.

<sup>29</sup> Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012, Official Journal L 257 of 28.8.2014 p 1, art 38(5).

<sup>30</sup> Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350 paras 11.141 to 11.144. See also G Morton, “Historical Introduction: The Growth of Intermediation and Development of Legal Analysis of Intermediated Securities” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 43. See M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-053 for a list of the advantages of pooled accounts.

<sup>31</sup> R Salter, “Enforcing Debt Securities” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 139.

## Chapter 2: Issues arising from intermediated securities chains

- 2.1 In this chapter, we set out some of the legal issues arising from the use of intermediated securities chains. These are gleaned from discussions with stakeholders, recent cases, academic work and previous studies in this area.
- 2.2 We wish to know whether the issues described below are causing problems in practice and, if so, how the situation could be improved through reform. Therefore, for each of these issues, we ask consultees:
- (1) whether they consider that the issue we have identified presents a problem in practice;
  - (2) whether they have examples, or specific evidence, of the issue; and
  - (3) what could be done to solve, or mitigate the impact of, the problem.
- 2.3 We encourage consultees to provide evidence and examples of how they and/or their stakeholders have been affected by these issues. In particular, we welcome any information which could be used to demonstrate the costs or benefits of a certain problem or solution. We also ask whether there are any additional problems that we should consider as part of our scoping study.

### VOTING RIGHTS

- 2.4 As we have set out above, companies may issue equity securities and/or debt securities. Shares, which are equity securities,<sup>32</sup> usually have rights and duties attached to them.<sup>33</sup> One such right is the right to vote on company resolutions.<sup>34</sup> It allows members to have a say in the way that the company is run and to engage constructively and vote on important corporate governance issues.
- 2.5 Debt securities, such as bonds, are issued by companies as a means of financing their operations. Holders of debt securities may also have rights to vote. Typically, these rights will be exercisable in situations where the financial stability of the company is at risk or the proposed company action relates to changes to the terms of the securities, rather than as a means of corporate governance.<sup>35</sup>

### The 2016 BIS research paper

- 2.6 As discussed above, in 2016 BIS published a research paper on the intermediated shareholding model.<sup>36</sup> This research exercise sought to ascertain the extent to which

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<sup>32</sup> See para 1.19 above.

<sup>33</sup> G Morse (general ed), *Palmer's Company Law* (2018) para 6.007.

<sup>34</sup> Companies Act 2006, s 284.

<sup>35</sup> L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 5.

<sup>36</sup> BIS, "Exploring the intermediated shareholding model" (2016).

individual and institutional investors wish to engage with companies and how voting procedures in intermediated chains work in practice.<sup>37</sup> One finding of the paper was that the intermediated securities model may act as a barrier to shareholders who wish to participate in votes.<sup>38</sup>

### This call for evidence

2.7 We would like to hear from consultees on the following issues:

- (1) whether ultimate investors find it difficult to secure and/or exercise voting rights in the first place;
- (2) whether ultimate investors find it difficult to confirm that their vote has been received and counted;
- (3) whether the rules and practical arrangements relating to the timing of voting affect the ability of an ultimate investor to vote;
- (4) whether issues over proxy voting affects ultimate investors' voting rights; and
- (5) whether there any other issues which affect ultimate investors' voting rights.

### Exercising the right to vote

2.8 The structure of the intermediated securities chain means that ultimate investors who wish to exercise the right to vote may find it difficult or impossible to do so. The principal reason for this difficulty is that, as explained above, the ultimate investor in an intermediated chain is not the legal owner of that security.<sup>39</sup> The ultimate investor is, therefore, not a "member" for the purposes of the Companies Act 2006 and does not have the right to vote.<sup>40</sup>

2.9 This difficulty under the Companies Act 2006 underpins other issues in relation to the exercise of the right to vote, including the following.

- (1) Ultimate investors may be entitled to arrange for shareholder rights to be passed back to them by their intermediaries if they want to exercise such rights, or instruct the intermediary how to vote on their behalf.<sup>41</sup> However, this depends on the terms of the contract appointing the intermediary. Such terms may exclude the requirement for an intermediary to exercise voting rights on behalf of the ultimate investor at all. Alternatively, the terms may exclude the

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<sup>37</sup> BIS, "Exploring the intermediated shareholding model" (2016) p 21.

<sup>38</sup> BIS, "Exploring the intermediated shareholding model" (2016) pp 75, 81 to 84, 119 to 127. See also Shareholder Voting Working Group, "Shareholder proxy voting: discussion paper on potential progress in transparency" (July 2015) pp 8 to 37.

<sup>39</sup> See para 1.29 to 1.31 above.

<sup>40</sup> Companies Act 2006, ss 126 and 284.

<sup>41</sup> See BIS, "Exploring the intermediated shareholding model" (2016) p 113 and J Payne, "Intermediated Securities and the Right to Vote in the UK" (2009) *University of Oxford Legal Research Paper Series No 18/2009*, 12, <http://ssrn.com/abstract=1431005>.

requirement for an intermediary to exercise such rights in accordance with instructions from the ultimate investor.<sup>42</sup>

- (2) Although Part 9 of the Companies Act 2006 provides for certain rights, including voting rights, to be passed back to ultimate investors, these provisions are optional.<sup>43</sup> Neither the company nor the intermediary is obliged to implement Part 9.<sup>44</sup> Further, Part 9 does not apply to AIM-listed companies. The usefulness of Part 9 to ultimate investors is therefore limited, and depends on the voluntary actions of the company and/or intermediaries. We have been told that it is rare for these options to be made available to retail investors.
- (3) There are also questions of transparency. Even if intermediaries pass back the voting rights to the ultimate investors, the ultimate investors do not appear on the register. Therefore, neither the company nor CREST can know with certainty the identity of the ultimate investor.<sup>45</sup> This requires ultimate investors to find a way to confirm their right to vote to the company.<sup>46</sup> Further, if ultimate investors want to join forces and vote together on an issue, they have to find a way to identify other ultimate investors.<sup>47</sup>
- (4) Even where the ultimate investor is legally entitled to certain rights, it is still dependent on the intermediary to promote and facilitate this. For example, the rules on ISAs (individual savings accounts) require that, although the relevant stocks and shares must be held by an intermediary,<sup>48</sup> the intermediary must arrange for the ultimate investor to have voting and other rights if the ultimate investor so chooses.<sup>49</sup> We have been told that intermediaries rarely advise ultimate investors of the availability of these rights, and charge additional fees if an ultimate investor wishes to exercise them.

2.10 Stakeholders have told us that some models of holding intermediated securities may make it easier to pass back voting and other rights to the ultimate investors. However, these models are not widely used except amongst the largest investors. We would like to explore specific systems or models of holding intermediated securities which could facilitate the passing back of direct rights for the majority of ultimate investors and the current obstacles to the use of such systems.

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<sup>42</sup> G Morton, *Intermediation and Beyond* (2019) p 31. See BIS, "Exploring the intermediated shareholding model" (2016) p 113 and J Payne, "Intermediated Securities and the Right to Vote in the UK" (2009) *University of Oxford Legal Research Paper Series No 18/2009*, 12, <http://ssrn.com/abstract=1431005>.

<sup>43</sup> Companies Act 2006, ss 145 and 146. For information rights to be passed back, the intermediary must voluntarily offer this option to the ultimate investor (s 146). The provisions on pass-back of other governance rights, including voting, are based on the company making provision for this in its articles, and the registered shareholder then nominating the ultimate investor (s 145).

<sup>44</sup> J Payne, "Intermediated Securities and the Right to Vote in the UK" (2009) *University of Oxford Legal Research Paper Series No 18/2009*, 21, <http://ssrn.com/abstract=1431005>.

<sup>45</sup> Some ultimate investors may prefer confidentiality and privacy. See, for example, BIS, "Exploring the intermediated shareholding model" (2016) p 25.

<sup>46</sup> BIS, "Exploring the intermediated shareholding model" (2016) p 17.

<sup>47</sup> BIS, "Exploring the intermediated shareholding model" (2016) p 126.

<sup>48</sup> Individual Savings Account Regulations 1998, SI 1998 No 1870 (as amended), regs 4(6)(a) and (b).

