Intermediated securities

Summary of responses to call for evidence

This document summarises the responses to the Law Commission’s call for evidence on intermediated securities

January 2021
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DESCRIBING RESPONSES

This paper describes the responses the Law Commission received in relation to the questions set out in the intermediated securities call for evidence, published in August 2019. This document aims to report the arguments raised by the consultees. It does not give the views of the Law Commission. The Law Commission’s conclusions on the current law and possible options for reform are set out in a scoping paper, published in November 2020.  

REFERENCES TO THE LAW COMMISSION’S CALL FOR EVIDENCE

In this summary of responses, when we refer to the Law Commission’s call for evidence, we use an abbreviated reference (“Call for evidence (2019)”) in the footnotes. The full reference with website link is as follows:


ONLINE CONTENT

All websites referenced in this document were last accessed on 8 January 2021.

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# List of abbreviations

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<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ABI</td>
<td>Association of British Insurers</td>
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<td>AFME</td>
<td>Association for Financial Markets in Europe</td>
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<td>AGC</td>
<td>Association of Global Custodians</td>
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<td>AMNT</td>
<td>Association of Member Nominated Trustees</td>
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<td>BEIS</td>
<td>Department for Business, Energy and Industrial Strategy</td>
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<td>CA 2006</td>
<td>Companies Act 2006</td>
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<tr>
<td>CASS</td>
<td>FCA Handbook Client Assets Sourcebook</td>
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<td>CLLS</td>
<td>City of London Law Society</td>
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<tr>
<td>COBS</td>
<td>FCA Handbook Conduct of Business Sourcebook</td>
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<tr>
<td>CSD</td>
<td>Central Securities Depository</td>
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<td>DLT</td>
<td>Distributed Ledger Technology</td>
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<td>EUI</td>
<td>Euroclear UK &amp; Ireland</td>
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<td>FCA</td>
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<td>FCARs</td>
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<td>Financial Services Compensation Scheme</td>
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<td>LSEG</td>
<td>London Stock Exchange Group</td>
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<td>PIMFA</td>
<td>Personal Investment Management &amp; Financial Advice Association</td>
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<tr>
<td>Abbreviation</td>
<td>Description</td>
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<td>--------------</td>
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<tr>
<td>PLSA</td>
<td>Pensions and Lifetime Savings Association</td>
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<td>PRI</td>
<td>Principles for Responsible Investment</td>
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<td>PRIMA</td>
<td>Place of the relevant intermediary approach</td>
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<td>QCA</td>
<td>Quoted Companies Alliance</td>
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<td>SAR</td>
<td>Special Administration Regime</td>
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<td>UKSA</td>
<td>UK Shareholders’ Association</td>
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<td>USRs</td>
<td>Uncertificated Securities Regulations 2001, SI 2001 No 3755</td>
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Chapter 1: Introduction

1.1 When people have money saved, they may wish to invest it. But not all investments are straightforward to own. If you buy a gold bar, you own the gold bar. If you buy a piece of art, you own the painting or sculpture. If you decide to buy securities, such as shares or bonds issued by a company, the position is more complicated.

1.2 In the modern era, when you decide to invest in shares or bonds, you are unlikely to receive a paper certificate. Instead, most investors “own” securities through computerised credit entries in a register called CREST, through a chain of financial institutions, such as banks, investment platforms and brokers (“intermediaries”). If you hold shares or bonds through this type of arrangement (an “intermediated securities chain”), you may not have access to all the shareholder rights which you would have with a paper certificate or a CREST membership, such as the right to vote on company resolutions. You may also be exposed to additional risks, especially if an intermediary in the chain suffers financial difficulties.

1.3 It is possible for an investor, whether an individual retail investor or an institutional investor such as a pension fund, to have an account in CREST and therefore to own securities directly, even where they are held electronically. However, it has become more common for investors to hold their investments through an intermediated securities chain.

1.4 In June 2019, the Department for Business, Energy and Industrial Strategy (“BEIS”) asked the Law Commission to undertake a “scoping study” into investor rights in a system of intermediated securities. We published a call for evidence in August 2019, followed by a scoping paper in November 2020.

RESPONSES

1.5 Our call for evidence sought views and evidence from market participants about their experiences of the intermediated securities system. We raised a wide range of issues and we asked consultees whether the law was fit for purpose and whether they had experienced problems in practice. We also asked consultees whether developments in technology had the potential to facilitate the exercise of shareholder rights.

1.6 We received 42 responses from 46 consultees from the following categories:

| Professional membership organisations | 13 |

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3 Some consultees – such as UKSA and ShareSoc, and AFME and UK Finance – provided a joint response.
A full list of consultees who responded to the call for evidence is included at the end of this paper, excluding two consultees who provided confidential responses.

This paper provides a summary of the responses the Law Commission received and includes key quotes to demonstrate the views expressed by consultees. Where our questions invited “yes”, “no” or “other” type responses, we have included figures to illustrate how many consultees answered in each way. However, given the nature of the questions, in some cases we have had to extrapolate an answer. The figures are therefore indicative rather than precise.

**NEXT STEPS**

In November 2020, we published our scoping paper on intermediated securities, in which we analyse the law underlying intermediated securities, together with concerns of market participants, and suggested possible solutions to those concerns. It is now for the Government to decide whether there should be further work, either by the Government or by the Law Commission, on these potential solutions.

**ACKNOWLEDGEMENTS**

We would like to thank all the consultees who took the time to respond to our call for evidence, or who met with us or contacted us to express their views. Although we are unable to quote all consultees’ submissions directly in this short summary, those views were important to us and taken into account in our formulation of the scoping paper.

<table>
<thead>
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<th>Consultee Type</th>
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<td>Businesses</td>
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<td>Other</td>
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<td>Confidential</td>
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Chapter 2: Voting rights

2.1 Companies may issue equity securities (such as shares) and/or debt securities (such as bonds) as a means of corporate finance. Shares usually have rights and duties attached to them, including the right to vote on company resolutions. This right 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.

2.2 Holders of bonds 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.4

2.3 Previous research has found that intermediated securities chains may act as a barrier to ultimate investors who wish to participate in votes.5 We asked several questions about voting in relation to intermediated securities in the call for evidence. In particular, we asked whether:

(1) ultimate investors find it difficult to exercise voting rights in the first place;

(2) there are other intermediated securities systems which are better for ultimate investors than the current system in the UK;

(3) the type of vote affects the extent to which an ultimate investor may exercise voting rights;

(4) ultimate investors find it difficult to confirm that their vote has been received and counted;

(5) the rules and practical arrangements relating to the timing of voting affect the ability of an ultimate investor to vote; and

(6) any problems with proxy voting affect ultimate investors’ voting rights.

QUESTION 1: EXERCISING THE RIGHT TO VOTE

2.4 We asked whether consultees considered that it is difficult for ultimate investors to exercise their voting rights. If so, we asked consultees to provide examples, or specific evidence, of difficulties experienced by ultimate investors in exercising their voting rights. We also asked consultees what could be done to solve these problems. We discuss possible solutions below.6


6 See from para 2.121 below.
**Ultimate investors find it difficult to exercise the right to vote**

2.5 Some consultees agreed that it is difficult for ultimate investors to exercise voting rights. Several consultees emphasised that it is particularly difficult for ultimate investors to exercise voting rights where there are long intermediated securities chains. For example, the Pensions and Lifetime Savings Association (“PLSA”) emphasised the complexity of some chains.

2.6 A minority of consultees said that it is not difficult for ultimate investors to exercise rights. A joint response from the Association for Financial Markets in Europe (“AFME”) and UK Finance said:

> In our review of issues connected with securities law reform, over the years, we have never identified a concern that English law will not recognise the interests of investors. The equitable jurisdiction of the courts of England is sufficient to address any potential issues that arise because of the practical alienation of investors from their property through intermediation, provided that the relevant securities are in the UK or sufficiently under the control of a person who is subject to the jurisdiction of the UK courts.

2.7 Euroclear UK & Ireland Limited (“EUI”) acknowledged that there are concerns about the way ultimate investors are able to exercise voting rights, but said they did not consider it a significant problem for the “overwhelming majority of investors”. They based that conclusion on three factors. First, the ultimate investor may hold the security through an intermediary that does pass on voting rights. Secondly, the ultimate investor may be a “Personal Member” on the CREST system, and therefore exercise voting rights. Thirdly, the ultimate investor may hold securities for economic benefit only and not wish to participate actively in corporate decision-making.

2.8 The City of London Law Society (“CLLS”) drew a distinction between personal investors (for whom they considered there are “undoubtedly concerns”) and “large professional investors, such as pension funds”, which are likely to be “well advised and unlikely to face difficulties in putting in place arrangements with … intermediaries to facilitate the exercise of voting rights”. They said that there was not a significant problem that needed fundamental law reform. Rather, any problems that active investors may experience are ones of non-compliance with contractual or regulatory obligations, or possibly a gap in regulatory requirements, and could be addressed through regulation.

**Ultimate investors and the desire to exercise a right to vote**

2.9 Registrars provided information about the level of voting, saying that levels of voting are already high. For example, Computershare referred to the Georgeson AGM Season Review. This review stated that the average 2019 quorum (that is, the percentage of shares in issue for which voting instructions were received) for FTSE

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7 Of the 35 consultees who responded to this question, 27 agreed that it is difficult for ultimate investors to exercise voting rights, that they had experienced difficulties or that they have been told of difficulties in exercising voting rights, two consultees disagreed, and six consultees answered “Other”.

8 The CLLS also drew a distinction between equity securities and debt securities. In relation to the latter, the CLLS said that they believed that the engagement of active personal investors is far smaller than in relation to equity securities and that any issues arise more from apathy than real or perceived structural issues.
100 issuing companies was 73.8%. The quorum for FTSE 250 issuing companies was 72.6%. Equiniti and the Registrars’ Group provided similar numbers, pointing out that the majority of issued share capital is held by institutional investors.

2.10 The UK Shareholders’ Association (“UKSA”) and ShareSoc, with whom John Hunter agreed, acknowledged that the current levels of voting by retail investors are low. According to UKSA and ShareSoc, these figures can, in part, be explained by the lack of information which goes to ultimate investors and by the practical difficulties faced by ultimate investors in exercising voting rights, which we describe below.

2.11 The CLLS said that most retail investors hold shares purely for economic reasons and are not concerned with voting on them. They did not think this was likely to change much in the foreseeable future. EUI also said that “many” investors hold securities for financial benefit only.

2.12 The Association of British Insurers (“ABI”) said that their members had not seen demand from customers to be able to vote and “by some estimates less than 1% of customers chose to exercise their right to vote”. However, the ABI also said that some of their members had reported that their customers want to see increased transparency in voting behaviour and they have asked asset managers who they work with to communicate how they vote.

2.13 The Personal Investment Management & Financial Advice Association (“PIMFA”) said that they had had feedback from their members that the majority of clients are not interested in voting:

[E]ven where firms have systems available to allow the ultimate investor to exercise their votes at no cost, the take up has still been low, despite the facility being marketed to their clients. Assuming the feedback we have had is correct, in making an assessment of the benefits to the ultimate investor, there needs to be recognition that the majority of clients do not avail themselves of functionality that has been made available to them to exercise their votes.

2.14 ShareAction said that there is a strong public policy case for improving corporate governance by encouraging retail investors to participate in delivering effective stewardship, and that this is particularly clear for AIM and small cap companies.

A mismatch in expectations

2.15 Some consultees suggested that the difficulties faced by ultimate investors in exercising a right to vote are due in part to a lack of understanding about how the system works or a mismatch between the ultimate investor’s expectations and the arrangement with their intermediary. UKSA and ShareSoc said that ultimate investors find it difficult to know their rights, particularly where the intermediary’s terms and conditions are unclear or complex.

Terms and conditions governing the intermediary-ultimate investor relationship

2.16 Consultees noted that contractual terms and conditions are often determinative of whether an ultimate investor may exercise voting rights. The service provided differs between intermediaries. For example, PIMFA explained:
The degree of difficulty faced by ultimate investors in exercising their voting rights will vary from firm to firm. A number of firms have automated systems which enable clients to exercise their votes at no additional costs. Other firms have more manual administrative arrangements and may levy a charge. The extent to which firms invest in systems to enable ultimate investors to exercise their voting rights may in part be driven by their service offering. For example, an execution only firm dealing with high volumes of individual investors would be more likely to invest in systems than a discretionary only firm where the discretion to vote is vested in the firm.

2.17 Dr Eva Micheler pointed out a further complexity relating to the terms and conditions:

In addition, the terms used by service providers frequently allow outsourcing. Ultimate investors do not know if their service providers have used the authority to outsource and they also do not have control over on what terms outsourcing occurs. It is therefore possible that the responsibility to pass on votes is not passed on to the providers to which custody services are outsourced.

Practical barriers to voting

2.18 Several consultees said that even if intermediaries are willing to pass back voting rights, practical obstacles remain. For example, some consultees said that ultimate investors are not told about voting events and are unlikely to know when to request a vote. Consultees said that even when an ultimate investor knows about an upcoming vote, there may be a complex process which they need to follow in order to vote, which Roger Lawson said is “tedious” and “deters investors from voting”. Registrars agreed that there “can be misunderstandings regarding the process”.

2.19 Although Andrew Turvey said that he had had a positive experience in relation to voting, he noted that it was clear that it was an “exceptional process: an investor must specifically request it for a specific purpose and you have to search through the help to find out how to do this”. The London Stock Exchange Group (“LSEG”) noted that the processes for receiving information and instructing an intermediary differed from provider to provider, and that “some investors speculate that providers make this intentionally difficult”. The Quoted Companies Alliance (“QCA”) said that such processes could be “highly cumbersome”.

2.20 Link Asset Services said that one of the issues associated with intermediated securities is timing and the limited time which an ultimate investor will have to vote, given delays in receiving information through the chain. Eric Chalker also remarked on what happens in practice:

The Companies Act and various regulations prescribe the information that company members must be given and when, but investors whose shares are held by nominees are dependent on the terms of contract with their intermediaries. The information needed to vote on company matters with due consideration includes annual reports, circulars to shareholders, notices of general meetings and the resolutions being proposed. At best, nominee account users will receive the information later than would be the case if they were registered as the shareholders.

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9 UKSA and ShareSoc said that they had heard of instances of members not being sent a voting form or link to online voting.
or at worst not at all, or they may have to pay to receive it in printed form (a right to which company members are entitled by law free of charge).

2.21 Consultees also said that fees for voting were a problem. For example, Ali Haouas said that an intermediary would only provide a letter of representation, allowing attendance at an AGM, for a fee of £20. The Registrars' Group, Equiniti and Computershare said that they had seen “a continued increase” in ultimate investors representing their own investment interests at meetings “by way of a Letter of Representation”:

[A] Letter of Representation … doesn’t need to be lodged with the Issuers Agent ahead of the meeting, and so provides some flexibility to the ultimate investor. However we understand that such appointments may come at a cost which in some cases we understand could be prohibitive.

2.22 Some consultees said that these practical barriers meant that ultimate investors were not motivated to, or were unable to, vote.

Part 9 of the Companies Act 2006

2.23 Link Asset Services said that Part 9 of the Companies Act 2006 (“CA 2006”) has “helped ultimate investors somewhat enabling investors using nominee accounts to receive information from the companies they invest in”. However, they also said they “understand that many stockbrokers do not facilitate this”.

2.24 Eric Chalker drew attention to the ISA Regulations, observing that the rights under these regulations are more comprehensive than rights provided under Part 9 of the CA 2006. However, he said that:

most ultimate investors are unaware of these rights, ISA managers do not bring them to their notice, they are not normally offered, resistance to providing them may be encountered and there is no body which enforces them.

Issuing companies and shareholder engagement

2.25 Although most consultees focused on the desire of ultimate investors to engage with companies, some consultees emphasised that issuing companies also wish to engage with ultimate investors. Andrew Turvey said that company investor relations teams had told him that it was “practically impossible” for them to obtain contact details for ultimate investors who had invested through an intermediated securities chain.

2.26 The CLLS said that active investors are valued by UK corporates and the exercise of rights by this group without undue expense should be facilitated. The QCA agreed, saying that engaging with ultimate investors allows their members (small and mid-size companies) to receive feedback on potentially contentious issues.

2.27 UKSA and ShareSoc said that retail investors are often excluded from shareholder engagement exercises.

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Intermediaries’ unwillingness to vote or pass back rights

2.28 Some consultees suggested that some intermediaries are unwilling to vote on behalf of ultimate investors, or to enable an ultimate investor to vote. For example, LSEG said that intermediaries managing assets on behalf of a number of ultimate investors abstain from voting rather than passing back rights.11 The Registrars’ Group said that one of the contributory factors to difficulties in voting is “failure on the part of the intermediary to provide confirmations of their entitlement to exercise votes”.

2.29 The Financial Conduct Authority (“FCA”) said that respondents to a recent discussion paper12 raised concerns that nominee companies may not adequately support voting in line with ultimate investors’ preferences, noting that:

One stakeholder commented that enabling shareholders who hold their shares in nominee accounts to use their shareholder vote easily and at no extra cost is critical to shareholder rights.

2.30 The Principles for Responsible Investment (“PRI”) said that any extent to which intermediation reduces the ability to reflect the preferences of beneficiaries (such as the ultimate investors) in how votes are cast could constitute a breach of fiduciary duty.

2.31 In Sir John Dermot Turing’s view, intermediaries “are obliged to process investors’ voting instructions”:

It would be a breach of a custodian’s English-law duty to disregard a properly given instruction except insofar as there is an agreement between the custodian and its client that certain instructions need not be acted upon.

2.32 Sir John Dermot Turing said that “it should not be assumed that there is an inherent problem in exercising investor rights when securities are held through an intermediated structure”. He noted that custodians are regulated under the Financial Services and Markets Act 2000 and that trade associations such as the International Securities Services Association and the Association of Global Custodians (“AGC”) periodically issue best-practice guidance on handling issues relating to voting rights and corporate actions.

POOLED FUNDS

2.33 The primary focus of our work was investors who purchase an interest in securities which they hold through an intermediated securities chain. We did not focus on

11 LSEG said that they were uncertain as to whether this practice is more prevalent among discretionary/non-discretionary managers or execution-only intermediaries operating omnibus accounts.

investors who pay money into pooled funds, which are a particular type of investment product distinct from intermediated holdings.\(^\text{13}\)

2.34 When responding to the call for evidence, some consultees referred to potential problems in relation to pooled funds. For example, the AMNT said that pension fund trustees “almost always find in practice” that intermediaries will “thwart” the ultimate investor who tries to instruct on voting, unless the ultimate investor’s instructions match the intermediary’s voting policy.\(^\text{14}\) The AMNT gave the following example:

An example of the problem is that trustee bodies that have adopted a voting policy aligned to the AMNT’s Red Line Voting initiative are told by managers that the latter will not accept instructions in accordance with that policy, even though those instructions expressly authorise managers to secure a different vote where they believe it in the client’s interest, so long as they explain the divergence to the trustee body. This sort of response has on occasion been received even where the manager in question had expressly agreed in the context of a selection “beauty parade” to accept Red Line Voting instructions as just described.

2.35 Ray Shepherd, a member nominated trustee of The Institute of Cancer Research Pension Scheme, provided an example of the problem outlined by the AMNT. She said that the pension scheme “included asking for adoption of red line voting as one of the criteria in our beauty parade for investment manager selection nearly four years ago”. The scheme chose an intermediary who agreed to adopt the AMNT’s voting policy. However, Ray Shepherd said that “after their appointment they were reluctant to adopt Red Lines specifically and said if we wanted them to vote differently from their own policy it would result in additional charges”.

2.36 ShareAction, who work with a range of asset owners, also said that they had heard of the difficulties faced by some owners in having their voting policies implemented by their managers.

2.37 The PLSA suggested that a refusal by intermediaries to accept instructions could be for a number of reasons, including the complexity in splitting votes in pooled funds, legal issues or as a matter of principle. The Association of Member Nominated Trustees (“AMNT”) remarked that this obstruction could be considered improper.

2.38 The PLSA suggested that solutions should aim at reducing administrative and technological barriers for exercising votes in pooled funds, and at increasing transparency in the investment chain. They said pension schemes would benefit from initiatives encouraging fund managers and other intermediaries to publish their voting policies, and, as far as possible, publicly disclose their voting records, in accordance with the Financial Reporting Council’s Stewardship Code 2020.\(^\text{15}\) This would enable investors to better assess whether the manager fully represents their views and hold them accountable for their decisions. They further suggested transparency should be

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\(^\text{14}\) PRI, ShareAction and Ario Advisory also raised this problem.

increased in CREST regarding who owns ultimate shares and ascertaining who are
the large investors in a company, as this would facilitate collective engagement and
promoting shareholder resolutions.

**QUESTION 2: IS THERE A BETTER SYSTEM OF INTERMEDIATION?**

2.39 We asked whether there are particular systems or models of holding intermediated
securities which could better facilitate the passing back of direct rights for ultimate
investors.\(^{16}\) We wanted to discover from consultees whether tweaks could be made to
the current system which would better serve its users, especially ultimate investors.
We also asked consultees whether there are obstacles to the use of other systems or
models.

2.40 We received a range of responses from consultees, without a strong consensus.\(^{17}\)

**Intermediation is the problem**

2.41 Some consultees said that intermediation itself was the problem and that the current
system should be replaced by a model of direct holding of securities. For example,
Eric Chalker said:

> Whatever systems or models of intermediation may be proposed to improve the
position of ultimate investors, none will be satisfactory. This is because
intermediation necessarily introduces an element of interference between issuer and
shareholder which will always cause time delays and, very probably, a degree of
inconvenience that will be self-defeating … Instead of trying to make a bad
arrangement better, the holding of company shares in nominee accounts by private
investors should be ended, a far simpler solution.

2.42 UKSA and ShareSoc explained that the removal of intermediation would be better
than a different system of intermediation. They said that if intermediation was
removed, the legal position would be that the intermediary would become an agent
acting on behalf of an ultimate investor, rather than holding a legal or beneficial
interest in the securities.

**Other international models**

2.43 The Registrars’ Group and Computershare both said that several international models
facilitate the pass-back of rights to ultimate investors. These models fall into the
following two broad categories.

(1) Systems where rights are provided on an evidential basis. Such evidence
typically takes the form of advice from the intermediary confirming the holder’s
entitlement. The Registrars’ Group and Computershare said that this type of
system raises questions about the verification and reconciliation of entitlement,
with a potential risk of fraud and inaccuracies.

\(^{16}\) Call for evidence (2019) para 2.12.

\(^{17}\) 20 consultees responded to this question. Ten consultees answered “yes”, three answered “no” and seven
answered “other”.

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Systems with a process that is sometimes known as re-registration or disclosure. Rights are conditional on the provision of the ultimate investor’s details before voting can take place. The Registrars’ Group and Computershare said that this type of system has the potential to improve transparency and certainty. However, it would need significant investment, discussed below.

2.44 The QCA drew a distinction between transparent systems and tiered, non-transparent systems.

(1) Transparent systems: ultimate investors and issuers are connected directly and intermediaries “have a more dormant role”.

(2) Tiered, non-transparent systems: there is no direct connection between issuers and ultimate investors. Such a connection can be facilitated by an intermediary. The QCA said that under this system, ultimate investors are “most frequently impeded from gaining access to their rights”.

2.45 John Hunter said that the Australian system of intermediated securities better facilitates the passing back of rights.

Technology is the solution

2.46 Some consultees said that technology could better facilitate the holding of intermediated securities. Mohammed Amin said that the UK should adopt an entirely electronic system. Link Asset Services said that nominees and custodians had recognised “the need to better distribute holder rights through the investment chain” and that the industry was developing a potential technology solution. Dr Eva Micheler said it would not be difficult to use technology to develop a solution that allows ultimate investors to hold securities directly.

Current methods of passing back rights to ultimate investors

2.47 Andrew Turvey said that he has used the proxy method successfully to participate in voting and that it can be applied to any intermediated securities holding model. The Registrars’ Group and Equiniti said that intermediaries provide different levels of service, which are set out in an intermediary’s contractual terms and conditions.

2.48 Link Asset Services suggested an approach using sponsored nominees, saying that they operated a number of such nominees on behalf of issuer companies. Under this approach, the company-sponsored nominee is named on the share register. The details of ultimate investors are named on the register of the nominee. The issuer companies “tend to have” terms and conditions for their nominee which ensure that rights such as voting rights are made available to ultimate investors. Link Asset Services said that such an approach works well to deliver shareholder rights to ultimate investors. However, they also said it is currently adopted in limited circumstances, where an issuer has large numbers of retail shareholders on its main share register.

Requiring intermediaries to pass account details to registrars

2.49 UKSA and ShareSoc suggested that the current intermediated system could be adjusted to require intermediaries with omnibus accounts to pass underlying account
details to registrars. That would provide registrars with an up-to-date record of beneficial share ownership.

2.50 UKSA and ShareSoc also said that the current system could be improved by a legislative amendment making Part 9 of the CA 2006 mandatory. They noted that there were disadvantages to this approach. For example, such an approach does not ensure ring-fencing of assets in the event of insolvency. Nor does it provide that ultimate investors have all the rights and remedies available to members under the CA 2006. Additionally, Part 9 does not currently apply to AIM listed companies.\(^\text{18}\)

**Other comments**

2.51 Both the CLLS and EUI said that they did not consider that other systems or models of holding intermediated securities would better facilitate the passing back of direct rights for ultimate investors in the context of English law.

2.52 Dr Ewan McGaughey said that rights do not need to be passed back. Rather, intermediaries should vote in accordance with instructions provided by the ultimate investors. The AGC said that the type of issues referred to in the call for evidence are mostly “behavioural” issues and do not reflect a fundamental problem with the system and substantive law.

2.53 Dr David Gibbs-Kneller observed that the question implied that passing back rights to the ultimate investor would have a positive effect on corporate governance. He said that it is not certain that the rights would be exercised to achieve the corporate purpose.

**Potential obstacles to the use of other systems or models**

**Current business models and commercial interests**

2.54 Some consultees identified intermediaries’ commercial interests as the key obstacle to the adoption of a new system. For example, John Hunter said:

> Key obstacle is the commercial interest of those who profit from ownership of rights that properly belong to others. Stock lending is an obvious example, but more serious is the use of control in takeover battles, when voting rights have enormous commercial value.

2.55 LSEG said that any move to a system in which the ultimate investor is on the register could necessitate “a fundamental reorganisation” of intermediaries’ business models, potentially leading to increased regulatory requirements and costs. They asserted that the impact of such a move should be considered from a competition perspective, particularly if, for example, such a model would only be economical for larger intermediaries.

2.56 The CLLS said that the legal adjustments which would be required to put the ultimate investor in the same position as a CREST sponsored member could not be justified. Instead, the emphasis should be on the identification of active ultimate investors,

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\(^{18}\) LSEG made the same point in relation to the application of Part 9 of the Companies Act 2006 to AIM-listed companies.
ensuring that they can participate effectively. Those investors should not use intermediaries who cannot take steps to provide rights to ultimate investors.

2.57 The AGC emphasised that the existence of cross-border holdings brings added complexity to the system.

Investment

2.58 Some consultees suggested that the adoption of specific technology or a move to a different type of system should be considered. For example, the Registrars’ Group and Computershare suggested that a re-registration or disclosure system had the potential to improve transparency and certainty. However, these consultees also warned that such a system would require significant investment from all stakeholders, including addressing any cross-border implications.

Identification and transparency

2.59 The QCA said that a lack of transparency and issuers’ inability to identify their shareholders in a timely manner prevent the passing back of rights to ultimate investors in the current system.

Would a new system raise new problems?

2.60 Even where consultees suggested a different system, they often pointed out that it may bring different problems. For example, the Registrars’ Group and Computershare observed that a re-registration or disclosure system would require data to be updated daily. In the absence of regularly updated data, there would need to be an early “entitlement date”, to ensure that the data is provided ahead of the meeting. This, in turn, would increase the risk of “empty” voting by ultimate investors who do not have an economic interest in the outcome of the meeting (because, for example, they have recently sold their shares).

QUESTION 3: THE TYPE OF VOTE

2.61 We asked consultees whether the type of vote affects the extent to which ultimate investors can exercise voting rights. If so, we asked for examples or specific evidence of this issue.

2.62 Several consultees said that the type of vote affects the extent to which ultimate investors can exercise voting rights. However, there was not a consensus as to whether it is easier or more difficult to exercise voting rights for particular types of votes.

Corporate actions compared with general meetings

2.63 Some consultees said that it is easier to exercise voting rights for AGMs than for corporate actions. For example, Andrew Turvey said that ultimate investors are more likely to be able to participate in a vote that is a predictable occurrence.

2.64 UKSA and ShareSoc agreed that the type of vote affects the exercise of voting rights, and said that it depends on whether the ultimate investor receives information rights. If

19 consultees responded to this question. Nine consultees answered “yes”, ten answered “no”.

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not, then the ultimate investor is likely to remain unaware of upcoming votes unless such votes have a high profile. Likewise, the Registrars’ Group observed that voting on special resolutions or on a corporate event may generate more interest. However, they also said that the same mechanics are available regardless of the type of vote.  

2.65 Other consultees said that it is easier to exercise rights for corporate actions than general meetings. For example, Eric Chalker said that there is a practice of reducing the notice period before general meetings, from 21 days to 14 days (apart from for AGMs). He asserted that such a reduction makes it more difficult for an ultimate investor to decide how to vote and make arrangements for voting.

2.66 Computershare and the Registrars’ Group both said that they did not see the type of issues that arise in relation to voting in general meetings arising in relation to corporate events. Both consultees posited that this was “most likely due to the fact that financial consequences of errors can be severe” and further said:

The intermediaries and the ultimate investors have developed systems and processes to ensure such elections are communicated and actioned in a timely, accurate and effective manner which implies that, when a direct financial consequence hangs on the process, it works effectively. One might conclude that it is a lack of will rather than process-failure which inhibits the exercise of voting rights.