<sup>49</sup> Individual Savings Account Regulations 1998, SI 1998 No 1870 (as amended), reg 4(6)(d).

### **Question 1.**

2.11 Do you consider that it is difficult for ultimate investors to exercise their voting rights?

If so:

- (1) Do you have examples, or specific evidence, of difficulties experienced by ultimate investors in exercising their voting rights?
- (2) What could be done to solve these problems?

### **Question 2.**

2.12 Are there particular systems or models of holding intermediated securities which could better facilitate the passing back of direct rights for ultimate investors?

If so, what are the current obstacles to the use of such systems?

2.13 Ultimate investors may have the opportunity to exercise voting rights at various times. For example, they may exercise voting rights at annual general meetings. They may also exercise voting rights in relation to significant corporate actions, such as takeovers, bonus issues and rights issues, which can affect the number or percentage of shares held.<sup>50</sup> We welcome the views of consultees as to whether the type of vote affects the extent to which ultimate investors can exercise voting rights.

### **Question 3.**

2.14 Do you consider that the type of vote affects the extent to which ultimate investors can exercise voting rights?

If so, do you have examples, or specific evidence, of this issue?

### **Vote confirmation**

2.15 Even where ultimate investors exercise a right to vote, they may find it difficult or impossible to have their vote confirmed, because of the number of intermediaries involved in the chain, a lack of transparency or inefficiency in the system. In 2016,

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<sup>50</sup> The Companies Act 2006 requires shareholder approval of certain decisions, such as the adoption of a scheme of arrangement, alterations to the rights attaching to shares or decisions to issue shares: ss 899, 630, 551. See P L Davies and S Worthington, *Gower Principles of Modern Company Law* (10th ed 2016) para 14.18 for a list of situations in which a shareholder vote is required.

the BIS research found that this was particularly evident in the context of pooled nominee accounts:<sup>51</sup>

Votes were usually pooled before sending and submitted as a single entry in the name of the broker. This did not create an audit trail for specific votes and there was rarely any way for an investor to confirm their vote had been placed in accordance with their instructions.

- 2.16 It is not clear whether, in practice, this is a substantial problem which requires reform. We welcome consultees' comments.

#### Question 4.

- 2.17 Do you consider that it is difficult for ultimate investors to obtain confirmation that their votes have been received and/or counted?

If so:

- (1) What is the impact of this?
- (2) Do you have examples, or specific evidence, of difficulties experienced by ultimate investors in confirming that their votes have been received and/or counted?
- (3) What could be done to solve these problems?

#### Timing of voting

- 2.18 Stakeholders have raised practical and legal concerns in relation to the timing of voting. From a practical perspective, it has been suggested that it is difficult for a company to provide information about an upcoming vote to an ultimate investor within the time allowed, particularly where that information must be passed through a chain of intermediaries. This difficulty is compounded because once the ultimate investor receives the information, they must have time to consider how to vote, and then send their decision back up the chain of intermediaries.

- 2.19 There is also a potential legal aspect to the timing problem. The 2016 BIS research paper referred to concerns about "record dates". The record date for entitlement to vote is the date on which an ultimate investor's right to vote on a resolution is determined. For dematerialised securities, the record date is no more than 48 hours before the time of the meeting.<sup>52</sup> However, the record date for voting (that is, when votes may be cast) is also 48 hours before the meeting. The deadline for receipt of proxy appointments is no more than 48 hours before the meeting.<sup>53</sup>

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<sup>51</sup> BIS, "Exploring the intermediated shareholding model" (2016) p 82. See also P Davies, "Investment Chains and Corporate Governance" in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) pp 204 and 205; J Payne, "Intermediated Securities and the Right to Vote in the UK" (2009) *University of Oxford Legal Research Paper Series No 18/2009*, 14 and 15, <http://ssrn.com/abstract=1431005>.

<sup>52</sup> Uncertificated Securities Regulations 2001, SI 2001 No 3755, reg 41(1).

<sup>53</sup> Companies Act 2006, s 327.

2.20 Setting these record dates simultaneously appears to raise issues in practice. For example, as the 2016 BIS research paper pointed out, an ultimate investor could not reasonably be expected to receive their entitlement to vote and vote simultaneously. It also means that proxy agents are working from information about voting entitlements which may not be up to date, which adds further complexity to the process.<sup>54</sup>

### Question 5.

2.21 Do you consider that the rules and practical arrangements relating to the timing of voting affect the ability of ultimate investors to vote?

If so:

(1) Do you have examples, or specific evidence, of these problems?

(2) What could be done to solve these problems?

### Proxy voting

2.22 A proxy acts as an agent for a member of a company (that is, the legal owner of the share), so that the member can vote and participate in the meeting of a company without being physically present.<sup>55</sup> Proxy voting is particularly relevant for institutional investors, who may use proxy voting agents who manage the voting process and pass votes to the registrar. They may also use proxy voting advisors to advise, and in some cases make recommendations, on voting.<sup>56</sup> In practice, the same parties often offer both proxy agent and proxy advisor services.

Although the use of proxies provides benefits, the problems we have discussed above, in relation to the complexity of intermediated securities chains<sup>57</sup> and transparency, and confirmation of votes,<sup>58</sup> arise equally in relation to proxy voting.

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<sup>54</sup> P Davies, *Intermediation and Beyond* (2019) p 205; Shareholder Voting Working Group, "Shareholder proxy voting: discussion paper on potential progress in transparency" (July 2015) pp 28 and 29. BIS, "Exploring the intermediated shareholding model" (2016) p 124. Professor Paul Davies also notes that there may not be enough time for a company to engage with shareholders proposing to vote against its proposal: P Davies, *Intermediation and Beyond* (2019) p 204.

<sup>55</sup> G Morse (general ed), *Palmer's Company Law* (2018) para 7.641. See section 324 of the Companies Act 2006. This right is mandatory and cannot be overridden by the company's articles: J Payne, "Intermediated Securities and the Right to Vote in the UK" (2009) *University of Oxford Legal Research Paper Series No 18/2009*, 12, <http://ssrn.com/abstract=1431005>. Professor Jennifer Payne points out that section 324 has the effect that a legal owner of securities can appoint the ultimate investor as the proxy, so that the ultimate investor can engage directly in the governance of the company: p 17.

<sup>56</sup> BIS, "Exploring the intermediated shareholding model" (2016) p 100.

<sup>57</sup> P Davies, *Intermediation and Beyond* (2019) p 202.

<sup>58</sup> BIS, "Exploring the intermediated shareholding model" (2016) p 125; and P Davies, *Intermediation and Beyond* (2019) p 206.

### Question 6.

2.23 Do you consider that there are aspects of proxy voting which may affect the rights of ultimate investors in the context of an intermediated securities chain?

If so:

- (1) Do you have examples, or specific evidence, of these problems?
- (2) What could be done to solve these problems?

## SCHEMES OF ARRANGEMENT

2.24 A scheme of arrangement is a binding compromise or arrangement between a company and its creditors or members.<sup>59</sup> Schemes of arrangement may be used in several situations, including to effect an arrangement with creditors or members as a way of avoiding insolvency or to reduce share capital. They can also be used to effect a merger or takeover of the company.<sup>60</sup> A scheme of arrangement must be approved by a meeting of creditors or members and sanctioned by the court under section 899 of the Companies Act 2006.

2.25 Section 899 provides that a court may sanction a compromise or arrangement upon application where there has been approval by:

- (1) a majority in number of the creditors or members (or class of creditors or members) (the “majority in number requirement” or “headcount” test); and
- (2) representing 75% in value of the creditors or members (or class of creditors or members) (the “majority in value requirement”).

2.26 The above requirements are based on the number of creditors or members who actually vote on the compromise or arrangement, rather than on the total number of creditors or members. There is no minimum participation level.

### Intermediated securities and schemes of arrangement

2.27 We have been told that, in the context of intermediated securities, the headcount test creates the following problems:

- (1) For schemes of arrangement involving bonds (a type of debt security), it is not clear who the “creditors” will be. The term “creditor” is not defined in the Companies Act 2006.<sup>61</sup> Depending on how bonds are issued, it is possible that

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<sup>59</sup> Companies Act 2006, s 895(1). See also G Morse (general ed), *Palmer's Company Law* (2018) paras 12.001 and 12.002 and L Gullifer and J Payne, *Corporate Finance Law: Principles and Policy* (2nd ed 2015), ch 15. See G Morse (general ed), *Palmer's Company Law* (2018) paras 12.034 and 12.035 for limitations of the use of schemes of arrangement (principally, the scheme must not be ultra vires the company).

<sup>60</sup> L Gullifer and J Payne, *Corporate Finance Law: Principles and Policy* (2nd ed 2015) pp 746 to 762.

<sup>61</sup> J Payne, “Intermediation and Bondholder Schemes of Arrangement” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) pp 175 to 186.

there will be only one legal owner, and thus only one creditor. In that situation, it would be impossible to apply the headcount test.<sup>62</sup>

- (2) For schemes of arrangement involving equity securities, only the registered owners of the shares will count as “members”.<sup>63</sup> As explained above, the registered owners of the shares are likely to be intermediaries, holding shares through nominee accounts.<sup>64</sup> Therefore an intermediary, regardless of the number of shares held for its account holders, will count as only one shareholder for the purposes of the headcount test. This issue was relevant to Unilever’s recent proposed scheme of arrangement, which we now turn to discuss.

### Unilever: an example of the headcount test in action

- 2.28 In October 2018, shareholders in Unilever plc were due to vote on a scheme of arrangement under the Companies Act 2006. The scheme related to the company becoming a subsidiary of a new Dutch holding company, together with the relocation of the company’s London headquarters to Rotterdam. The impending vote received considerable media attention and was expected to be controversial. To pass, the scheme required both the majority in value test and the headcount test to be satisfied.
- 2.29 The headcount test might have been expected to make the votes of individual holders of small numbers of shares important to the passing of the vote. However, many such shareholders held their shares through brokers and other intermediaries, who were the legal owners of the shares. As such, an intermediary holding shares for 20,000 ultimate investors would only count as a single “member” for the purposes of the headcount test, greatly diluting the voting power of such ultimate investors. This dilutive effect of intermediation was criticised by shareholder advocacy groups. The vote was ultimately cancelled.<sup>65</sup>

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<sup>62</sup> J Payne, *Intermediation and Beyond* (2019) p 180; L Gullifer (ed), *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) p 264. This is particularly a problem when bonds are issued as a “global note”. This means that only one note is issued, representing the whole of the bond issue, regardless of the number of ultimate investors. That global note is held by an international central securities depository, which holds the note for its account holders (which may be the ultimate investors or may be intermediaries for the ultimate investors): L Gullifer and J Payne, *Corporate Finance Law: Principles and Policy* (2nd ed 2015) pp 376, 385.

<sup>63</sup> See paras 1.20 to 1.25 above. See also J Payne, *Intermediation and Beyond* (2019) p 180 and *Re Abbey National plc* [2004] EWHC 2776 (Ch), [2004] 11 WLUK 182 at [13]: “Where an individual has invested money with an institution to acquire shares for his benefit that institution will be the shareholder in the relevant company and it will be that institution which will be consulted over any scheme of arrangement.”

<sup>64</sup> See paras 1.26 to 1.28 above.

<sup>65</sup> We understand that several factors contributed to the cancellation.

### **Question 7.**

2.30 Do you consider that the headcount test in section 899 of the Companies Act 2006 has the potential to cause problems in the context of intermediated securities? In what way?

If so:

- (1) Do you have examples, or specific evidence, of problems arising out of the application of section 899 of the Companies Act 2006 to intermediated securities?
- (2) What could be done to solve these problems?

## **INVESTOR'S ABILITY TO SUE THE COMPANY OR A HIGHER INTERMEDIARY**

2.31 The ultimate investor's ability to bring proceedings against a company or intermediary has the potential to serve as an important tool of corporate governance. For example, the ultimate investor's ability to bring an action may deter the board of directors from acting otherwise than in the investors' interests. The ability to sue could also enable an ultimate investor to seek redress for any damage or injury caused to them by the actions of the company or intermediary.

2.32 However, the current law limits the ultimate investor's ability to sue anyone in the intermediated securities chain beyond their immediate intermediary, including the company. This is because of the "no look through principle".

### **What is the no look through principle and what is its effect?**

2.33 Under the no look through principle, the ultimate investor may only bring an action against its immediate intermediary. The ultimate investor does not have the right to enforce the terms of the securities, or bring an action for breach of trust, against any higher-tier intermediary in the chain, including the company.<sup>66</sup> For example, if a company defaults on its obligations to its shareholders, the ultimate investor will not be able to sue the company directly. Nor will the ultimate investor's immediate intermediary be liable to the ultimate investor for the company's default.

2.34 In theory, depending on the circumstances, the ultimate investor could claim against their immediate intermediary, encouraging them to claim against the next intermediary, and so on up the chain. Larger institutional investors could also use their commercial position to persuade their immediate intermediary to take action. However, such action or litigation would be complex and time-consuming, because of the need for each intermediary in the chain to sue the one above it, in order to eventually reach the issuer. In some circumstances, it may be precluded by the

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<sup>66</sup> See also *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350 paras 11.115 to 11.117.

Companies Act 2006.<sup>67</sup> The terms of the security or contract may also exclude such action.<sup>68</sup>

- 2.35 The no look through principle has been described as “controversial”.<sup>69</sup> Richard Salter QC points out that the ultimate investors are the ones who have paid for the securities and taken the economic risk, yet they “get the downside of the advantages that this principle confers on others”.<sup>70</sup>

### Recent cases

2.36 The no look through principle has been highlighted in recent cases:

- (1) In *Eckerle v Wickeder Westfalenstahl GmbH*,<sup>71</sup> the ultimate investors in an intermediated securities chain were prevented from challenging a special resolution under section 98 of the Companies Act 2006. Section 98 requires a challenge to be brought by the “holders of not less ... than 5% in nominal value of the company’s issued share capital”. The ultimate investors held not less than 5% of the value of the company’s issued share capital. However, the application failed because they held their shares through intermediaries.<sup>72</sup>
- (2) In *Secure Capital SA v Credit Suisse AG*,<sup>73</sup> the ultimate investors in an intermediated securities chain were prevented from bringing an action for breach of contract for misleading statements.
- (3) In *Re Public Joint-Stock Company Commercial Bank “Privatbank”*,<sup>74</sup> the ultimate investors were entitled to vote on a proposed scheme of arrangement. However, this was only because the parties had taken steps to ensure that the ultimate investors were enfranchised. These steps included the company giving the ultimate investors an express right of direct recourse against the company in certain circumstances, and the company entering into a deed poll creating direct liability to the ultimate investors.

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<sup>67</sup> See *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), [2014] Ch 196. In some circumstances this may result in no party being able to bring a claim.

<sup>68</sup> Richard Salter QC, “Intermediated securities and the rights of the ultimate investor” (2016) 3 *Butterworths Journal of International Banking and Financial Law* 153 at 154. Subject to certain exceptions, the Contracts (Rights of Third Parties) Act 1999 allows a third party to enforce a term of a contract if (1) the third party is specifically mentioned in the contract as someone authorised to enforce it; or (2) if the term “purports to confer a benefit” on that third party. Importantly, the operation of the Act may be excluded by the terms of the contract, preventing third parties from relying on it.

<sup>69</sup> V Dixon, “The Legal Nature of Intermediated Securities: An Insurmountable Obstacle to Legal Certainty?” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 53, noting that other jurisdictions give the ultimate investor rights, including enforcement rights, directly against the company.

<sup>70</sup> R Salter, *Intermediation and Beyond* (2019) p 139. See L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-14 for a summary of the advantages and disadvantages of the no look through principle.

<sup>71</sup> *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), [2014] Ch 196.

<sup>72</sup> *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), [2014] Ch 196 at [30].

<sup>73</sup> [2017] EWCA Civ 1486, [2017] 10 WLUK 154.

<sup>74</sup> *In the matter of Public Joint-Stock Company Commercial Bank “Privatbank”* [2015] EWHC 3299 (Ch), [2015] 11 WLUK 345.