2.67 The CLLS said that the pass through to ultimate investors of information in relation to restructurings of debt securities is high. They said that this is because intermediaries may be at risk of claims if they do not make proper efforts to obtain instructions from the ultimate investors. On other, “less critical”, issues, “it can be difficult to drum up interest”. However, the CLLS said that this was not simply because of intermediation, but also because of the “wide distribution of holdings”.

Other points raised by consultees

2.68 UKSA and ShareSoc suggested that Eckerle v Wickeder Westfalenstahl GmbH demonstrates that investors are excluded from some votes and that that exclusion makes it easier for companies to secure resolutions (particularly special resolutions). Roger Lawson said that there are particular problems with schemes of arrangement.

2.69 Dr David Gibbs-Kneller said that investors would be more inclined to vote on matters clearly relating to share value, such as takeovers and re-registering from a public company to a private company, than other matters such as accounting and audits.

2.70 The CLLS commented on voting requirements for bondholder (a type of debt security) resolutions. They said that voting requirements are typically dealt with by the bond documentation, which may provide for a lower quorum or other requirements if the initial voting threshold is not passed. To the extent that there may be a risk for ultimate

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20 EUI made the same point, emphasising that the CREST system facilitates voting on resolutions as determined by issuers or their agents. From a functional perspective, ultimate investors will be able to exercise their voting rights through the CREST system where this is facilitated by intermediaries.

21 [2013] EWHC 68 (Ch), [2014] Ch 196.

22 UKSA and ShareSoc also said that companies try to use ordinary resolutions (which are passed with a simple majority) rather than special resolutions (which must be passed with a majority of not less than 75%).
Investors in relation to bonds, the CLLS said that this was a matter for regulation rather than legislation or structural change to the system.

The type of vote does not affect the exercise of voting rights

2.71 A minority of consultees said that the type of vote does not affect the extent to which ultimate investors can exercise voting rights. For example, Link Asset Services said:

It is not our experience that the type of resolution has an impact on the level of investor voting. In addition, voting and the approval of resolutions relating to corporate actions occur in the same manner and to the same level as at an annual general meeting. Where the corporate action requires investor to make elections or choose options, the intermediaries and the ultimate beneficial holders have established processes to enable elections to be actioned.

2.72 The AMNT said that there was a view that votes covered by section 153(1) of the CA 2006 were easier to exercise. However, they said that they had seen no evidence that these types of votes were easier in practice.

2.73 The AGC said that the type of vote does not affect the extent to which ultimate investors can exercise voting rights. They said that it is important to distinguish between voting through the intermediated securities chain and outside of that chain.

(1) Voting through the chain. This is the standard process and involves the ultimate investor providing its "securities account provider" with a "notice of participation". The notice advises how the ultimate investor will exercise its voting rights (such as by attendance in person, appointment of a proxy, details of voting instructions). The AGC said that this process is very similar to the standard process for corporate actions. Problems that may occur are linked to specific features of the vote or of the corporate action (such as timing) rather than to the type of vote or corporate action.

(2) Voting outside of the chain. This occurs when an ultimate investor contacts the issuer or the issuer’s agent directly. The AGC referred to this as a “non-standardised process” and said that it was conceptually and operationally complex. They said that voting outside of the chain may be more “vulnerable” to problems.

QUESTION 4: CONFIRMING A VOTE

2.74 Even when ultimate investors are able to 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.

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23 Section 153(1) of the Companies Act 2006 relates to the power to require a circulation of statement or resolution; members’ power to include matters in business dealt with at an AGM for a traded company; power to require an independent report on poll and power to require website publication of audit concerns.

24 Call for evidence (2019) paras 2.15 and 2.16.
We asked consultees whether they consider that it is difficult for ultimate investors to obtain confirmation that their votes have been received and/or counted. If so, we asked consultees about the impact and whether they have examples or specific evidence of difficulties experienced by ultimate investors in confirming that their votes have been received and/or counted. We also asked what could be done to solve these problems. We discuss possible solutions below.\textsuperscript{25}

**Difficulty confirming that votes have been received and/or counted**

Almost all consultees who answered this question agreed that it is difficult for ultimate investors to obtain confirmation that their votes have been received and/or counted.\textsuperscript{26}

Several consultees said that it could be difficult for ultimate investors to receive confirmation because of the length and complexity of intermediated securities chains. The AMNT provided the following example:

We are aware of a very large pension scheme that sought to determine for sure the fate of one of the votes it had instructed in respect of a security in which it had a beneficial interest; it found that, even though the security was held in a segregated account, it took dozens of man-hours at quite senior level to get an answer that was close to definitive.

The PLSA said that the lack of voting confirmation is a “source of frustration” for their members. Eric Chalker said in most situations, “it is always going to be virtually impossible” for ultimate investors to obtain confirmation that their votes have been received by the registrar.\textsuperscript{27} The CLLS agreed that it is difficult for ultimate investors to obtain evidence that their votes have been received and said that there is generally no requirement for issuers to provide evidence.\textsuperscript{28}

The Registrars’ Group, Computershare and Equiniti said that systems are in place to provide vote confirmation to registered members only. They also remarked that although provision of confirmation of votes is often viewed as a “simple solution”, the practical reality is more complex. For example, Equiniti said:

While Issuer Agents receive a voting instruction from a registered holder, there is no way for them or the Issuer to be able to ascertain who may sit behind that registered holder and so vote confirmations can only be provided to the shareholder (or the person that lodges the vote on their behalf). Dissemination of such confirmation to ultimate investors cannot accurately be undertaken without full knowledge of all the actions taken both prior to and at the meeting. However, this information should be

\textsuperscript{25} See from para 2.121 below.

\textsuperscript{26} 21 consultees responded to this question. 17 consultees agreed that it was difficult for ultimate investors to obtain voting confirmation and four answered “other”.

\textsuperscript{27} Eric Chalker said that there are two exceptions. The first is where shares are held in a designated nominee account under the ultimate investor’s own name. The second is if no other client of the intermediary invests in the company and the ultimate investor is able to discover this.

\textsuperscript{28} EUI also noted that there is no obligation on issuers to provide evidence of vote confirmation to ultimate investors.
in the hands of those in the investment chain, who should be able to provide the relevant confirmation.

2.80 The AGC said a “key reason” for the difficulty in vote confirmation is that the current Market Standards for General Meetings do not cover this issue. They said that ultimate investors are forced to take a “proactive effort” to confirm voting.

2.81 Three consultees did not agree that it is difficult for ultimate investors to confirm that their votes have been received and/or counted. PIMFA said:

Our firms have told us they have never been asked by clients for confirmation that a firm has exercised their votes in accordance with their instructions. Having submitted their vote, the client relies on the firm to act in their best interests and vote in accordance with their instructions. It is difficult for an ultimate investor to get definitive confirmation in a pooled holding as firms would need to disclose the complete audit trails which they are unable to do so as it would result in the disclosure of the details of other ultimate investors.

2.82 The ABI agreed that ultimate investors “rarely” ask for voting confirmation. They also said that if firms needed to provide voting confirmation, they would need to disclose details of ultimate investors, which may give rise to objections.

Confidence in the system and engagement

2.83 Several consultees said that the absence of voting confirmation can lead to decreased confidence in the accuracy of a vote. ShareAction said that the difficulties around obtaining vote confirmation “can actively dissuade some investors” from exercising a right to vote and that for retail investors, “the problem is even more acute”. Eric Chalker said that “cynicism and a discouragement to vote are inevitable”.

2.84 The QCA argued that there were “considerable implications for governance” and that:

The ultimate investor is unable to have any certainty that their vote has been cast or whether a vote has been placed in accordance with their instructions.

2.85 However, the CLLS said they did not believe that the lack of voting confirmation is a “significant” problem.

Potential legal consequences

2.86 The PLSA observed that a failure to confirm votes has potential legal consequences for their members:

[T]he lack of vote confirmation can have a very real implication for schemes when trying to comply with the new [SRD II] requirements, as they will be unable to demonstrate whether votes have been cast in accordance in a way which aligns with their broader investment and stewardship objectives and principles.

2.87 The CLLS remarked that larger ultimate investors are expected to vote and report on voting under the UK Stewardship Code. However, the CLLS said that this requirement does not require “provision of evidence by issuers of votes cast beyond the steps that they already take”.

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QUESTION 5: TIMING OF VOTING

2.88 We asked consultees whether they consider that the rules and practical arrangements relating to the timing voting affect the ability of ultimate investors to vote. If so, we asked for any examples or specific evidence of such problems. We also asked consultees what could be done to solve these problems. We discuss possible solutions below. 29

2.89 Several consultees agreed that timing of voting affects the ability of ultimate investors to vote. 30

Delay in the intermediated securities system

2.90 Some consultees said that timing and delays are inherent in the intermediated securities system. For example, the PLSA said that it can take “too long for information to be sent across the entire length of the chain”, which means that ultimate investors may not have sufficient time or resources to decide on a position and vote.

2.91 Eric Chalke agreed that intermediaries “inevitably” cause delays, “which the rules and practical arrangements affecting transfers of shares can only amplify”. However, he emphasised that the “problem is intermediation, not the necessary rules governing registration of ownership and proxy deadlines”. John Hunter highlighted that there is no legal requirement on an intermediary to pass on voting instructions or other documents within any timeframe at all.

The current system is adequate

2.92 Other consultees said that the current intermediated securities system is adequate and flexible, with some consultees suggesting that intermediaries’ behaviour may be causing the delay. For example, the registrars all agreed that timing of voting is not “a key barrier”. The Registrars’ Group and Equiniti both said that the “high level of voting” at meetings of UK public companies indicates that “challenges associated with the timeline” have been addressed.

2.93 Link Asset Services drew a distinction between long-term and retail investors, who do not change investments rapidly, and institutional investors with “more fluid holding positions”. For the former group of investors, Link Asset Services said that it is possible for information regarding resolutions or corporate actions to be made available in plenty of time for ultimate investors to take decisions and communicate voting intentions. For the latter groups of investors they said it may be more difficult, but still possible, to communicate information: the system is flexible and allows voting intentions to be lodged in advance of the deadline and amended at any time up until voting. Link Asset Services said that it depends on intermediaries and that “inefficiencies within the chain remains the problem”.

See from para 2.121 below.

24 consultees responded to this question. 12 answered “yes”, nine answered “no” and three answered “other”.

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LSEG said that the current listing framework (such as the DTRs\textsuperscript{31} or AIM Rules\textsuperscript{32}) and market disclosure rules require issuers to disseminate information publicly. Depending on the service offered by intermediaries, they may pass this information onto ultimate investors. However, the efficacy of that process will depend on the length of the intermediated securities chain.

The CLLS did not consider the issues outlined in the call for evidence to be “problematic in practice” in the context of equity securities. They set out the notice periods for company meetings and explained that any lengthening of notice periods would be a “retrograde step”. The CLLS contrasted the position with debt securities. They explained that communication of information about a corporate action requiring a vote through the intermediated securities chain will be slow, because intermediaries are less prepared for passing on information due to voting events for debt securities being less common.

EUI said that they did not consider the rules and practical arrangements relating to the timing of voting to impact on the ability of ultimate investors to vote.

The practical effect of delay

UKSA and ShareSoc said that sometimes ultimate investors do not decide how to vote until the day before or the day of a vote. However, it can take up to five days for an ultimate investor to arrange with an intermediary to vote at an AGM. PIMFA explained that timing of voting is particularly problematic when an ultimate investor seeks advice from an intermediary, because of the time it takes to formulate advice tailored to that investor. The ultimate investor will then need time to consider that advice before providing voting instructions.

The QCA said that there are both “practical and legal concerns in relation to the timing of voting” which are “magnified when the information must be passed down through the chain of intermediaries”. The QCA said that small and mid-sized quoted companies are particularly affected:

it is especially difficult to provide information to shareholders in an intermediated security chain about an upcoming vote in a timely and efficient manner as these companies have smaller capacities and less resources to be able to locate shareholders and then distribute information accordingly.

Andrew Turvey said he had not experienced any timing issues because his usual practice is to ask his intermediary to appoint him as a proxy for the meeting, so there is no requirement to transmit a vote along the chain.

Record dates

The AGC agreed that timing affects the ability to vote and said that the “critical” issue is the position of the record date. The AGC explained the complexity of this issue:

\textsuperscript{31} FCA Handbook, Disclosure Guidance and Transparency Rules Sourcebook.

The record date has to be positioned so that all ultimate investors with a position on [the] record date can issue votes based on definitive positions fixed on [the] record date. If this is not the case, then ultimate investors are obliged to issue votes based on anticipated positions. In the event that the anticipated position is not equal to the record date position, then there will be a problem with the voting instruction. The voting instruction will have to be cancelled, or amended, or a new voting instruction will have to be issued. If the record date is set two days before the meeting date, then such processing will have to be carried out on the day between the record date and the meeting date. Operationally, this is highly challenging for all parties (issuer agents, intermediaries, and ultimate investors), and in some cases this may be impossible, if, for example, the ultimate investor is located in a different country and in a different timezone.

2.101 Computershare and Equiniti noted that a current concern with the timing structure relates to the disparity between the record date and the proxy appointment cut-off. In relation to the former, voting entitlements are crystallised at the close of business on the record date. However, proxy appointments must be lodged at 11 am on the record date. Computershare explained that this disparity requires intermediaries to lodge proxies at a time where voting entitlements may be uncertain.

Postal voting

2.102 Roger Lawson said that delays in postal voting can cause problems, “particularly when there is more than one intermediary in the chain”. The ABI also drew attention to postal voting, noting that investors who use postal voting are often older people. The ABI said:

If a vote is processed by post or manually through the intermediary it is often the case that the deadline for voting for the investor can close weeks in advance of the vote at the firm’s AGM happening.

2.103 PIMFA agreed that many older investors do not have email and that this needs to be taken into account when considering timing, “to allow every investor a fair chance of recording their votes”.

Other issues

2.104 Eric Chalker drew attention to “another factor to consider” relating to the precise timing and handling of transactions:

As shares owned by an intermediary are held in the intermediary’s own name, what happens when one client sells 100 BP shares and another client buys 100 BP shares on the same day? If the transactions are notified to the registrar in the instant they occur, then the shareholder (ie the intermediary) will have lost ownership of the shares by the time the second client buys, so there will be two entries on the share register, even though one may be a simple reversal of the other. However, if the transactions are handled differently, then the voting rights attached to the shares might not have been lost and could therefore be exercised by the second client as the intermediary’s proxy without waiting 48 hours.
2.105 The PLSA also highlighted that most AGMs in the UK take place between April and July, suggesting that this could limit the time and resource ultimate investors can devote to considering and submitting their vote.

2.106 Dr Ewan McGaughey said that timing is less important than the general practice of the industry. He also emphasised that the practicalities of mass voting mean that it will usually be better to ensure that voting policies are in place.