### **Question 8.**

2.37 Do you consider that, in practice, the no look through principle may restrict the rights of ultimate investors who wish to bring an action against an issuing company or intermediary?

If so:

- (1) Do you have examples, or specific evidence, of problems caused by the no look through principle?
- (2) What could be done to solve these problems?

### **Question 9.**

2.38 In practice, what, if any, are the benefits of the no look through principle?

## **INSOLVENCY AND INTERMEDIATED SECURITIES**

2.39 When an investor buys investment securities, such as shares issued by a company, there will always be an element of economic risk. For example, the company may flounder or become insolvent, leading to a decrease in the value of the shares issued. The risk of the company's insolvency – and the corresponding effect on the investment securities it has issued – is part of the risk that an ultimate investor accepts when deciding to purchase shares.

2.40 Compared to the risk of a company's insolvency, the risk of an intermediary becoming insolvent is less likely to have been in the contemplation of the investor. We explore below how the interests of an ultimate investor may be affected by an intermediary's insolvency. This will depend on which party in the intermediated securities chain becomes insolvent. We also look at how an ultimate investor's right to set off may be affected by an intermediated securities chain when the company becomes insolvent.

### **The regulatory regime**

2.41 Below, we consider the impact of insolvency on an intermediated securities chain from a private law perspective. There is, of course, also a regulatory perspective. The Financial Conduct Authority ("FCA") regulates the financial markets sector and establishes and enforces rules designed to protect client assets if a business (such as an intermediary) fails. These rules are set out in the Client Asset Sourcebook ("CASS") in the FCA Handbook. Part 6 of CASS deals with custody of client assets, including investment securities.

2.42 The regulatory regime was enhanced following the collapse of Lehman Brothers. In our initial discussions, some stakeholders have told us this regime is now sufficiently robust that any review of the law of insolvency in relation to intermediated securities is unnecessary. Others have said that a review of the private law principles, keeping in mind the regulatory regime, would be valuable. We welcome consultees' views.

### Question 10.

- 2.43 Do you consider that the regulatory regime alone is sufficient to address the risks and consequences of an insolvency in a chain of investment intermediaries?

### Question 11.

- 2.44 Do you consider that there is merit in our reviewing the consequences of insolvency in an intermediated securities chain from a legal, as opposed to regulatory, perspective?

## Insolvency of an intermediary

- 2.45 We explained above that an intermediated securities chain has been considered by the High Court to be a series of trusts and sub-trusts, with the ultimate investor having a beneficial interest in the securities.<sup>75</sup> The categorisation of intermediated securities chains has implications for the ultimate investor in the event of an intermediary's insolvency.
- 2.46 In general, assets held in trust are effectively "ringfenced" and not available to the general creditors upon the trustee's insolvency.<sup>76</sup> Trust law provides that the intermediated securities held on trust must be held for the beneficial owner (in this case, the ultimate investors) and not made available to the general pool of creditors.<sup>77</sup> Therefore, the general position is that the ultimate investor's assets will be protected.
- 2.47 However, there is a risk that the intermediary may not have sufficient securities in a pooled or omnibus account to satisfy claims by its account holders. This is called a "shortfall".<sup>78</sup>

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<sup>75</sup> See paras 1.29 and 1.30 above and *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 (Ch), [2010] 11 WLUK 494 at [226]; *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2012] 11 WLUK 69 at [163]: "It is an essential part of the English law analysis of the ownership of dematerialised securities that the interest of the ultimate beneficial owner is an equitable interest, held under a series of trusts and sub-trusts between it, any intermediaries and the depository in which the legal title is vested".

<sup>76</sup> See Insolvency Act 1986, s 283(3) in relation to individual trustees. In relation to corporate trustees, *Lewin on Trusts* says that despite the absence of an express statutory provision, it has always been accepted that property held on trust by the company at the commencement of the winding-up falls outside the insolvency regime: L Tucker, N Le Poidevin, J Brightwell, *Lewin on Trusts* (19th ed 2018) para 22-027.

<sup>77</sup> This depends on the trust assets being properly segregated: see V Dixon, *Intermediation and Beyond* (2019) p 77 and *MacJordan Construction Ltd v Brookmount Erostin Ltd* [1994] CLC 581; *Re Global Trader Europe Ltd* [2009] EWHC 602 (Ch), [2009] 3 WLUK 606.

<sup>78</sup> See V Dixon, *Intermediation and Beyond* (2019) p 80; L Gullifer and J Payne, "Conclusion" in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 372.

## Shortfalls

- 2.48 A shortfall may arise through the legitimate use of the securities, such as under a securities lending transaction<sup>79</sup> to which the ultimate investor has consented. In a securities lending transaction, the holder of securities transfers them to a third party, who undertakes to return securities of the same kind at a later point.<sup>80</sup> The third party will provide collateral, usually cash but sometimes securities.<sup>81</sup> In this type of transaction, the results of a shortfall for the ultimate investor “may not be quite as dramatic as envisaged”.<sup>82</sup> This is because the counterparty will be under a contractual obligation to return the securities to the intermediary (or their insolvency office holder), at which point the shortfall will be reduced or extinguished, depending on the value of the security. Although there may be a small mismatch between the value of the collateral and the value of the security due to market movements, we have been told that any net shortfall should not ordinarily represent a significant amount.
- 2.49 A shortfall may also arise because assets are removed from the account through breach of trust, fraud, administrative error or poor record keeping.<sup>83</sup> What can the ultimate investor do in this situation? In theory, the ultimate investor may attempt to recover the assets.<sup>84</sup> In practice, the complexity of an intermediated securities system and the processes involved mean that it would be difficult to trace a transfer of particular securities to a specific recipient.<sup>85</sup>
- 2.50 Where the shortfall has been caused by the insolvency of an intermediary higher up in the chain, the other, solvent, intermediary will be obliged to reconstitute the trust property.<sup>86</sup> They could achieve this by acquiring securities in the market or, if that is not possible, by paying compensation to the ultimate investor.<sup>87</sup>

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<sup>79</sup> E Micheler, “Intermediated Securities from the Perspective of Investors: Problems, Quick Fixes and Long-term Solutions” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 241.

<sup>80</sup> T Keijser and C W Mooney Jr, “Intermediated Securities Holding Systems Revisited: A View Through the Prism of Transparency” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 319. See also L Gullifer (ed), *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22, which provides a useful summary of the possible contexts of when shortfalls may arise.

<sup>81</sup> J Benjamin and L Gullifer, “Stewardship and Collateral” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 218.

<sup>82</sup> L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22. Nonetheless, it is important to note that the ultimate investor will still be exposed to the risk that the counterparty will themselves become insolvent.

<sup>83</sup> T Keijser and C W Mooney Jr, *Intermediation and Beyond* (2019) p 319; and V Dixon, *Intermediation and Beyond* (2019) p 80.

<sup>84</sup> Using following or tracing, which is a mechanism used to identify property against which a remedy may then be claimed. See *Foskett v McKeown* [2001] 1 AC 102 at [127]; *Boscawen v Bajwa* [1996] 1 WLR 328 at [334] and *Lewin on Trusts* (19th ed 2018), ch 41.

<sup>85</sup> L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22; and V Dixon, *Intermediation and Beyond* (2019) p 82. See also Financial Markets Law Committee, “Issue 3 – Property interests in investment securities” (July 2004), para 5.2.

<sup>86</sup> A trustee has an obligation to account for his or her stewardship of the trust: *Low v Bouverie* [1891] 2 Ch 250 at [268] per Lindley LJ. L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22.

<sup>87</sup> L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22. The FCA’s *CASS Client Assets* also provides for what a (solvent) intermediary must do in the event of a shortfall: FCA, *CASS Client Assets* CASS 6.6.54.