**QUESTION 6: PROXY VOTING**

2.107 We asked consultees whether there are aspects of “proxy voting” which may affect the rights of ultimate investors in the context of an intermediated securities chain. If so, we asked consultees for examples, or specific evidence, of such problems. We also asked what could be done to solve these problems.

**Terminology**

2.108 Several consultees cautioned against confusing the terms “proxy agent” and “proxy appointment”. For example, Computershare explained:

A proxy agent is an entity often appointed to manage the communication and tabulation of votes for the clients of the intermediary. At a self-appointed time/date (no later than 48 hours before the time and date of the general meeting) the proxy agent will transmit an aggregated voting instruction through to us as the Issuer’s Agent. A proxy appointment however is where the institution has provided us with an instruction at least 48 hours prior to the time & date of the meeting, as to the name of an ultimate investor or party nominated to exercise voting rights in respect of some/all of the shares recorded in the institution’s name. Such appointments are recorded by the Issuer Agent, such that when the named party attends the company general meeting, they are expected and can be admitted with the requisite voting rights. These individuals are often referred to as ‘third party proxy appointees’.

2.109 The AGC explained that an ultimate investor can exercise rights in respect of a general meeting in three ways:

- It can (i) attend the meeting in person, and at the meeting it can issue its votes. It can (ii) appoint another person to attend the meeting on its behalf, and that person can issue the votes at the meeting. And (iii) it can issue votes on the resolutions in advance of the meeting.

2.110 The AGC said that the term “proxy” is often used to designate the person appointed by the ultimate investor to attend the meeting on its behalf (that is, scenario (ii)). The term “proxy” may also be used to designate the voting process in scenario (iii).

2.111 In relation to intermediated securities, the AGC said that the SRD II and the Market Standards for General Meetings use the concept of a “Notice of Participation”. They described this notice as an “authenticated message sent through the custody chain that advises the issuer or its agent as to how the entitled ultimate investor will participate in the meeting, and that, in the case of (iii), contains the details of the votes”.

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Proxy voting may affect the rights of ultimate investors

2.112 Several consultees agreed that some aspects of proxy voting may affect the rights of ultimate investors in the context of an intermediated securities chain.\(^{33}\) Shepherd and Wedderburn LLP and the Law Society of Scotland said that the problems with ultimate investors exercising their rights may be “exacerbated in the context of detailed or complex proxy voting requirements”. Similarly, the QCA said that proxy agents add an additional element to an intermediated securities chain, adding to “the complexity of the chain, and creat[ing] further issues relating to transparency and voting confirmation”.

2.113 Computershare said that they had “minimal anecdotal evidence” about proxy appointments.\(^{34}\) However, in relation to proxy agents, the Registrars’ Group and Computershare each said that they had “first-hand experience of issues which affect the lodgement of votes on behalf of ultimate investors”, including proxy agents providing inaccurate votes, exceeding the level of the shareholding, before a meeting.

2.114 Computershare said they had been told by ultimate investors (who have attended meetings in the capacity as a third party proxy appointee) that “they have opted to exercise their voting rights in person in an effort to overcome the issues mentioned above”. The Registrars’ Group said they had been told by ultimate investors that they have opted to exercise their voting rights in person because “proxy agents set unrealistic deadlines for investors to review meeting materials and make an informed voting decision prior to the meeting”.

2.115 LSEG said that proxy advisers “play an increasingly important role”. They said that they had received feedback of examples of proxy advisers incorrectly identifying the regulatory framework which applies to smaller companies on AIM. They also said that proxy advisers often lack the resources needed for their job, which can lead to recommendations that clients should vote against a resolution without transparent justification or evidence. LSEG noted that these issues are less about “the ability to exercise rights and more an issue of the conduct surrounding directing how such rights are voted”. They also noted that the FCA proposes to monitor proxy advisers.\(^{35}\)

2.116 UKSA and ShareSoc said that the “main problem” is one of timing: when the voting instruction must be given to the proxy. Roger Lawson focused on the inability of individual ultimate investors to vote their shares easily. He said that this inability “creates enormous difficulties when running campaigns … to ensure a particular resolution is passed or defeated”.

Proxy voting does not affect the rights of ultimate investors

2.117 Other consultees disagreed that there are aspects of proxy voting which may affect the rights of ultimate investors in the context of an intermediated securities chain.

\(^{33}\) 20 consultees responded to this question. Seven consultees answered “yes”, ten consultees answered “no” and three answered “Other”.

\(^{34}\) The Registrars’ Group also said that they “often see reasonable levels of third party proxy appointments received prior to the meeting”.

PIMFA said that their members “have not reported any issues with proxy voting”. EUI said that they were not aware of any particular aspects of proxy voting which may cause issues.

2.118 The CLLS said that the proxy voting system works well for both shareholders and ultimate investors. In particular, the CLLS explained:

(1) proxy voting facilitates the exercise of voting rights by members (who have a statutory right to appoint a proxy to attend a meeting and vote on their behalf);

(2) the registered member may act on the instruction of another person on whose behalf they hold the securities when they appoint a proxy, which may enable an ultimate investor to direct the exercise of voting rights;

(3) the majority of proxy appointments appoint the chair of the meeting as proxy to vote on behalf of the member in accordance with the instructions set out on the proxy voting form (which may provide the company with transparency as to how the votes will be cast before the meeting); and

(4) the proxy voting system can provide flexibility by allowing the member to change their proxy instructions any time up until the vote is taken.

2.119 Andrew Turvey said that in his experience, proxy voting “works well, is effective and flexible”. The AMNT said that their members generally have “good experience of proxy voting companies when their relationships with their asset managers permit them to use directly the services of such a company”.

2.120 The AGC said that proxy advisers and agents provide services to both issuers and investors (which we take to mean both the registered members and ultimate investors), and that “They are not themselves the source of the complexity”.

SOLUTIONS SUGGESTED BY CONSULTEES

2.121 In question 1 (exercising the right to vote), question 4 (confirming a vote), question 5 (timing of voting) and question 6 (proxy voting), we asked consultees what could be done to solve any problems which might exist.

A “name on register” system

2.122 Several consultees suggested that placing ultimate investors on the company’s register of members (a “name on register” solution) would address problems regarding the exercise of voting rights.36

2.123 For example, UKSA and ShareSoc referred to the Kay Review recommendation that investors should be allowed to hold shares in their own name, on an electronic

36 Of the 35 consultees who responded to this question, seven suggested the “name on register” system as a solution.
register.\textsuperscript{37} They referred to the Registrar Group’s work on dematerialisation (which we refer to below)\textsuperscript{38} and suggested that if dematerialisation were to be implemented for all ultimate investors, it could result in the following benefits.

(1) It would ensure that the ultimate investor’s name is held on the register of members and that the ultimate investor would be the legal owner of the shares. Ultimate investors would enjoy full rights of share ownership (such as receiving communications from the company, attending AGMs or EGMs and voting). Companies could identify individual members, how long they had been members and the extent of their interest in the company.

(2) Ultimate investors would not be at risk of losing money as a result of administrative failings, malfeasance or bankruptcy of intermediaries.

(3) There would be improved communication, both between companies and ultimate investor and between ultimate investors.

(4) Maintaining all shareholding records in electronic form would increase efficiency.

2.124 The AMNT suggested a modified version of a “name on register” system, pursuant to which ultimate investors would retain a beneficial interest in their shares. However, all ultimate investors would be named on the register of members, which would specify the extent of their beneficial interest. The owner of the legal title should be required to act in accordance with timely voting instructions from the ultimate investor, or their proxy. Issuing companies and intermediaries should be banned from restricting voting rights through contractual terms.

2.125 Eric Chalker proposed that the CA 2006 should be amended to give all ultimate investors the legal right to be named on share registers as the full legal owners of shares bought with their money, “even when these have been purchased through an intermediary”. This would ensure that all shareholder rights are held directly by the ultimate investor.

Facilitating electronic voting and communication

2.126 Some consultees suggested that problems regarding voting and communication could be addressed through the operation of electronic voting systems. A few consultees proposed other technological solutions.

2.127 Andrew Turvey said intermediaries should, by default, pass notices to ultimate investors, appoint them as proxies, and facilitate electronic voting for them, and that intermediaries should share information of ultimate investors with companies to facilitate their inclusion in investor relations programmes. He said these changes could initially be adopted as best practice and then reinforced by regulatory or legislative measures. Mohamed Amin agreed that all intermediaries should be...
required to facilitate electronic voting, and that additional charges for such voting should be prohibited, to avoid the risk of disproportionate fees.

2.128 Sir John Dermot Turing said that delays in communication between a company and its investors, which are likely to be encountered in long intermediation chains, can be addressed through technology. He said that the European Post Trade Forum Report indicates how this might be addressed, if the issuer knows the identity of its ultimate investors, and intermediaries are using up-to-date methodologies. He added that, in similar circumstances, a technological solution could be adopted on the issue of the record date for voting, by providing for a reconciliation between votes cast and the investors at the record date.

2.129 The PLSA also recognised the potential for technological solutions, such as the use of distributed ledger technology (“DLT”), to reduce the complexity of the intermediary system, and to improve transparency and strengthen the rights of ultimate investors. However, they cautioned that the effectiveness of technological solutions such as blockchain would depend on their widespread use by industry stakeholders, potentially requiring significant regulatory changes and enhanced security to ensure that solutions would not pose any risks to the market.

Amending Part 9 of the CA 2006

2.130 Link Asset Services suggested that the provisions in the SRD II should be extended to require intermediaries to facilitate the exercise of rights by ultimate investors. They suggested that this could happen by amending Part 9 of the CA 2006 to require intermediaries to provide certain rights regarding voting, rather than leaving it to their discretion. Link Asset Services recognised that this would be difficult as issuer companies have limited information on the identity of ultimate investors.

2.131 The Share Centre also supported an amendment of Part 9 of the CA 2006, or the introduction of legislation to that effect, requiring intermediaries to provide a straightforward voting access service, and a regular voting record statement to ultimate investors.

2.132 The PLSA said that amending Part 9 of the CA 2006 to require the passing back of votes to the ultimate investor would help a minority of institutional investors. According to the PLSA, pension funds are more likely to hold assets in collective investment vehicles, such as pooled funds (rather than omnibus accounts). Any proposed legal changes to Part 9 of the CA 2006 would not be applicable to many smaller pension fund investors and would not significantly impact the number of investors being able to vote.

Investor education and improving access to information

2.133 Two consultees said that solutions aimed at the improvement of investor education should be prioritised. Consultees also suggested that ultimate investors’ access to

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41 See from para 2.33 above.
information should be improved, and suggested solutions to increase transparency in the intermediated securities chain.

2.134 The CLLS said that the most important solutions are the education of investors and regulation to ensure the services that investors want are available to them at a reasonable price. EUI suggested that any issues regarding the exercise of voting rights may be addressed by improving, through education and greater disclosure, the decision-making of ultimate investors when selecting their intermediary. They emphasised that it is open to investors to choose to become a CREST member.

2.135 Computershare and Equiniti suggested that requiring better information to be provided to ultimate investors would mitigate many voting issues. This information could relate to how investments are held, how to obtain confirmation of their rights and how to exercise their voting rights.

2.136 Dr David Gibbs-Kneller suggested that solutions should focus on making it easier for investors to know where their money is invested. Increased transparency would make it easier for investors to move their investments ("voting with their money" rather than voting at general meetings) if they so wish. ShareAction suggested that the publication of voting records would help increase transparency and the emphasis placed on voting by investors. ShareAction stressed the importance of addressing the legal and regulatory problems in the intermediary chain, particularly considering the increasing public interest in voting decisions.

Other suggested solutions

2.137 Dr Eva Micheler referred to her discussion of potential solutions in *Intermediation and Beyond*. She argued that technological solutions, such as the use of DLT, are unlikely to fix problems with the intermediated securities market. She said that investors holding shares directly would be a short-term solution, and identified several long-term solutions that could be implemented by Government.

   (1) Refrigering section 98 of the CA 2006, which would allow registered shareholders to claim for indirect investors.

   (2) Introducing a requirement to disclose the identity and the terms operated by intermediaries.

   (3) Limiting the ability of intermediaries to outsource custody.

   (4) Introducing a requirement to synchronise the reconciliation of holdings along the intermediary chain.

   (5) Introducing a requirement for computer systems to earmark client securities.

   (6) Promoting a more proactive approach in relation to regulators’ consultations to ensure feedback from stakeholders beyond the custody industry, legal practitioners and academics, and to facilitate contributions from individuals who are “closer to the retail perspective”.

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Chapter 3: Schemes of arrangement

3.1 A scheme of arrangement is a binding compromise or arrangement between a company and its creditors or members. Schemes of arrangement may be used in several situations, including to effect an arrangement with creditors or members as a way of avoiding insolvency, to reduce share capital or to reorganise different classes of shares. They can also be used to effect a merger or takeover of the company.

3.2 A scheme of arrangement must be approved by a meeting of creditors or members and sanctioned by the court under section 899 of the CA 2006. That section 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”).

3.3 These 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.

QUESTION 7: SCHEMES OF ARRANGEMENT AND INTERMEDIATED SECURITIES

3.4 We asked consultees whether they consider that the headcount test in section 899 has the potential to cause problems in the context of intermediated securities. If so, we asked consultees for examples or specific evidence. We also asked consultees what could be done to solve these problems.

3.5 A majority of consultees agreed that the headcount test in section 899 may be problematic in the context of intermediated securities.

The current system does not work

3.6 The CLLS said that the headcount test may lead to “unintended consequences in the context of current methods and holding securities” and that it “no longer serves a useful purpose in its current form”. They said that it is “also impossible to comply with

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44 CA 2006, s 895(1).


46 20 consultees answered this question. 14 agreed and six answered “other”. No consultees disagreed.
[the headcount test] in the context of debt restructurings where there are contingent claims and the number of claimants cannot be ascertained with any certainty”.

3.7 PIMFA highlighted that the current method of dealing with the headcount test in the context of intermediated securities is “cumbersome, expensive and … dependent on the share registrar being geared up to process transactions very quickly and efficiently”. They explained that if an ultimate investor is to vote on a scheme of arrangement, the intermediary must “rematerialise” the ultimate investor’s shareholding before the vote so that the ultimate investor has a share certificate in their name. The share certificate must then be dematerialised after the vote, so that the intermediary is once again the legal owner of the share.

3.8 PIMFA noted that there will be a period of time between the “rematerialisation” and dematerialisation. During that time, it is difficult to effect transactions because of “uncertainty as to when the stock can be delivered for settlement”.

3.9 The QCA emphasised that the application of the headcount test in the context of intermediated securities may mean that “the voting power of the ultimate investor is greatly diluted”. They also said that where ultimate investors have opposing views and are connected by the same intermediary, those views may not be accurately represented.

3.10 In *Intermediation and Beyond*,47 Professor Louise Gullifer QC and Professor Jennifer Payne highlighted that company law has historically accorded an important role to creditors/shareholders to approve schemes of arrangement. They said that this provision has been part of English company law since the late nineteenth century, and it is “hardly surprising” that it does not take into account the possibility of intermediation. They said that this is particularly a problem where a scheme involves the restructuring of corporate bonds.