## The Financial Services Compensation Scheme

- 2.51 Retail investors are often encouraged to put all their savings with a single intermediary, which may run an investment platform, on the basis that it will be convenient to hold everything together. An investment platform is an online tool or service that facilitates the purchase and sale of securities.<sup>88</sup> Although this approach may be convenient and efficient for both brokers and ultimate investors, the platform also comprises a potential single point of failure.
- 2.52 As explained above, if an intermediary becomes insolvent, the ultimate investor's assets will not be included in the general pool of creditors, which provides some protection.<sup>89</sup> However, if the intermediary becomes insolvent due to fraudulent or negligent activity, that activity may mean that there are insufficient assets in the account available for distribution.
- 2.53 In that case, the ultimate investor may have recourse to the Financial Services Compensation Scheme ("FSCS"), which provides compensation to customers of financial services firms that have failed.<sup>90</sup> The amount of compensation which can be claimed depends on the relevant financial activity (that is, whether the insolvent firm was taking deposits, involved in investments, or selling insurance or pensions, for example).<sup>91</sup> In many instances, including for investment intermediation, the available compensation is capped.<sup>92</sup> Where individuals have invested their entire life savings through one platform, this capped compensation may not be sufficient to cover their losses.<sup>93</sup>
- 2.54 For example, in March 2018 Beaufort Securities, a broker with approximately 17,500 retail and corporate clients, was placed into insolvency and a special administrator was appointed.<sup>94</sup> Client assets were held in pooled, nominee accounts. The administrators informed the firm's clients that the (considerable) costs of the administration would be taken out of the client assets, as permitted by the relevant rules,<sup>95</sup> thereby significantly reducing the amount in the nominee accounts.

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<sup>88</sup> BIS, "Exploring the intermediated shareholding model" (2016) p 10.

<sup>89</sup> See para 2.47 above.

<sup>90</sup> Financial Services Compensation Scheme, "About FSCS", <https://www.fscs.org.uk/about-fscs/>. See Financial Services and Markets Act 2000, s 213; The Financial Services and Markets Act 2000 (Financial Services Compensation Scheme) Order 2013, SI 2013 No 598, arts 2 and 3 and FCA Handbook COMP 1.1.5 and 1.1.7. See FCA Handbook COMP 5.2.1 for a list of claims for which compensation may be payable.

<sup>91</sup> For an overview, see Financial Services Compensation Scheme, "Compensation limits", <https://www.fscs.org.uk/what-we-cover/>.

<sup>92</sup> The compensation limits are set by the Financial Conduct Authority or Prudential Regulation Authority, depending on the type of financial activity in question. Some are prescribed in or based on EU legislation.

<sup>93</sup> The compensation limits apply per person per firm. If a platform fails, investments in other funds might be protected if they are ring-fenced from the platform/fund manager. This depends on the specifics of the case.

<sup>94</sup> There were two related companies which were declared insolvent: Beaufort Securities Ltd and Beaufort Asset Clearing Services Ltd.

<sup>95</sup> CASS 7.17.2 R(4)) and the Investment Bank Special Administration (England and Wales) Rules 2011 SI 2011 No 1301, rule 135.

- 2.55 For the vast majority of Beaufort's clients, the FSCS was able to cover shortfalls of client money or custody assets. There were a small number of retail investors for whom the costs of distribution and any shortfalls would be over the (then) FSCS compensation limit of £50,000, so that they would not be fully compensated.<sup>96</sup>
- 2.56 This situation highlighted the potential for retail ultimate investors to lose a significant proportion of their savings where an intermediary becomes insolvent and there is a large shortfall. However, the FCA recently increased the FSCS compensation limit for certain claims, including investment intermediation and investment provision, from £50,000 to £85,000.<sup>97</sup> From 1 April 2019, compensation of up to £85,000 may be available for each eligible claimant.<sup>98</sup> In its consultation paper, the FCA said that FSCS data showed that if the compensation limit had been £85,000, 94.4% of consumer losses would have been fully compensated in the period between 2015 to 2017.<sup>99</sup> Therefore, it is possible that the risk we identify above would only affect a relatively small proportion of retail investors.
- 2.57 The fact that the amount of compensation available depends on the nature of the product can lead to what looks like strange inconsistencies in some cases. For example, it is possible to purchase certain types of long-term insurance as an investment product, instead of purchasing investment securities themselves. While the goal of the ultimate investor in each case is the same (investment), and the losses may be similar where the relevant firm fails, an ultimate investor who has invested through an insurance product is not subject to the £85,000 cap. For long-term insurance, there is no upper limit.
- 2.58 Stakeholders have told us that this puts ultimate investors in a difficult position. If the ultimate investor buys investment securities, they may have at least the opportunity to exercise voting rights. However, the available compensation will be capped. In contrast, if an ultimate investor buys an insurance policy which returns the performance of the underlying investment, they will not have rights in those investments securities. However, they may have the security of more compensation.
- 2.59 It is not clear, however, that these differences are relevant in practice, given the FCA's conclusion that the £85,000 cap is sufficient in the great majority of cases.

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<sup>96</sup> See FCA, "Information for customers of Beaufort Securities Limited (BSL) and Beaufort Asset Clearing Services Limited (BACSL)" (2018), <https://www.fca.org.uk/news/news-stories/information-customers-beaufort-securities-limited-bsl-and-beaufort-asset-clearing-services-limited>.

<sup>97</sup> Financial Conduct Authority, *Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP17/36, final rules and new proposals for consultation* (May 2018) CP 18/11.

<sup>98</sup> FCA Handbook COMP 10.2. See also Financial Conduct Authority, *Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP17/36, final rules and new proposals for consultation* (May 2018) CP 18/11 p 18.

<sup>99</sup> Financial Conduct Authority, *Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP17/36, final rules and new proposals for consultation* (May 2018) CP 18/11 paras 3.11 to 3.13. For investment intermediary claims, the number of less-than-fully-compensated claims would have decreased to only 2.6% of the total number of claims: para 3.13.

## Distribution of assets where there is a shortfall

2.60 If there is a shortfall, how would the existing assets in an omnibus or pooled account be distributed? Commentators generally appear to agree that assets should be distributed between ultimate investors on a proportionate basis and that they should share the losses equally.<sup>100</sup> However, a court may take a different approach.<sup>101</sup>

### Question 12.

2.61 Do you consider that the insolvency of an intermediary in an intermediated securities chain has the potential to cause problems? In what way?

If so:

- (1) Do you have examples, or specific evidence, of problems arising out of the insolvency of an intermediary in an intermediated securities chain?
- (2) What could be done to solve these problems?

### Question 13.

2.62 Do you consider that there is uncertainty about how assets would be distributed in the event of an intermediary's insolvency? If so, how could this uncertainty be resolved?

### Question 14.

2.63 Do you consider that there is a need for better education of ultimate investors about the risks of an intermediary's insolvency, and a better awareness about the application of the Financial Services Compensation Scheme?

2.64 What could be done to reduce the exposure of ultimate investors in the event of an intermediary's insolvency?

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<sup>100</sup> This is known as the *pari passu* principle. See A Keay, *McPherson's Law of Company Liquidation* (4th ed 2017) para 13-001. See also V Dixon, *Intermediation and Beyond* (2019) pp 82 and 83; L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22; L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 372. If the intermediary is an investment bank, then the Investment Bank Special Administration Regulations apply: Investment Bank Special Administration Regulations 2011, SI 2011 No 245. These regulations provide that a shortfall in an omnibus account shall be borne pro rata by all clients, in proportion to their beneficial interest in the securities. They also provide that the ultimate investor's shortfall is a claim against the investment bank, which shall rank as an unsecured claim.

<sup>101</sup> See V Dixon, *Intermediation and Beyond* (2019) pp 82 and 83.

## Insolvency of a company

2.65 Where debt securities are held directly, and the company that issued the debt securities becomes insolvent, a right to “set off” may be available. *The Law of Insolvency* explains set off:<sup>102</sup>

The basic principle is that where... A has a money claim against the company, and the company has a money claim against A, one claim can be set-off against the other, an account must be taken and the balance only can be proved for.

2.66 The advantage of set off in an insolvency context is that it has similar effect to a security. The solvent party is paid in full to the extent of the set off rather than joining a queue of creditors.<sup>103</sup> Therefore, where the ultimate investor has a debt security, and the company that issued the debt security has a claim against the ultimate investor (for example, because the company has lent the ultimate investor money to purchase the debt security), those claims may be set off against each other.

2.67 The right to set off is provided for in the Insolvency (England and Wales) Rules. Under these rules several conditions must be satisfied for set off to apply, including a requirement that there must be “mutual credits, mutual debts or other mutual dealings between the company and a creditor proving or claiming to prove for a debt”.<sup>104</sup>

2.68 However, Professor Louise Gullifer points out that it is not beyond question whether the right to set off will apply in the context of an intermediated securities chain. This is because it is not clear that the ultimate investor’s beneficial interest in the debt security satisfies the requirement for a “mutual debt”. Nor is it certain that the ultimate investor is a “creditor” for the purposes of set off.<sup>105</sup>

2.69 Although it appears that this may affect the rights of the ultimate investor, we are not aware of whether this is a problem in practice and we welcome consultees’ views, particularly those of insolvency practitioners.

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<sup>102</sup> I Fletcher, *The Law of Insolvency* (5th ed 2017) para 23-021. If these conditions are met, set off is mandatory: Insolvency (England and Wales) Rules 2016, SI 2016 No 1024, rules 14.24 and 14.25 and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 7.82.

<sup>103</sup> L Gullifer, “Insolvency set-off in the context of intermediated debt securities” (2019) 5 *Journal of International Banking and Finance Law* 287 at 288; G Morse (general ed), *Palmer’s Company Law* (2018) para 14.143.

<sup>104</sup> Insolvency (England and Wales) Rules 2016, SI 2016 No 1024, rules 14.24 and 14.25.

<sup>105</sup> See L Gullifer, “Insolvency set-off in the context of intermediated debt securities” (2019) 5 *Journal of International Banking and Finance Law* 287 and L Gullifer, “The Consequences of the Intermediated Holding of Debt Securities: Examining Discharge of Debt and Set-off” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) pp 167 to 174.

### Question 15.

2.70 Do you consider that the application of a right to set off has the potential to cause problems in the context of an intermediated securities chain?

If so:

- (1) Do you have examples, or specific evidence, of such problems?
- (2) What could be done to solve these problems?

## THE GOOD FAITH PURCHASER AND INTERMEDIATED SECURITIES

2.71 In the current financial world, fast-paced securities transactions make it difficult (if not impossible) for purchasers to investigate assets before deciding to buy them.<sup>106</sup> To what extent does a person who purchases securities in good faith take those securities free of any defects of title (such as where the disposition is unauthorised) or competing interests?<sup>107</sup> The answer is different dependent on whether the securities are held directly by the ultimate investor or through an intermediary.

2.72 As discussed above, where securities are held directly, the ultimate investor holds the legal title.<sup>108</sup> That means when the securities are sold, the legal title is transferred to the purchaser. There is a general common law rule that no one can give what they do not have. The application of this rule would mean that a person whose securities are transferred could recover them from a purchaser if the person purporting to transfer them did not have authority or legal title to do so.<sup>109</sup> However, a purchaser who acquires such securities may be protected from such a claim, if they have bought the securities in good faith, without notice of existing equitable claims.<sup>110</sup>

2.73 Under the law of England and Wales, that protection does not apply to the transfer of equitable interests such as those held by the ultimate investor. Where only that is transferred to the purchaser, the purchaser of intermediated securities takes them subject to any defects or other interests, even where the purchaser has no notice of such interests.<sup>111</sup>

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<sup>106</sup> Financial Markets Law Committee, "Issue 3 – Property Interests in Investment Securities" (July 2004) para 6.8.

<sup>107</sup> L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 379 and 380.

<sup>108</sup> See paras 1.20 to 1.25 above.

<sup>109</sup> Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 5.16.

<sup>110</sup> Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 5.22 onwards; Financial Markets Law Committee, "Issue 3 – Property Interests in Investment Securities" (July 2004) para 6.8; L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 371, 379 and 380. See also the Uncertificated Securities Regulations 2001, SI 2001 No 3755, reg 35 and CREST Rules (June 2019), rule 7.3.2.

<sup>111</sup> L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 371 and 380; Financial Markets Law Committee, "Issue 3 – Property Interests in Investment Securities" (July 2004) para 6.8; Law Commission,

2.74 This issue has been previously considered by both the Law Commission and the Financial Markets Law Committee.<sup>112</sup> In 2008, the Law Commission concluded:<sup>113</sup>

This disparity cannot be justified on legal or commercial grounds and potentially gives rise to arbitrary and anomalous results. It does not reflect market expectations and should be removed.

2.75 We welcome consultees' views on whether this clear difference in the protection provided to purchasers of directly held securities and purchasers of intermediated securities causes problems in practice.

#### Question 16.

2.76 Do you consider that the disparity in the way that purchasers of directly held securities and intermediated securities are protected by law has the potential to cause problems?

If so:

- (1) Do you have examples, or specific evidence, of such problems?
- (2) What could be done to solve these problems?

## TRANSFER OF AN EQUITABLE INTEREST

2.77 In our report on the *Fiduciary Duties of Investment Intermediaries*, we referred to section 53(1)(c) of the Law of Property Act 1925 as a potential source of legal uncertainty.<sup>114</sup> Under this section, a transfer of an equitable interest must be effected by a disposition in writing, signed by the transferor.<sup>115</sup>

2.78 Although section 53(1)(c) does not apply to transfers through CREST, we noted in our 2014 report<sup>116</sup> that it does appear to apply to transfers which are settled at a lower tier

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*The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) paras 5.40 to 5.43.

<sup>112</sup> Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Updated Advice to HM Treasury* (May 2007), Pt 5; Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008), Pt 5; and Financial Markets Law Committee, "Issue 3 – Property Interests in Investment Securities" (July 2004) para 6.8.

<sup>113</sup> Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 5.1.

<sup>114</sup> *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350 para 11.122.

<sup>115</sup> In *Electronic execution of documents* (2018) Law Commission Consultation Paper No 237, we provisionally concluded that a statutory requirement for "writing" or for something to be "signed" could be satisfied through electronic means: paras 3.7 to 3.14 and 3.83 to 3.86. This conclusion would apply to transfers of equitable interests. See <https://www.lawcom.gov.uk/project/electronic-execution-of-documents/> for the latest publication on this project.

<sup>116</sup> *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350 para 11.122.

in the chain.<sup>117</sup> This would be relevant where a transfer from one ultimate investor to another ultimate investor, both of whom hold accounts with the same intermediary, is achieved through settlement across the books of the intermediary. During our project on fiduciary duties, we were told that the practice of settling computerised securities does not reflect the law, which was developed for a paper-based system.

2.79 We welcome consultees' views on whether the potential legal uncertainty causes problems in practice.

#### **Question 17.**

2.80 Do you consider that the application of section 53(1)(c) of the Law of Property Act 1925 has the potential to cause problems in the context of an intermediated securities chain?

If so:

- (1) Do you have examples, or specific evidence, of such problems?
- (2) What could be done to solve these problems?

## **TECHNOLOGICAL DEVELOPMENTS**

2.81 Commentators have suggested that developments in technology could make it easier for ultimate investors to exercise rights associated with ownership, particularly voting rights.<sup>118</sup> Recently, attention has been focused on the potential for distributed ledger technology ("DLT") to facilitate transactions without the need for intermediaries. However, we think that there may also be other ways in which more conventional technology can assist. We ask consultees for their views.

### **What is DLT?**

2.82 As the name suggests, distributed ledger technology involves a ledger through which a digital record of transactions is shared across participants in the network. The record is distributed to all the users on the network. This means that there is an identical copy of a record maintained on multiple computers. DLT uses a type of technology called "public key cryptography" to store information about a transaction securely.<sup>119</sup> There are two types of distributed ledger systems:

- (1) "Permission-less" or "public" systems. Anyone can join this system without the need to prove their identity.<sup>120</sup> Once they have joined, participants can view

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<sup>117</sup> Uncertificated Securities Regulations 2001, SI 2001 No 3755, reg 38(5). In the Financial Markets Law Committee's paper "Issue 3 – Property interests in investment securities" (July 2004) at para 6.9, it said that although arguments to deal with this problem can be found, "the reasoning is invariably complex".

<sup>118</sup> See para 2.85 below and P Davies, *Intermediation and Beyond* (2019) pp 200 and 201, 204 and 205.