**The headcount test is unfair to ultimate investors**

3.11 Several consultees observed that the application of the headcount test in the context of intermediated securities may lead to an unfair result for ultimate investors.

3.12 Andrew Turvey said that ultimate investors who purchase shares through an intermediary will have a “legitimate expectation” that their rights would be “substantially identical” to their rights if they bought shares directly. He said that the headcount test does not give “identical treatment” to all investors, regardless of how they purchase their shares.

3.13 Eric Chalker said that the application of section 899 to intermediated securities is “nothing short of scandalous”, especially when a scheme of arrangement relates to a takeover under Part 26 of the CA 2006. He explained that section 899 may be used to give effect to a takeover of companies “without making an offer to all the ultimate investors as would be the case otherwise”. He said that “this effectively disenfranchises many ultimate investors in a proposed takeover of company shares which they may value more highly than the consideration being offered”.

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3.14 Dr Ewan McGaughey said that although the headcount test represents a historic presumption of “one person, one vote”, the current reality is that a “group of unaccountable middlemen are dominating most companies”.

Examples in practice

3.15 Several consultees cited the Unilever example, which we discussed in the call for evidence. For example, Roger Lawson said that this showed that the application of the headcount test in the context of intermediated securities may lead to “perverse results”. The AMNT pointed out that the potential difficulties in relation to Unilever “never came to a head … at least partly because the impact on pension schemes may have contributed to reputational damage”.

3.16 The CLLS provided the example of Re Dee Valley Group plc\(^{48}\) which they said illustrated an attempt to manipulate the headcount test and therefore defeat a scheme of arrangement by splitting a shareholding. The court sanctioned the scheme, using its discretion to allow split shareholdings to be disregarded. The CLLS also said that in relation to debt securities, they had evidence of a recent scheme of arrangement where “it was felt necessary for a holder to designate a separate proxy to attend and vote in order to meet concerns about the headcount”.

3.17 Eric Chalker provided the example of an application under section 899 in relation to the acquisition of a company, TDG plc. He said that the case before the High Court revealed “a situation where 79 per cent of the scheme shareholders did not vote and 54 per cent of the scheme equity was not voted”. Eric Chalker said that Mr Justice Morgan “acknowledged that investors with shares held by nominees would likely be one reason for their not being included in the vote”.

Other responses

3.18 Dr David Gibbs-Kneller said that the headcount test is a “specific example of the more general problem of intermediaries representing a variety of interests” in a resolution. He said that schemes of arrangements may cause “problems” as much as any other decision involving a headcount of members. However, he referred to the “practical difficulties” of a system that enabled an intermediary “to be counted 20,000 times in the headcount”.

3.19 Shepherd and Wedderburn LLP said that although mechanisms exist which are designed to mitigate problems with the headcount test, there are “policy issues” relating to its appropriateness in different circumstances and its “manipulation in the context of a given scheme”. They did not provide further information as to these issues. Shepherd and Wedderburn LLP and the Law Society of Scotland each said that resolution of voting rules would not address those policy issues.

3.20 Computershare and the Registrars’ Group both observed that there are differences in the market view of the legal interpretation of the headcount rule. The Registrars’ Group said that these differences lead to “an increased misunderstanding of its application by the wider market”.

\(^{48}\) [2017] EWHC 184 (Ch), [2018] Ch 55.
3.21 The AMNT said that most of their members did not have experience of problems with schemes of arrangements.

**Solutions suggested by consultees**

3.22 We asked consultees what could be done to solve problems arising in relation to intermediated securities in the context of schemes of arrangement. We received a limited range of responses to this question.49 PIMFA said that “recognition of the ultimate investor” might resolve issues around schemes of arrangement. Consultees’ suggestions included amending the CA 2006, either to remove the headcount test or to include the ultimate investor within the test; and affording the court greater discretion.

**Amending the CA 2006**

3.23 Several consultees advocated for a review of the CA 2006. UKSA and ShareSoc, The Registrars’ Group and Equiniti recommended that section 899 should be changed so that it referred to ultimate investors. Roger Lawson said that section 899 should be reworded to clarify its intention.

3.24 Eric Chalker said that Part 26 of the CA 2006 as a whole needed to be reviewed. He said that many aspects of it are open to abuse, such as the fact there is no minimum participation requirement for voting on a scheme under section 899. He also suggested extending the rights in the Takeover Code50 to all ultimate investors.

3.25 Andrew Turvey suggested that the headcount test could be applied on a “look through basis” to take ultimate investors into account. Mohammed Amin said that intermediaries should be obligated to pass ultimate investors’ details back to companies, which would facilitate this.

**Increasing the court’s discretion**

3.26 The CLLS and John Hunter said that courts should be given more discretion when approving schemes of arrangement in order to achieve a fair result for ultimate investors. The CLLS supported abolishing the headcount test requirement and either having the majority by value requirement alone, or replacing it with a broad court discretion to take into account:

> the number of investors who vote for and against a scheme, overall turnout and other factors it considers relevant … . This approach could enable the court to take into account a range of relevant considerations including potentially the number of ultimate investors on whose behalf a member held shares, rather than focusing purely on legal title holders.

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49 Of the 14 consultees who responded to this question, four did not propose any changes.

Comparison with other jurisdictions

3.27 The CLLS said it would be worth considering the approaches of other jurisdictions. They pointed to Hong Kong, which has replaced the headcount test with a requirement that the votes cast against the arrangement do not exceed 10% of the total voting rights attached to all “disinterested” shares in the company. They also referred to the Australian system, which has, since 2007, provided courts with the discretion to dispense with the headcount test.\footnote{Corporations Act 2001 (Cth), s 411(4)(a)(ii), discussed in Re Boart Longyear Ltd [2019] FCA 62.}

A “name on register” system

3.28 Several consultees also said that the issues surrounding schemes of arrangement could be resolved if ultimate investors were identified as shareholders by a “name on register” system.

Existing solutions

3.29 Some consultees said that ultimate investors could already avoid the issues around the headcount test by rematerialising their shares. Computershare acknowledged that this process was currently cumbersome but said that the proposed model of dematerialisation would increase efficiency.

3.30 Dr David Gibbs-Kneller and Dr Ewan McGaughey said that one currently-available solution is a members’ right to demand a poll under section 321 of the CA 2006. In a poll, one share counts for one vote, so an intermediary can fully represent their ultimate investors.
Chapter 4: The no look through principle

4.1 Under the no look through principle, the ultimate investor can only make a contractual or trusts claim against their immediate intermediary, and not against any other intermediary in the chain, or against the issuing company. 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.

4.2 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. However, this can be complex and time consuming, and may be precluded by the terms of the security, the contract, or the CA 2006.

QUESTION 8: THE EFFECT OF THE NO LOOK THROUGH PRINCIPLE

4.3 We asked consultees whether they 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, we asked consultees to provide examples or specific evidence of problems caused by the no look through principle. We also asked what could be done to solve any problems identified.

4.4 Several consultees agreed that the no look through principle does restrict the rights of ultimate investors to bring actions against issuing companies. However, some consultees pointed out that the principle is a fundamental aspect of the English law of contract. They warned that any interference with the principle may result in far-reaching and unintended consequences.

4.5 Only one consultee, EUI, said that the no look through principle does not restrict the rights of ultimate investors. Some consultees commented on the principle but did not give a firm answer either way.

4.6 The majority of consultees also noted that principle has benefits in practice. We summarise these benefits below.

The no look through principle and privity of contract

4.7 Several consultees suggested that it may be helpful to think about the no look through principle in the context of privity of contract, which is a principle of contract law. For example, the CLLS (with whom EUI agreed) said that the no look through principle is

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52 Call for evidence (2019) paras 2.33 to 2.38.
53 20 consultees responded to this question. Nine consultees agreed that the no look through principle does restrict the rights of ultimate investors to bring actions against issuing companies, six consultees disagreed, and five consultees answered “other”.
54 Of the 13 consultees who responded to this question, 11 agreed that the no look through principle has benefits in practice.
55 See from para 4.35 below.
“a logical expression of the English rule of Privity” which provides autonomy to all the parties involved and the freedom for them to choose their preferred contractual structure. They submitted that interfering with the no look through principle would violate party autonomy.

4.8 The CLLS said that the ultimate investor also benefits from this autonomy. They have a “real and effective choice” to hold securities directly, by being a CREST personal member, rather than through a chain of intermediaries. This allows an ultimate investor, as the legal owner of the securities, to bring an action against the issuing company directly.

4.9 Other consultees pointed out that although ultimate investors will not be able to sue companies for breach of contract because they are a third party to the relevant contract, they may be able to sue the company in tort. For example, Sir John Dermot Turing said:

One consequence of the privity-of-contract analysis is the assertion that English law does not allow ‘look-through’ a chain of intermediaries from the end-investor to a higher tier of intermediary … One option for an end-investor is to bring a claim in tort. While the result will depend on the facts underlying the claim and thus the particular tort, the principal concerns are likely to be the nexus of a duty of care to end-investors and the foreseeability of loss.

4.10 Dr David Gibbs-Kneller said that the no look through principle should be understood as privity of contract, and that “privity of contract is not a problem”. He further said that whilst privity of contract may prevent an ultimate investor being able to sue a company in contract law, the ultimate investor could, in theory, sue a company in the law of torts, trusts, property, unjust bailment or fiduciary duties. However, in practice:

problems have arisen because the law developed and was largely designed for certificated securities between two parties, which is no longer the case. The practical realities of the intermediated securities chain means third parties are the reality and the restriction of any rights of ultimate investors stems from having to rely on disparate and uncertain areas of law without unifying principles that make it difficult for even a lawyer to know what rights an investor has against third parties and vice versa.

Is there a problem in practice?

4.11 As set out above, some consultees considered that it is difficult for ultimate investors to bring claims against companies because they must do so under disparate areas of law that are not necessarily fit for purpose. However, some consultees noted that the recent decision in SL Claimants v Tesco Plc[56] demonstrates that certain statutory provisions can be used by ultimate investors to bring an action against issuing companies.

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[56] [2019] EWHC 2858 (Ch).
4.12 In *Intermediation and Beyond*, Professor Louise Gullifer QC and Professor Jennifer Payne said that two main consequences of the no look through principle are:

(1) “no member of the chain (including the ultimate account holder) can bring an action against another member of the chain except the one which is immediately above or below it”; and

(2) there is an “information gap”: “no one in the chain knows any information about any other person in the chain except the people immediately above or below them”. They said this leads to problems in practice, such as difficulty in voting shares and taking part in corporate actions, the possibility of shortfalls, and the fact that information about beneficial ownership – which may be required in cases of money laundering and terrorist financing and investment – is not readily available.

4.13 Dr Eva Micheler pointed to the cases cited in the call for evidence for examples of the ways in which the rights of ultimate investors are restricted by the no look through principle.

4.14 UKSA and ShareSoc said that in certain circumstances ultimate investors should be able to claim against companies:

   It is primarily the responsibility of the company to ensure that the accounts accurately reflect the financial soundness of the organisation. If they don’t it seems fair that the investors should be able to bring an action against the company or its directors and, if appropriate, the auditors. This would be true for the situation at Carillion and Thomas Cook. The problem we have at present is that the members are the nominees. As it is not their money that is at stake they have little interest in pursuing a claim.

4.15 Two consultees pointed out that some ultimate investors simply do not know what their rights are and how those rights may be limited. For example, Dr Eva Micheler said that the current system puts ultimate investors at a disadvantage:

   The principle is convenient for intermediaries but has the effect of generating a significant amount of risk for ultimate investors. Ultimate investors allow intermediaries to build intermediation chains by accepting the general terms of their immediate intermediary. My intuition is that effect of intermediation chains on the value of assets is not widely known amongst retail investors.

4.16 However, Chancery Advisors Limited said that this was not a problem:

   Contrary to claims by some academics, there is much anecdotal evidence that instead of ultimate account holders having unfulfilled high expectations (expressing surprise when they learn that all they have is the ultimate economic interest), outcomes actually exceed lowered expectations.

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4.17 The QCA said the no look through principle does not restrict the rights of ultimate investors, but makes bringing a claim against an issuing company or intermediary more complex:

the ultimate investor still has the power to claim against their immediate intermediary, encouraging them to claim against the next intermediary/company, or use their commercial position to apply pressure to their intermediary to take action. Whilst this process may not be as straightforward or as direct as a challenge to the company, the ultimate investor still has the capacity to encourage the relevant intermediary to assert the rights associated with their shareholdings on their behalf.

Do ultimate investors want to bring claims?

4.18 Some consultees suggested the principle does not cause a problem in practice because ultimate investors rarely want to pursue a claim against a company in which they hold shares. For example, the AMNT noted:

Most pension schemes are sufficiently small, but at the same time sufficiently diversified, that any litigation in respect of a particular investment would occasion for them a disproportionate administrative and/or financial cost and so although the no look-through principle in our view does restrict their rights, in practice it has seldom arisen. Absent the “no-look-through” principle, though, relatively smaller schemes might find it sometimes worthwhile to subscribe to group litigation against investee entities.

4.19 Similarly, PIMFA said:

Feedback from our member firms indicates that retail clients do generally not take legal actions against companies and therefore this is not an issue our firms have encountered. However, it would be helpful if the Commission could consider the extent to which this issue is a problem in respect of class actions.

4.20 Sir John Dermot Turing said that cases in which ultimate investors assert breach of contract claims against companies “seem to be rare, implying that there is no substantial issue at stake.” Similarly, EUI said that “the overwhelming majority of ultimate investors are not impacted negatively by the no look through principle”.

4.21 Chancery Advisors Limited said that:

For now, we must recognise that the problems which may exist for UAHs seeking to vindicate shareholder rights pre-date intermediated securities systems. But we must also assess whether the perceived hardship is as severe as we are led to believe, by reference to actual, not assumed, expectations. There is a risk that the few authorities in this area magnify the extent of the problem. The reality is that the day-to-day experience of ultimate account holders and interaction with issuers is, for a variety of reasons, unimpacted and uneventful, notwithstanding the absence of standing to enforce rights against issuers.

Current regulation is sufficient

4.22 The CLLS pointed out that the current system already affords broad protections to ultimate investors. They also noted that any restriction which the no look through
principle places on the ultimate investor’s ability to bring an action against a company can be “robustly and fairly managed” through the appropriate application of rules already in place. These rules include regulatory protections, such as an obligation on the intermediary to act honestly, fairly and professionally in accordance with the best interests of the ultimate investor.58

**Is reform desirable?**

4.23 Some consultees said that reform in this area may be desirable because it would enhance corporate governance and the rights of ultimate investors.59 Other consultees warned that any reform of the no look through principle could cause far-reaching and unintended consequences.

Reform may be useful in relation to corporate governance issues

4.24 UKSA and ShareSoc said the benefits enjoyed by companies because of the no look through principle need to be counterbalanced by the reduced accountability of directors who know they are less likely to be sued. Another balancing factor is the public perception of the difficulty of getting redress/holding directors to account and the perceived closeness of the platforms and companies … In practice we are doubtful about the merits of shareholders suing companies in which they have invested for the simple reason that, as shareholders, they are ultimately suing themselves. However, the mere fact that they had the power to bring an action against the company could act as a reminder to directors that they needed to maintain the highest standards of governance. The ability to bring action against the directors themselves would add real weight to the power of the ultimate investors.

4.25 The Share Centre said that any reform in this area should be limited to corporate governance, rather than operational matters which should be within the remit of the intermediary only.

The unintended consequences of potential reform

4.26 Some consultees also warned against unintended consequences of any reform of the no look through principle. For example, the CLLS said that the no look through is “extremely valuable both legally and economically:”

It would require a major legislative programme to produce an alternative to the principle and the legal uncertainty caused by such a major change would be damaging to the operation of the financial markets and the wider UK economy. A look through principle would risk unnecessary litigation of a plethora of competing claims, many of which would never have arisen when each level of the chain could operate independently.

4.27 Other consultees suggested that instead of general reform of the no look through principle, there could be consideration of whether other types of actions, including

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58 FCA Handbook Conduct of Business Sourcebook (“COBS”) 2.1.1R.

59 UKSA and ShareSoc and the Share Centre noted that reform in this area may enhance corporate governance.
derivative and ancillary rights of action, could be used by ultimate investors. For example, Shepherd and Wedderburn LLP said:

Introduction of direct look through as an overriding proprietary interest will, however, require radical reappraisal of overall laws relating to all types of proprietary interests in securities to avoid creating unforeseen anomalies … Derivative and ancillary rights of action in specific identified circumstances or the capacity to put these in place appears more likely to address concerns without creating unforeseen problems than introducing general look-through interests.

4.28 Whilst acknowledging that the no look through principle restricts the rights of ultimate investors, the Law Society of Scotland said:

At the same time we consider that the introduction of a “look-through” capability could not be done in isolation and would require a review of overall law in this area, taking into account the breadth of proprietary security interests. Without such extensive review, it is likely that unforeseen consequences would result, which might frustrate the anticipated benefits of reform. We also note that ultimate investors may expressly wish to delegate management functions in relation to their investments to intermediaries. We therefore consider that derivative and/or ancillary rights of action might be more helpful or appropriate in addressing concerns. Such arrangements would also guard against the concerns around unintended consequences which might arise from general reform.

Solutions suggested by consultees

Statutory changes

4.29 Some consultees suggested that any issues arising from the no look through principle should be resolved through amending relevant legislation. For example, EUI suggested that any changes addressing “perceived or actual issues” arising from the no look through principle should be “statutory (and not contractual or by way of trust)” and should focus on facilitating the exercise of ultimate investors’ rights in respect of their investments.

4.30 The Share Centre proposed the inclusion of additional provisions in company law legislation to simplify legal actions by nominee share owners against companies and/or their advisers. They said that this should be restricted to corporate governance issues rather than operational services provided by intermediaries.

4.31 The Share Centre also noted that Part 9 of the CA 2006 already enables nominee shareholders to join in with shareholder circularisations and resolutions. Similarly, ultimate investors should also be able, as interested parties, to take legal action, either on an individual basis or jointly with others.60

Providing ultimate investors with the ability to claim against issuers and intermediaries

4.32 A few consultees argued that the more sensible solution would be to grant certain rights of action to ultimate investors. For example, Shepherd and Wedderburn LLP proposed that establishing (or creating the capacity to establish) “derivative and

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60 The Share Centre gave a class action against RBS as an example of where this has taken place.
ancillary rights of action in specific identified circumstances” would address concerns adequately, without causing unforeseen consequences.

4.33 Andrew Turvey suggested that, instead of the ultimate investor having to sue the intermediary through a “chain of litigation”, it would be more sensible to require intermediaries to “appoint” ultimate investors to exercise their right to claim through a power of attorney. He said that this would be “analogous to the appointment as proxy”.

Placing the ultimate investor on the company register

4.34 A few consultees maintained that any problems arising out of the operation of the no look thorough principle would be resolved by implementing a “name on register” system.

QUESTION 9: THE BENEFITS OF THE NO LOOK THROUGH PRINCIPLE

4.35 We also asked consultees what, in practice, are the benefits of the no look through principles. Although some consultees said that there are none, most consultees agreed that the principle has some benefits.61

Legal certainty under English law

4.36 Some consultees said that the main benefit of the no look through principle is that it creates clarity and legal certainty for all the parties in an intermediated securities chain. For example, the CLLS said that the no look through principle is a necessary and logical expression of the privity rule, freedom of contract and the party autonomy principle, and that parties who contract under English law should be able to expect that these principles will apply. They said parties who wish to provide third parties, such as ultimate investors, with rights may do so either through a deed poll or through the Contracts (Rights of Third Parties) Act 1999, which the no look through principle does not prevent.

4.37 The CLLS also noted that the characterisation of intermediated securities as a “series of trusts and sub-trusts” is firmly based upon the no look through principle. The equitable rights which the parties in the chain of intermediation have under trusts law complement and supplement the rights of the parties in contract law.

4.38 The CLLS warned that any change to the no look through principle would have consequences for English conflict of laws principles, which govern the holding of international securities.

Market efficiency

4.39 Some consultees said that the no look through principle helps to allow the intermediated securities market to operate efficiently. For example, the CLLS said that the principle allows for the effective settlement of securities transactions in CREST. They said that the issuing company has no obligation to investigate the identity of the account-holder or CREST member when they make certain decisions, such as to sell or buy securities in accordance with the terms of issue of the securities. This allows

61 13 consultees responded to this question. 11 consultees agreed that the no look through principle has benefits in practice and two consultees disagreed.
for the swift and smooth settlement of securities transactions in CREST without the company having to make further delaying enquiries.

4.40 The QCA agreed that the principle helps effect settlement:

We consider that there are significant benefits to the no look through principle. For instance, the no look through principles promotes certainty and consistency in securities markets. This is so as the principle reduces the likelihood of disruption, thereby increasing settlement efficiency through decreasing settlement volumes in the post trade infrastructure.

Benefits to the company

4.41 Andrew Turvey said that there could be significant administrative and practical benefits for issuers from the no look through principle as it provides a definitive list of investors that they have to engage with. Requiring issuers to look through to underlying shareholdings could create significant practical challenges.

4.42 Some consultees said that one benefit of the no look through principle is that it protects companies from the costs of litigation.

Benefits to the ultimate investor

4.43 The CLLS said that ultimate investors also benefit from the no look through principle in that, by structuring their investments in an intermediated form, the ultimate investor can, in effect, insulate themselves from the administrative burdens and legal responsibility associated with the direct holding of securities. They said the principle protects ultimate investors from the direct exercise of rights, or direct imposition of costs or administrative procedures, by the company, leaving the intermediary alone to manage the ultimate investor’s securities-related activities and events that occur higher up the holding chain.

4.44 However, other consultees doubted the benefits for the ultimate investor. For example, UKSA and ShareSoc said that the no look through principle reduces transparency and that:

Any benefits all accrue to the ‘agents’ of the end investor because (or so it appears) under privity of contract each party in the chain of intermediated share ownership can only sue or be sued by the party with whom they have a direct relationship. Thus the no-look-through principle protects others within the chain. This is attractive for the investment industry participants but not for customers (the ultimate investor) whose rights of redress are severely curtailed.
Chapter 5: Insolvency

5.1 Investors who invest in a company should be aware that there is always an element of economic risk. The company may flounder or become insolvent, leading to a decrease in the value of their investment. That risk of the company’s insolvency – and the corresponding effect on shares in the company – is part of the risk that an investor accepts when deciding to invest.

5.2 However, compared to the risk of a company’s insolvency, the risk of an intermediary becoming insolvent is less likely to have been in the investor’s contemplation. The legal framework for insolvency in the context of intermediated securities in England and Wales is complex. It includes the Insolvency Act 1986 and the Insolvency (England and Wales) Rules 2016,62 the Investment Bank Special Administration Regulations 2011 (the “2011 Regulations”),63 as well as regulation through the FCA Handbook Client Assets Sourcebook (“CASS”).

5.3 In the call for evidence, we asked consultees for evidence on:

(1) the current regulatory framework and whether it is sufficient;

(2) the effect of an intermediary’s insolvency on an ultimate investor; and

(3) the effect of an issuing company’s insolvency on an ultimate investor.

QUESTIONS 10 AND 11: THE INSOLVENCY REGULATORY FRAMEWORK

5.4 We asked consultees whether the regulatory regime alone is sufficient to address the risks and consequences of an insolvency in a chain of investment intermediaries. We also asked whether there is merit in our reviewing the consequences of insolvency in an intermediated securities chain from a legal, as opposed to regulatory, perspective.

Is the current regulatory regime sufficient?

5.5 A few consultees said that the regulatory regime alone is sufficient to address the risks and consequences of an insolvency in a chain of investment intermediaries.64 For example, the QCA said:

Following the financial crisis, the regulatory regime was appropriately and sufficiently amended to address the risks and consequences of an insolvency in a chain of investment intermediaries.

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62 SI 2016 No 1024.

63 SI 2011 No 245.

64 19 consultees answered this question. Three consultees said that the current regulatory regime alone is sufficient. Eight consultees said that current regulatory regime alone is not sufficient. Eight consultees answered “other”.
More consultees suggested that the regulatory regime alone is not sufficient. For example, Roger Lawson said that the regulatory regime is “totally ineffective”.

Most consultees said that there would be merit in reviewing the consequences of insolvency in an intermediated securities chain from a legal, as opposed to regulatory, perspective.65

The only consultees who said there would be no merit in this type of review were AFME and UK Finance, who provided a joint response. They said that it is the machinery of insolvency, rather than insolvency law, which is defective, with the result that it takes insolvency practitioners a significant amount of time to distribute assets. Although they did not think law reform is necessary, they said it would be desirable for the law to set out the principles that are meant to be given effect to.

Other deficiencies in the regulatory framework

Shepherd and Wedderburn LLP and the Law Society of Scotland said that the regulatory regime cannot remove the risks of intermediary insolvency entirely, but that improvements could help to mitigate these risks. They said the risks may be increased if ultimate investors hand some of their rights over to intermediaries, but this needs to be balanced against the need to ensure that the system caters for commercial realities.

Eric Chalker said that there is a fundamental lack of transparency in the current system, which increases the risks for ultimate investors:

The regulation of intermediaries for private investors is invisible. There is no known programme of inspection to ensure that client records are matched by the securities bought in their names, or that adequate insurance is in place to make good losses in an expeditious manner. When this writer brought a litany of custodian risks to the attention of a Financial Conduct Authority committee in April 2014, investors’ concerns were dismissed by reference to the FCA CASS rules in the FCA Handbook, implying that the rules protect investors. When concern was expressed about the time it can take (potentially months) to identify and release investors’ holdings from a frozen account, to enable them to be sold, this was met with a shrug of the shoulders.

Regulatory reform

The AMNT warned against regulatory reform. They said:

Regulatory action may have a deterrent effect on incompetents and malefactors, but may actually make things worse for ultimate investors who have been disadvantaged by an intermediary’s failure.

UKSA and ShareSoc said that “there is already too much regulation” and that those so minded to, within the financial services industry, will find a way around any new regulation.

65 13 consultees answered this question. 12 consultees said that there is merit in reviewing insolvency law. One consultee, PIMFA, answered “other”.

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Law and regulation should work together

5.13 Several consultees agreed that it is important for law and regulation in this area to complement one another. For example, LSEG said that the regulatory regime should be proportionate to the risk it is trying to address, given that defaults are relatively rare. They also pointed out that it is critical that the regulatory regime complements the legislative framework.

5.14 The AGC said that a clear lesson learned from the financial crisis is that regulation and insolvency law must be considered and addressed together.

QUESTIONS 12 TO 14: THE INSOLVENCY OF AN INTERMEDIARY

5.15 A key objective of insolvency law is to ensure that the company’s assets are distributed fairly among its creditors. When an intermediary becomes insolvent, it may be holding intermediated securities on behalf of ultimate investors. Those intermediated securities are not included in the intermediary’s assets for the purposes of distribution. Under the law of England and Wales, assets, such as intermediated securities, which are held on trust are effectively “ringfenced” and not available to general creditors upon the trustee’s insolvency. Therefore, the general position is that the ultimate investor’s assets will be protected when an intermediary becomes insolvent.

5.16 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”. A shortfall may arise through the legitimate use of securities, such as under a securities lending transaction. It may also arise through fraud, breach of trust, or an administrative error.

5.17 Ultimate investors may be able to claim compensation from the Financial Services Compensation Scheme (“FSCS”), which provides compensation to customers of financial services firms that have failed.

5.18 In the call for evidence we asked consultees several questions about the effect of an intermediary’s insolvency on an ultimate investor.

(1) We asked whether consultees consider that the insolvency of an intermediary in an intermediated securities chain has the potential to cause problems. If so, we asked consultees to provide examples, or specific evidence, of problems arising...
out of the insolvency of an intermediary in an intermediated securities chain. We also asked what could be done to solve such problems.

(2) We asked whether consultees consider that there is uncertainty about how assets would be distributed in the event of an intermediary’s insolvency. If so, we asked consultees how this uncertainty could be resolved.

(3) We asked whether 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 FSCS. We also asked consultees what could be done to reduce the exposure of ultimate investors in the event of an intermediary’s insolvency.

5.19 In answer to these questions, most consultees agreed that an intermediary’s insolvency could cause problems in the context of an intermediated securities chain.\(^{71}\) Several consultees pointed to the recent examples of Lehman Brothers International and Beaufort Securities. No consultee said that intermediary insolvency did not have the potential to cause problems.

5.20 Consultees also generally agreed that there is uncertainty about how assets would be distributed in the event of an intermediary’s insolvency.\(^{72}\) A majority of consultees who answered the question also said 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 FSCS.\(^{73}\)

**Shortfalls**

5.21 Shepherd and Wedderburn LLP and the Law Society of Scotland said that intermediary insolvency causes particular problems for ultimate investors whose securities are held in omnibus accounts, and where the intermediary is entitled to use the securities in question.\(^{74}\) Roger Lawson agreed that omnibus accounts “are a major problem”. The QCA said that despite ultimate investors’ assets being “ringfenced”, shortfalls can still be created. It is more difficult for ultimate investors who hold their assets in an intermediated form to recover their assets.

5.22 Some consultees commented on shortfalls caused by accounting and record-keeping practices. For example, Sir John Dermot Turing commented that insufficiencies in accounting regimes can cause shortfalls:

> where that incoming delivery fails – which may be through no fault of the short-seller, for example where a repo fails to unwind on time, or the counterparty to the incoming delivery transaction defaults – there may be a debit from the relevant securities account nonetheless in order to satisfy the seller’s delivery obligation. This

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\(^{71}\) 19 consultees answered question 12. 17 consultees answered “yes” and two consultees answered “other”.

\(^{72}\) 12 consultees who answered question 13. 11 consultees answered “yes”. One consultee answered “other”. No consultee suggested that the distribution of assets is an entirely certain process.