<sup>119</sup> For an explanation of public key cryptography, see Electronic execution of documents (2018) Law Commission Consultation Paper No 237 paras 2.18 to 2.21.

<sup>120</sup> J Bacon, J D Michels, C Millard and J Singh, "Blockchain Demystified: A Technical and Legal Introduction to Distributed and Centralised Ledgers" (2018) 25 *Richmond Journal of Law & Technology*, 7,

transactions and participate in the network by, for example, verifying transactions. This type of system is “decentralised”, which means that there is no central authority to control the processing of transactions. One example of a permission-less system is the Bitcoin blockchain.

- (2) “Permissioned” or “private” systems. Permission is required to join such a system and to be able to participate in and view transactions. There is a central authority to control access to the system, which could also act, for example, as an intermediary holding securities on behalf of investors.<sup>121</sup>

### The impact of DLT on the intermediated shareholding model

- 2.83 Commentators have suggested that DLT has the potential to transform the intermediated shareholding model by removing the need for intermediaries. Professor Sarah Green and Ferdisha Snagg have argued that DLT could remove the need for a CSD entirely: instead, legal title to securities could be transferred directly on the ledger.<sup>122</sup> Therefore, both the holding and the settlement of securities could take place within the DLT system.<sup>123</sup> This means that the ultimate investors could appear on the system as the legal owners of the shares.
- 2.84 This approach could also make it easier for investors to exercise their voting rights. For example, removing the need for intermediaries means that ultimate investors would no longer have to ask for their rights to be passed back to them or instruct the intermediary how to vote on their behalf. It could be easier to confirm that votes had been received and counted.<sup>124</sup>
- 2.85 We understand that permissioned DLT systems are of increasing interest to the financial services market, in part because such systems may allay concerns about the privacy of the data of ultimate investors.<sup>125</sup> These systems often have a central authority. Where that is the case, commentators including Eva Micheler and Luke von

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<https://jolt.richmond.edu/files/2018/11/Michelsetal-Final-1.pdf>; S Green and F Snagg, “Intermediated Securities and Distributed Ledger Technology” in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) pp 338 to 341.

<sup>121</sup> E Micheler and L von der Heyde, “Holding, clearing and settling securities through blockchain/distributed ledger technology: creating an efficient system by empowering investors” (2016) 11 *Butterworths Journal of International Banking and Financial Law* 652, 654.

<sup>122</sup> S Green and F Snagg, *Intermediation and Beyond* (2019) p 341.

<sup>123</sup> We recognise that this is likely to require a change in the law: see Uncertificated Securities Regulations 2001, SI 2001 No 3755, reg 24 and S Green and F Snagg, *Intermediation and Beyond* (2019) p 341.

<sup>124</sup> F Panisi, R P Buckley and D Arner, “Blockchain and Public Companies: A Revolution in Share Ownership Transparency, Proxy-voting and Corporate Governance?” (2019) 2 *Stanford Journal of Blockchain Law and Policy*, 25 to 27, <https://ssrn.com/abstract=3389045>.

<sup>125</sup> S Green and F Snagg, *Intermediation and Beyond* (2019) p 339 and F Panisi, R P Buckley and D Arner, “Blockchain and Public Companies: A Revolution in Share Ownership Transparency, Proxy-voting and Corporate Governance?” (2019) 2 *Stanford Journal of Blockchain Law and Policy*, 23, <https://ssrn.com/abstract=3389045>.

der Heyde have questioned whether there is a real benefit to using a DLT system over other forms of technology.<sup>126</sup>

2.86 We are aware that the following jurisdictions have announced the development of DLT solutions for securities transactions:

- (1) Australia. The Australian Securities Exchange is planning to utilise the technology to replace its current clearing and settlement system for equity securities.<sup>127</sup>
- (2) Estonia. The Nasdaq Stock Market and the Republic of Estonia have announced a blockchain-based e-voting service. The service will allow shareholders of companies listed on Nasdaq's Tallinn Stock Exchange to vote in shareholder meetings.<sup>128</sup>
- (3) South Africa. The Nasdaq Stock Market and Strate, the South African CSD, have announced that Nasdaq will deliver a blockchain-based e-voting solution to shareholders. The aim is to make voting processes less administratively intensive and ensure that all information is transparent to shareholders when required.<sup>129</sup>

2.87 The financial services market and the role of intermediated securities will vary between jurisdictions. This should be taken into account when considering technology solutions: a one-size-fits-all approach is unlikely to be appropriate. However, we invite views from consultees as to their experiences in other jurisdictions which may be developing DLT solutions.

#### **Question 18.**

2.88 Do you consider that distributed ledger technology has the potential to facilitate the exercise of shareholders' rights and, if so, in what way? What are the obstacles to adoption of this technology?

Are there any other jurisdictions we should look to as examples?

#### **Other technologies**

2.89 Although we have focused on DLT, there are other ways in which technology might be usefully applied to solve current issues.

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<sup>126</sup> E Micheler and L von der Heyde, "Holding, clearing and settling securities through blockchain/distributed ledger technology: creating an efficient system by empowering investors" (2016) 11 *Butterworths Journal of International Banking and Financial Law* 652, 655.

<sup>127</sup> ASX, "CHESS Replacement", <https://www.asx.com.au/services/chess-replacement.htm>.

<sup>128</sup> Nasdaq, "Nasdaq's Blockchain Technology to transform the Republic of Estonia's e-Residency Shareholder Participation" (2016), <http://ir.nasdaq.com/news-releases/news-release-details/nasdaqs-blockchain-technology-transform-republic-estonias-e>.

<sup>129</sup> Nasdaq, "Nasdaq to deliver blockchain e-voting solution to Strate" (2017), <https://business.nasdaq.com/mediacenter/pressreleases/1648022/nasdaq-to-deliver-blockchain-e-voting-solution-to-strate>.

- 2.90 For example, a recent report of the Association of Member Nominated Trustees noted that the current manual process of voting is said by fund managers to be a barrier to allowing split voting on behalf of ultimate investors in pooled accounts. This appears to be a clear example of a situation in which technology could be used to improve efficiency and strengthen the rights of ultimate investors.<sup>130</sup>

### Question 19.

We welcome consultees' views on, and any evidence of, ways in which technology in general might be able to solve problems in the context of an intermediated securities chain.

## DEMATERIALISATION

- 2.91 We explain above that “dematerialisation” allows companies to issue securities without a paper certificate to constitute or evidence them.<sup>131</sup> A dematerialised (or “uncertificated”) security is represented instead by an entry in an electronic register and is transferred by amending the register.
- 2.92 Although investment securities are increasingly held in dematerialised form, some people still hold paper securities. In its 2016 research paper, BIS reported that research indicated that “around half of equity investors held certificated (or ‘paper’) shares”.<sup>132</sup>
- 2.93 However, this may change in the future. In September 2014 the Central Securities Depositories Regulation (“CSDR”) came into force, although some provisions apply at a later date.<sup>133</sup> This is an EU regulation which applies directly in all member states without need for further implementation. Therefore, the CSDR is currently part of the law of England and Wales.
- 2.94 The CSDR sets deadlines of 2023 for ceasing the issue in paper form of most new publicly traded securities and 2025 for the dematerialisation of existing paper shares for publicly traded securities.<sup>134</sup> This development will affect ultimate investors. For example, it will impact on individual shareholders who hold their shares directly through paper share certificates. These certificates will need to be replaced with an electronic form of holding shares.

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<sup>130</sup> Association of Member Nominated Trustees, *AMNT review into fund managers' voting policies and practices* (May 2019), 9, <https://amnt.org/wp-content/uploads/2019/05/AMNT-final-review-for-FCA-22-May-2019.pdf>.

<sup>131</sup> See para 1.21 above.

<sup>132</sup> BIS, “Exploring the intermediated shareholding model” (2016) p 15.

<sup>133</sup> Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012, Official Journal L 257 of 28.8.2014 p 1.

<sup>134</sup> CSDR, arts 3 and 76. Under the European Union (Withdrawal) Act 2018, s 3, the CSDR is part of retained EU law. In the event of a no-deal exit from the EU, the 2023 and 2025 deadlines will not apply in the UK: see draft Central Securities Depositories (Amendment) (EU Exit) Regulations 2018, reg 22(8).