\(^{73}\) 15 consultees answered this question. 10 answered “yes”, 2 answered “no” and 3 answered “other”.

\(^{74}\) These consultees acknowledged that pooling and re-use of the assets may provide advantages to ultimate investors. However, Shepherd and Wedderburn LLP said that “awareness of those risks of very important – including of such risks further up a given chain.”
can give rise to a shortfall if the seller’s securities are held in an omnibus account – a situation known as 'borrowing from the pool'.

5.23 Sir John Dermot Turing also said that a shortfall can occur if the principles of “no credit without credit” and “no credit without debit” are not adhered to:

‘No credit without credit’ means that the custodian should not credit the investor’s account without there being a corresponding credit to its own client account at the CSD or other upper-tier intermediary. ‘No credit without debit’ means that the custodian should not credit the investor’s account without making a debit entry in its books.

5.24 The CLLS agreed that shortfalls can be created by “factual confusion” over debit and credit entries, if the reporting requirements are not observed. They also noted that:

Even where the failed firm has been largely compliant with its obligations, record keeping may well be a secondary consideration for management focused on saving their business, and the records rapidly become outdated. To resolve the uncertainty, a much clearer division needs to be established between segregated assets and firm assets with clear review and governance. There should be clear accountability and lines of responsibility, and both civil and criminal sanction on intermediaries and their directors.

5.25 The AGC said that effective “behavioural” enhancements to intermediaries’ record-keeping practices were necessary. These could be achieved through market practice and regulation.

Delay

5.26 Several consultees complained that there is a significant delay in the return of assets to ultimate investors upon the insolvency of an intermediary. For example, the AGC provided the example of the failure of Lehman Brothers International (Europe), where “a very significant passage of time was required to adequately identify and return assets belong to those counterparties”. AFME and UK Finance also observed, in their joint response, that insolvency practitioners take too long to distribute assets.

5.27 PIMFA said that there are problems with the Investment Bank Special Administration Regime (“SAR”), saying that:

the Special Administrators have no previous experience of administering a regulated firm and are not familiar with the client asset rules and the settlement of trades. Whilst the complexity of administrations will vary, it does appear that the time taken, (and associated costs), to complete similar administrations varies considerably and we believe the experience of the administrator is a contributory factor.

5.28 Roger Lawson agreed that intermediary insolvency can impose costs on an ultimate investor’s assets, and that their assets can be frozen for a considerable period of time. This puts the ultimate investor at a financial loss, as they miss out on dividends and interest payments. UKSA and ShareSoc pointed out that, in addition, ultimate investors are not able to participate in corporate actions whilst their assets are frozen.
5.29 The FCA noted that the “costs of the exercise to return the assets” has been the subject of many letters from MPs to the FCA.

The FSCS limit

5.30 Several consultees questioned the adequacy of the current FSCS limit of £85,000. For example, the CLLS said that that limit is “a wholly inadequate figure and needs to be increased significantly”. The CLLS said that FSCS gives a “contradictory message” by encouraging ultimate investors to use a single investment platform for cost and convenience reasons, whilst limiting compensation. This approach particularly affects ultimate investors with high-value portfolios. The CLLS advocated for “an unlimited compensation protection regime primarily funded by the industry”.

5.31 Similarly, Eric Chalker and UKSA and ShareSoc agreed that the compensation limit should be increased. However, Roger Lawson observed that such an increase may “put a significant burden on the Scheme and be difficult to fund”.

5.32 Other consultees highlighted the need to increase awareness of the FSCS limit. For example, the AMNT said that despite recent industry efforts, their members are “inadequately aware of the limitations of the FSCS”. Likewise, Dr David Gibbs-Kneller said the whilst most intermediaries advertise that they are covered by FSCS, they do not say that the compensation limit is £85,000. He also noted that education on whether particular investments are covered is important:

London Capital and Finance plc, for example, were authorised by the FCA and protected by the FSCS but not all the investments they provided were covered, leaving 11,605 investors £236m investment unprotected. Most intermediaries will only advertise that they are covered by the FSCS. Stating that it is capped at £85,000 should increase awareness of what is covered. Also, when investing, anyone providing a product covered by the FCA and FSCS should receive information about the protection offered from the product provider, much like the requirement on banks to do so when opening a bank account.

5.33 The CLLS said that it would be better for ultimate investors if it were clearer and simpler to assess whether protection under FSCS would be available in a particular scenario.

Insurance

5.34 Three consultees suggested that it should be compulsory for intermediaries to purchase insurance.

Distribution of assets

5.35 Some consultees said that there is uncertainty as to how assets would be distributed upon an intermediary’s insolvency.⁷⁵

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⁷⁵ 12 consultees answered question 13. 11 said that there is uncertainty about how assets would be distributed in the event of an intermediary’s insolvency. No consultee suggested that the distribution of assets is an entirely certain process. Dr Eva Micheler said that evidence of uncertainty could be found in final notices issued by the FCA to Barclays Bank in September 2014, and to Bank of New York Mellon in 2015: see FCA
5.36 The Law Society of Scotland and Shepherd and Wedderburn LLP said that there would be advantages to clarifying the rateable distribution of omnibus accounts where there is no agreed alternative distribution on shortfall.

5.37 The CLLS observed that, while English law requires a line-by-line analysis of securities held by the intermediary to determine availability for distribution, there is no mechanism to address shortfalls. They pointed out that the regulatory regime fails to explain how assets should be distributed if there is some of a particular line of securities that is held but is not sufficient to meet all client entitlements. They contrasted this with the position under the regulatory regime for client money and said that if the law and regulatory regime prescribed an approach to shortfalls in lines of stock, the cost of distributing assets would be reduced and the process would be less time-consuming.

**Education for ultimate investors**

5.38 Almost all consultees who answered this question agreed that some form of education for ultimate investors could be beneficial. In particular, consultees suggested that ultimate investors could be better informed about:

1. the different risks attached to a particular method of investing or execution channel and how to “choose trusted intermediaries”;
2. the risk of intermediary insolvency;
3. ringfencing of ultimate investors’ assets in the event of an intermediary’s insolvency;
4. the rights of administrators to be paid out of client assets;
5. the FSCS limit of £85,000.

5.39 The CLLS said that although there is a need for better education, this alone is “unlikely to add significant value”. Ultimate investors are unlikely to consider the consequences of insolvency when balanced against the advantages immediately available. The CLLS warned that “merely setting out the risks in a disclosure document is hopelessly inadequate. No one reads it and the issues are complex”.

5.40 Dr David Gibbs-Kneller agreed that the regulatory regime is “complex” and that it is unfair, at least for retail investors, to suffer losses because of “an oddity in the regulation that goes against the reasonable expectations of the investor”.

5.41 Several consultees said that education would not be helpful, as ultimate investors have limited bargaining power and are therefore have no choice but to agree to standard terms and conditions. For example, Roger Lawson said that ultimate investors have “little choice about how they purchase stockbroking services and almost all operators have similar contracts”.

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5.42 Eric Chalker said that education could be “counter productive” because ultimate investors seeking equity opportunities have nowhere to go except into managed funds. He said that it would be “far better” to ensure that ultimate investors can have their own names on share registers, rendering them “entirely free from third party insolvency risk”.

5.43 UKSA and ShareSoc said that education fails to deal with the root of the problem; the aim should be to reduce or eliminate the risk of loss – not just tell investors about it, particularly when they remain powerless to do much about it.

**Solutions suggested by consultees**

Clarifying distribution in a shortfall

5.44 Some consultees said that it would be useful to clarify the way that investors’ assets held in an omnibus account would be distributed in the case of a shortfall. The CLLS said that this would significantly reduce the time and costs associated with processing assets in insolvency.

Increased segregation of client assets

5.45 Several consultees called for increased segregation of client assets. The CLLS said that there should be a clearer division between segregated assets and firm assets, and ideally a complete segregation of client property. They suggested that this should be implemented by regulation. There should also be a requirement that contracts are clear on the status of assets held for clients.

5.46 Roger Lawson and Eric Chalker both said that segregation could go further, and that one possible solution would be to prohibit omnibus accounts altogether. Roger Lawson said that omnibus accounts “often frustrate the identification of ownership”. Instead, he suggested that all assets held by intermediaries are held in “designated” accounts where the owner is clearly recorded. The Law Society of Scotland and Dr Hamish Patrick noted that omnibus accounts provided advantages such as increased efficiency to investors.

Clarifying liability within the intermediated securities chain

5.47 The AMNT called for the clarification and enhancement of the rights of ultimate investors as against participants in the intermediated securities chain. Dr Eva Micheler said that an intermediary should not be able to limit their liability when outsourcing to another intermediary, but should be liable for another intermediary’s actions in the same way as they are liable for the actions of in-house staff.

Enhancing record-keeping practices

5.48 A few consultees suggested that intermediaries should be held to higher standards of accountability regarding record keeping. The AGC said that there was a need to establish effective enhancements to intermediaries’ record keeping practices, either through market practice or regulation. They suggested that regulatory requirements and rules on insolvency should be considered together and periodically reviewed in order to keep pace with changing conditions.
Sir John Dermot Turing noted that custodians should already adhere to the principles of “no credit without credit” and “no debit without debit” but said it might be useful to set these principles out expressly in the FCA rules.

A stricter legal framework

Several consultees referenced increased law or regulation as a way of reducing an ultimate investor’s exposure to insolvency risk. Dr Eva Micheler said that it might be useful to treat securities accounts like bank accounts by requiring intermediaries to hold capital against them and provide deposit insurance. Mohammed Amin and Eric Chalker agreed that mandatory insurance would be useful.

Eric Chalker suggested that intermediaries should be subjected to regular inspections by a relevant regulatory authority. The CLLS said that there should be clear accountability, with both civil and criminal sanctions on intermediaries and their directors.

Roger Lawson said that ultimate investors’ exposure to insolvency risks would be reduced by stricter requirements on intermediaries’ balance sheets, but noted that this might increase costs on ultimate investors and deter new market entrants. Andrew Turvey suggested that the FCA’s existing framework for assessing adequate financial resources was sufficient.

UKSA and ShareSoc said that more regulation would only increase the costs and complexity negotiated by investors and businesses.

Transfer of claims

The CLLS said that the insolvency regime should be amended to create a mechanism whereby an intermediary’s claims and liabilities in respect of securities held for others can be automatically transferred to a successor free and clear of any liabilities to third parties. This would ensure a solvent party was substituted into the chain of ownership with minimum delay and disruption.

Comparison with other jurisdictions

Mohammed Amin and the CLLS said that it would be useful to compare the English law analysis with the US approach under the Securities Investors Protection Act (“SIPA”). The CLLS said that generally, “SIPA produces a swift and high recovery solution”. Eric Chalker said that compensation available to investors should at least match the levels available in the US.

Reviewing the SAR

The Share Centre and PIMFA both raised the concern that Special Administrators may be appointed under the SAR without adequate practical knowledge of retail brokers, resulting in unnecessary delays in return of assets. The Share Centre recommended that the SAR should be subjected to a significant review. The Share Centre pointed to two “rescues” of intermediaries it had undertaken, one before the

SAR and the other after, saying that the first was executed considerably faster than the second.

A “name on register” system

5.57 Several consultees also said that the issues surrounding insolvency could be resolved if ultimate investors were identified as shareholders by a “name on register” system, which we refer to above.

QUESTION 15: INSOLVENCY OF A COMPANY

5.58 In the call for evidence we said that where debt securities are held indirectly, and the company that issued the debt securities becomes insolvent, a right to “set off” may be available.\textsuperscript{77} We explained that under the Insolvency (England and Wales) Rules, the right to set off requires mutuality. This has been defined as “mutual credits, mutual debts or other mutual dealings between the company and a creditor proving or claiming to prove for a debt”.\textsuperscript{78}

5.59 Professor Louise Gullifer QC has pointed 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.\textsuperscript{79} We noted that although it appears that this may affect the rights of ultimate investors, we were not aware that this is a problem in practice.

5.60 We asked consultees whether they 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, we asked consultees to provide examples or specific evidence of such problems. We also asked what could be done to solve such problems.

Is set off available to ultimate investors in chains of intermediation?

5.61 Sir John Dermot Turing said that “set-off is not permitted as between an end investor and an issuer”. He said that whilst set off requires mutuality, “what is less clear is whether insolvency set off ‘looks through’ a trust”. He pointed out that debt securities’ intermediation chains are usually very long and complex, and may cross borders, so that each step in the chain should not be “characterized as a bare trust allowing look-through by a debtor-investor”. He observed that set off may, however, be available to investors who hold their debt securities directly.\textsuperscript{80}

5.62 The CLLS said that set off is unlikely to apply to debt securities held through an intermediary, because mutuality is unlikely to exist. They said this will primarily be the


\textsuperscript{80} This is under the Insolvency (England and Wales) Rules 2016, SI 2016 No 1024, rr 14.24 and 14.25.
result of the wording of the particular debt instrument and the fact that it might be constituted through a global note. The intermediation itself will only be a secondary reason why mutuality may not exist.

5.63 The AGC said that, strictly speaking, intermediated debt securities are not money claims and therefore set off is not possible but, as they are “inextricably linked” to money claims, an intermediary may set off in order to reduce its exposure to the ultimate investor.

5.64 With regards to the law in Scotland, Shepherd and Wedderburn LLP said that:

It is probably clearer under Scots law than English law that set off is not possible between an ultimate investor and an issuing company and may indeed be prevented between the issuing company and the first level owner/trustee by virtue of the trust arrangement unless the counterclaim of the issuing company is against the first level owner in its capacity as trustee.

Is it a problem in practice?

5.65 Some consultees agreed that the application of set off causes problems. For example, UKSA and ShareSoc said that ultimate investors’ assets “must be fully ringfenced”. The QCA said that problems are caused by uncertainty over the ways in which set off applies, and to which party in the intermediated securities chain set off applies.

5.66 Other consultees said that they were not aware that the application of the right to set off is a problem in practice. The CLLS said the issue rarely arises because:

noteholders do not usually hold credit balances and, where they do, they would normally have specific collateral over the credit balances to secure their claims.

81 Of the ten consultees who responded to this question, six answered “yes”, two answered “no” and two answered “other”.
Chapter 6: The good faith purchaser and the transfer of an equitable interest

QUESTION 16: THE GOOD FAITH PURCHASER PRINCIPLE

6.1 In the call for evidence we discussed what happens when intermediated securities are bought and sold. We explained there is a disparity between the protection offered to a good faith purchaser of a legal interest and a good faith purchaser of a beneficial interest (such as may occur when intermediated securities are transferred).

6.2 We asked consultees whether they considered that this disparity in the protections for purchasers of directly held securities and intermediated securities has the potential to cause problems. If so, we asked consultees for examples, or specific evidence, of such problems. We also asked what could be done to solve such problems.