- 2.95 Regardless of the status of the CSDR in this jurisdiction in the future, stakeholders have told us that dematerialisation is generally considered to be a positive step towards greater efficiency.
- 2.96 During 2016 and 2017, the Government actively engaged with industry participants on the process for dematerialising existing paper share certificates. The Government proposed as part of the engagement that shareholders currently holding paper certificates should remain direct shareholders after dematerialisation with no loss of shareholder rights. The work was suspended in view of the uncertainties about the UK's approach to the CSDR and other matters after exiting the EU, but we understand that the assumption remains that these shareholders should retain their direct shareholder rights.
- 2.97 Against this background, we welcome views from consultees. In particular, we would like to know about the approaches being developed in relation to the proposed dematerialisation of paper share certificates. As set out above, the Government proposed that shareholders currently holding paper certificates would not lose their shareholder rights after dematerialisation. Could the approaches being developed for dematerialisation be applied to the ultimate investors in an intermediated securities chain to provide that they have the same or similar rights as direct shareholders?
- 2.98 Additionally, some of the current paper certificate holders may be long-time shareholders. We welcome comments from consultees as to the whether this may raise issues of digital poverty or exclusion.<sup>135</sup>

**Question 20.**

- 2.99 Has the market started to prepare for the dematerialisation that would be required under CSDR? If so, what steps have been taken and by whom?

**Question 21.**

- 2.100 Are there approaches in relation to dematerialisation in the context of CSDR which could be applied to the ultimate investors in an intermediated chain to provide ultimate investors with the same or similar rights as direct shareholders?

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<sup>135</sup> Digital poverty or "digital exclusion" refers to exclusion from the opportunities afforded by digital technologies, for example due to a lack of access to the internet. See HM Government, Delivering Digital Inclusion: An Action Plan for Consultation (2008), <http://webarchive.nationalarchives.gov.uk/20120919213425/http://www.communities.gov.uk/documents/communities/pdf/1001077.pdf>. See also Age UK, Digital Inclusion Evidence Review (2013), 3, [https://www.ageuk.org.uk/globalassets/age-uk/documents/reports-and-publications/reports-and-briefings/active-communities/rb\\_sept13\\_age\\_uk\\_digital\\_inclusion\\_evidence\\_review.pdf](https://www.ageuk.org.uk/globalassets/age-uk/documents/reports-and-publications/reports-and-briefings/active-communities/rb_sept13_age_uk_digital_inclusion_evidence_review.pdf).

### **Question 22.**

2.101 Are there concerns about imposing dematerialisation on long-time shareholders currently holding paper certificates, when they may not be confident users of technology?

## **DEVOLUTION**

2.102 The purpose of this project is to produce a scoping study which will not include formal recommendations for reform. This means that questions of legislative competence and devolution do not arise as major issues at this stage, but it is nevertheless important to be aware of the devolution settlements and any relevant legal differences between the jurisdictions of the UK.

2.103 As described above, the project will consider financial markets and services for the United Kingdom. These are reserved matters under the Government of Wales Act 2006, the Scotland Act 1998 and the Northern Ireland Act 1998.<sup>136</sup> Notwithstanding this position, we are naturally keen to ensure that our work on the scoping study – and any potential further work – is alive to differences in law and practice in devolved jurisdictions.

2.104 The Law Commission can only make recommendations for England and Wales. If we were asked to take on further work in this area, with a view to law reform, we would need to consider with the Government, the Scottish Law Commission and the appropriate devolved bodies the best way to proceed.

### **Question 23.**

2.105 We welcome comments from consultees as to whether there are aspects of the law of the devolved jurisdictions which we should be aware of given the work we propose in relation to intermediated securities.

## **COMPARISON WITH OTHER JURISDICTIONS**

2.106 As part of our scoping study, we intend to consider the position in relation to intermediated securities in a sample of other jurisdictions. We are particularly interested in discovering how other jurisdictions address concerns relating to investor rights. We welcome suggestions from consultees as to which jurisdictions and systems we should consider as part of this exercise.

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<sup>136</sup> Government of Wales Act 2006, s 108A, sch 7A, paras 17 to 18; Northern Ireland Act 1998, s 4(1), sch 3; Scotland Act 1998, s 30, sch 5, paras A3 to A4 and paras C1 to C2.

### **Question 24.**

2.107 What other jurisdictions should we consider and why?

### **WHAT OTHER ISSUES SHOULD WE CONSIDER?**

2.108 In the preceding paragraphs, we have set out a summary of the issues we currently plan to consider in the call for evidence. These issues have been derived from initial conversations with stakeholders, recent academic work and cases, as well as previous work on intermediated securities.

2.109 We are keen to hear from consultees whether there are other issues which cause problems in practice and which should be included in the scope of our review.

### **Question 25.**

2.110 We welcome suggestions from consultees as to other issues which arise in practice which should be included in our scoping study. For each issue, we would be grateful for the following information:

- (1) A summary of the problem.
- (2) An explanation of and evidence of the effect of the problem in practice.
- (3) Suggestions as to what could be done to solve the problem, and any evidence of the costs and benefits of the solution.

### **IMPACT ASSESSMENT**

2.111 Our terms of reference require us to consider the costs and benefits – financial and otherwise – of any potential solutions to the issues highlighted above, and any others which stakeholders draw to our attention. Of course, in this call for evidence we have not proposed any solutions, so our questions, and any responses we receive, will necessarily be general. However, we hope that consultees will be able to give some rough indications of costs and benefits in answer to our questions below. Where possible, we would welcome estimates of figures and/or any available evidence.

2.112 We have been told, for example, that facilitating guaranteed voting rights for ultimate investors could see noticeable benefits in corporate governance and stewardship, leading to long-term economic and other benefits for society as a whole. We have also heard that ensuring legal remedies for ultimate investors, and ensuring they are protected in the event of an insolvency somewhere in the chain, will lead to a fairer system for those who entrust their money to the hands of others.

2.113 On the other hand, we have been urged to be alert to “unintended consequences” which could flow from attempts to make changes to the current system. Some stakeholders have suggested that any attempts to enhance the rights of ultimate investors will lead to more complexity and expense in the chain.

2.114 We are also keen to hear about the benefits of the current system, as well as any costs to which it gives rise, particularly for ultimate investors.

**Question 26.**

2.115 What are the benefits – financial or otherwise – of the current system of intermediation? What are the costs or disadvantages – are there any problems beyond those we have highlighted above?

**Question 27.**

2.116 What could be the benefits – financial or otherwise – of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain?

**Question 28.**

2.117 What could be the costs – financial or otherwise – of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain?

## Appendix 1: Terms of reference

This project was included in the Law Commission’s Thirteenth Programme of Law Reform.<sup>137</sup> It is sponsored by the Department for Business, Energy and Industrial Strategy (BEIS). It consists of a twelve-month scoping study of investor rights in a system of intermediated securities.

The scoping study will provide:

- (1) An accessible statement of the current law, including a clear explanation of how shares and bonds are “owned” and held;
- (2) A description of the corporate governance and other legal issues associated with intermediated shareholdings and an assessment of whether the issues cause difficulties in practice;
- (3) A range of possible solutions – both legislative and non-legislative – presented in sufficiently developed form to provide a basis for future focused policy development and consultation by BEIS;
- (4) A summary of technological developments that might make it easier for underlying investors to exercise shareholder rights;
- (5) A summary of the costs and benefits of the potential solutions (in a form that will be useful to BEIS analysts), and suggestions about where further analytical work might be needed (eg interview, survey, and/or behavioural research with stakeholders);
- (6) A view on whether systems being put in place to remove paper certificates by 2025 (with the issue of new paper certificates phased out in 2023) offers opportunities to enhance the rights of investors already holding shares electronically as well as maintain in full the existing rights of holders of paper certificates;
- (7) An account of the views of the main stakeholders.

Given recent work by the European Commission and HM Treasury, the scoping study will not address conflict of laws issues.

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<sup>137</sup> Thirteenth Programme of Law Reform (2017) Law Com No 377 p 16.