6.3 Most consultees who responded to this question agreed that the disparity in the way purchasers are protected has the potential to cause problems.82

The difference in protection

6.4 The CLLS said that it is undesirable, from the perspective of international financial markets and market confidence, that there should be inequality in the protections afforded to a purchaser of securities, depending on whether the purchaser acquires legal or equitable title to the securities. They noted that, having regard to the speed and volume of transactions in the financial markets, it is not possible for the purchaser of securities to investigate the seller’s title prior to the transaction, regardless of the method of settlement. They said there is no “proper policy reason” why a good faith purchaser of intermediated securities should not benefit from the same protections as a good faith purchaser of legal title.

6.5 The AGC agreed, saying that this disparity cannot be justified on legal or commercial grounds and potentially gives rise to arbitrary and anomalous results. Sir John Dermot Turing also agreed that “it is important for the success and liquidity of securities markets that transfers of securities occur without carrying invisible encumbrances in the form of equitable interests”.

6.6 Dr Eva Micheler noted that there is a significant difference in risk for investors who hold their shares in an intermediated form, compared to investors who hold their shares directly. While direct holders of securities “only bear the risk associated with the issuers”, she said that an investor who holds intermediated securities bears the risk of the issuer and the risks associated with all the parties in the intermediated securities chain.

82 Of the 13 consultees who responded to this question, 11 answered “yes” and two answered “other”.

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Notice

6.7 The CLLS strongly favoured reform of the requirement for notice under the good faith purchaser defence. They said that, in the context of intermediated securities, actual knowledge of defects in title, rather than constructive knowledge, should be required. They said this would enhance market confidence in the UK’s settlement infrastructure.

6.8 Sir John Dermot Turing said that the definition of “notice” under English law is “slippery” and that, in the context of intermediated securities, the defence would require an examination of market practice, and what ought reasonably to be done, to be carried out.

Foreign securities

6.9 Both Sir John Dermot Turing and the CLLS said that the Law Commission should include foreign securities in its analysis of this issue.

No problem in practice

6.10 Several consultees said that they had not experienced any problems in practice. For example, Sir John Dermot Turing said that “a vast number of transactions occurs and is settled daily without difficulty”. He said that, in practice, it may be difficult for a beneficiary under a security to make a claim against the purchaser of the security, for several reasons, including the following.

(1) The claimant would need to show that the property held by the purchaser is the same thing which the claimant had. The thing which the claimant had was a chose in action against an intermediary. This is distinct from the underlying security and therefore not the same thing which the purchaser has.

(2) It may be difficult to trace the right attached to the security through the settlement processes and any subsequent transactions entered into by the purchaser. This is particularly so if the security was held in an omnibus account, which is subject to frequent inward and outward flows of securities.

Solutions suggested by consultees

6.11 We asked consultees what could be done to solve any problems caused by the disparity in the legal protection afforded to purchasers of directly held securities and purchasers of intermediated securities.

6.12 The CLLS, with whom EUI agreed, expressed a strong preference for reforming English law to provide legal protection to good faith purchasers of intermediated securities that are held outside a “relevant system”. They suggested that these protections could be based on the drafting of Article 18 of the Geneva Securities Convention,83 which affords legal protection to an innocent person acquiring securities, provided that the acquirer does not have actual or constructive knowledge of another person’s rights over the relevant securities being violated by the acquisition. The CLLS proposed that any reform should adopt only an “actual knowledge/notice” test (rather than also including constructive knowledge). The CLLS

83 UNIDROIT Convention on Substantive Rules for Intermediated Securities (May 2009), art 18.
said that this would ensure that securities held outside a “relevant system” are treated equally with securities held in a “relevant system”, which are subject to a similar “actual notice” test under the Uncertificated Securities Regulations 2001.84 This would provide protection for the “finality” of the settlement of securities under the “different securities holding models”.

**QUESTION 17: TRANSFERS OF EQUITABLE INTEREST**

6.13 In the call for evidence, we noted that statutory formalities requirements may be a potential source of legal uncertainty in relation to intermediated securities.85 We said that section 53(1)(c) of the Law of Property Act 1925 does not apply to transfers of intermediated securities through CREST, but that it appears to apply to transfers settled at a lower tier of the intermediary chain. This would include transfers between ultimate investors which are settled across the books of the intermediary.86

6.14 We asked consultees whether they 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, we asked consultees for examples, or specific evidence, or such problems. We also asked what could be done to solve these problems.

**Few, if any, problems in practice**

6.15 Consultees said that they did not have specific examples or evidence of the section causing problems in practice.87 For example, Sir John Dermot Turing said that the section “may be more of a bugbear than an actual problem” because:

modern law is tolerant when it comes to what constitutes writing and signature. A custodian’s or broker’s electronic communications methodology for transmission of instructions would usually comply with the statutory requirements for ‘writing’ and ‘signature’.

6.16 He also noted that, under the CA 2006, transfers of equitable interests in securities on CREST do not require a written instrument. He said that, while it is “technically possible” to transfer an equitable interest in securities without going through CREST, it is unclear how often this occurs in practice.

6.17 Similarly, Roger Lawson said that the section poses a “potential problem”, but that transfers between ultimate investors are “relatively rare” in practice.

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84 SI 2001 No 3755, reg 35.
85 Call for evidence (2019) para 2.77.
86 Call for evidence (2019) para 2.78.
87 Of the 12 consultees who responded to this question, none identified an example or gave specific evidence of problems caused by the section. Three consultees answered “yes”, and nine consultees answered “other”.

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The Law Society of Scotland and Shepherd and Wedderburn LLP noted that the section does not cause problems in Scotland, because Scots law does not recognise equitable interests and the Law of Property Act 1925 does not apply in Scotland.

**Legal uncertainty**

Three consultees said that while there is no specific evidence that the section causes problems in practice, it is a source of legal uncertainty. For example, the CLLS (with whom EUI agreed) commented that "good arguments" can be made that the section does not apply to book entry transfers of intermediated securities. Nonetheless, they identified a "material concern" that section 53(1)(c) could be applied by a court to these transfers, which they said could undermine market confidence in the effectiveness of book entry transfers of intermediated securities.

Sir John Dermot Turing said that the potential application of the section has "given many headaches to academic lawyers considering the problem".

The AGC said that the "better view" is that the section does not apply to book entry transfers, but that there should be clarification of any uncertainty.

**Section 136 of the Law of Property Act 1925**

Section 136 of the Law of Property Act 1925 provides that assignments of legal rights must be made in writing. Two consultees considered whether this section might apply to transfers of intermediated securities. The CLLS commented that this might be the case because:

- in addition to any equitable proprietary interest in or in relation to the underlying securities, legal contractual rights constituted by an account agreement are intended to vest and be given effect by the credit of the intermediated securities to the transferee's securities account.

However, Sir John Dermot Turing said that a transfer of intermediated securities does not involve an "assignment", because it is effected by an instruction to the trustee or custodian to dispose of the property, rather than by a transfer of property by the ultimate investor.

**Solutions suggested by consultees**

**Statutory disapplication**

Three consultees said that transfers of intermediated securities should be expressly excluded from section 53(1)(c). For example, the CLLS said that this would clearly and finally remove any potential risk of impractical and unworkable formality requirements applying to the electronic holding and transfer of intermediated securities.

Dr David Gibbs-Kneller commented that the formality requirements in section 53(1)(c) are not necessarily inappropriate. These requirements enable investors to “know

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88 The CLLS referred to comments of Mr Justice Hildyard in *SL Claimants v Tesco PLC* [2019] EWHC 2858 (Ch) at [116].
when funds are transferred, which may be relevant to them personally for reasons such as knowing where money is invested”.

Article 11 of the Geneva Securities Convention

6.26 The CLLS suggested that there should be a reform “wider than simply disapplying sections 53(1)(c) and 136 of the LPA to any transfers of intermediated securities”. Instead, they said reform should be modelled on Article 11 of the Geneva Securities Convention. This would provide that:

subject to certain clearly defined exceptions, intermediated securities are acquired by an account-holder by the credit of the securities to that account-holder’s securities account, and without the requirement for any further formal step to make the transfer effective against third parties.

6.27 They noted that this approach may require the creation of new provisions to govern related issues such as competing priorities and unauthorised dispositions.

Registration of the beneficial interest

6.28 Two consultees noted that the potential legal uncertainty concerning section 53(1)(c) would not arise if the ultimate investor was named on the company register or if beneficial interests could be recorded on the register.
Chapter 7: Technological developments

QUESTION 18: DISTRIBUTED LEDGER TECHNOLOGY

7.1 Commentators have suggested that distributed ledger technology ("DLT") has the potential to change the intermediated model by removing the need for intermediaries and improving the exercising of voting rights for ultimate investors.89

7.2 We asked consultees whether they consider that DLT has the potential to facilitate the exercise of shareholders’ rights, and, if so, in what way. We also asked about the obstacles to the adoption of this technology. We asked consultees whether there are any other jurisdictions we should look to as an example.

7.3 Some consultees agree that DLT has the potential to facilitate the exercise of rights, with several consultees referring to its advantages.90 Consultees highlighted several barriers to its adoption, which we outline below.

Benefits of DLT

7.4 Some consultees outlined the advantages of DLT. For example, the QCA said that DLT has the potential to resolve two main issues in relation to ultimate investors’ rights in an intermediated securities chain.

1. The complex system of intermediaries creates a lack of transparency and trust between ultimate investors and issuers in the exercise of shareholder rights and sharing information. The QCA said that DLT has the potential to establish trust between parties because the information stored on the ledger is “immutable and verifiable”. Through the use of DLT, ultimate investors may also be able to see for themselves that their vote has been received and counted.

2. The different means through which an ultimate investor can engage with companies creates inequalities and disadvantages between different types of ultimate investor. The QCA said that the adoption of DLT could help “ameliorate these inequalities and harmonise systems of engagement through the offering of common digital discussion platforms”.

7.5 Link Asset Services said that the DLT “has great potential to change the future operational structure of financial services” and that there is “no doubt that DLT is a key technology and is part of our thinking about the future”. The PLSA said that DLT could “reduce the complexity of the intermediary system, and if correctly implemented, could be used to improve transparency and strengthen the rights of ultimate investors”.

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89 Call for evidence (2019) paras 2.81 to 2.85.

90 25 consultees responded to question 18. Six answered “yes”, two answered “no” and 17 answered “other”. Some consultees said that DLT might have the potential to facilitate the exercise of rights in the context of intermediated securities, but also acknowledged barriers to its implementation, or considered it was not the only solution.
The AGC said that DLT could improve transparency and security to the voting process:

The current well known issues around opacity in the global voting market could potentially be allayed by providing the Issuer, Issuer Agent, Vote Agent and Investor transparency within one eco system: DLT could enable parties to receive the same data at the same time with an auditable trail in immutable form.

A technology under development

Some consultees pointed out that DLT is still developing as a technology and that it is too early to use it in the context of intermediated securities. For example, Link Asset Services emphasised:

[DLT] is an emerging technology and is not seen as something that can be utilised in all areas or be a disrupter to all industries or parts thereof. It is doubtful in the short to medium term that it is realistic to envisage a world where shared registers or employee share plans are copied to an open ledger even if they can be secured with cryptographic sealing. As well as technological challenges, there would need to be material and significant changes of law and regulation before such changes could be envisaged.

They explained that DLT may be suitable for some activities (such as transactional functions) but not for others (such as “core shareholder register database activities”). They said that centralising the reconciliation of share registers is unlikely, given DLT’s current functionality, for the following reasons.

1. If everyone is participating directly in the ledger, there would be questions about regulation, liability in the event of a technical malfunction and responsibility for the integrity of the securities issued and the stability of the system.

2. The current notary and booking functions of the central settlement authorities ensure that the amount of securities that are publicly issued are traded and that newly issued securities are properly authorised. Investors have confidence that the security they purchase is valid and that should they wish to trade they would receive value for that security in the settlement system. This system would need to be replicated.

LSEG pointed out that the term “DLT” is currently used to described various types of technology, and that there are differences between “consensus models, functional specifications, performance and implications as regards transparency of data and network governance”.

Bulkar Sheena described DLT as “nascent technology and unnecessary”. In comparison, the central securities depository (“CSD”) “is the trusted single source of truth.”

The requisite investment is a potential barrier

The Registrars’ Group, Equiniti and Computershare said that the key barriers are the cost of deployment, which would be required of all stakeholders in the intermediated securities chain, and any potential legislative changes.
The PLSA said that there would need to be “strong take up” of the technology for changes to be effective and that ensuring the widespread use of DLT could be “challenging”.

Dr Eva Micheler said that although technology might be able to help, the problem has to do with how intermediaries have organised their businesses. They benefit from the current situation and have no incentive to invest money in a technology that undermines their revenue stream.

Technology will not fix the underlying problems

Computershare similarly said that although there is “significant potential” for new technologies, that technology by itself is not sufficient:

Simply overlaying new technology on the current intermediated system will not deliver the mooted benefits without addressing the underlying problems in proxy voting. Many benefits relating to integrity, confidence, efficiency and competition can be implemented without having to first deploy technologies such as blockchain. Relatively simple principles such as share reconciliation and vote confirmation will go a long way to improving the integrity and confidence in the system.

Eric Chalker said that the issues around the legal ownership of securities, as well as dematerialisation, must be considered first. It would be “serious mistake” to implement a DLT solution without addressing these issues and would “risk the UK being left behind as other jurisdictions become fully dematerialised”.

The AMNT agreed, saying that the potential for technology to offer “the best solution some time in the future should not be used as an argument” against a “good alternative” solution to the current problems now.

Technology neutrality

Some consultees observed that regulation and any legislative reform should be technology neutral and should not favour a particular type of technology. For example, LSEG said:

[W]e believe that authorisation and supervision of those providing regulated activities is a model which helps ensure that only those with adequate systems and controls in place are able to perform such functions, leaving those firms to adopt the most appropriate form of technology. Where technology is not fit for purpose, investors should have the ability to easily switch providers.

The FCA said:

We aim to strike a proportionate regulatory balance between the risks and opportunities presented by new technology such as DLT. In general, the regulatory framework is ‘technology-neutral’ unless we see particular risks, or opportunities to advance our objectives.
Other technology may be more appropriate than DLT

7.19 Roger Lawson did not agree that DLT has the potential to facilitate the exercise of ultimate investors’ rights. He said that there was no need to use DLT for this purpose and that “traditional IT software” could be used.

7.20 The CLLS acknowledged that technology, including better information flows and communications systems, could mitigate many of the issues around exercising ultimate investors’ rights. However, they said that these issues would not necessarily require DLT to solve them. They noted that a lot of time has been spent “over a number of years” to analyse the legal impact of the CREST system and that:

It may be preferable to see what system changes can be made within existing legal frameworks to address any perceived issues rather than introducing a new technology which requires changes to the law.

7.21 Similarly, EUI said that the CREST system already provides a level of legal certainty and “robust regulatory oversight”. They cautioned that new technology may introduce new problems. The AGC said that it should be examined whether fixes using current technology would be more appropriate than DLT solutions.

7.22 The AGC also observed that there is an operational aspect to the question of DLT’s suitability, because certain processes, such as the notary function and custody, will still need to be performed by intermediaries even if DLT is used. EUI and Dr David Gibbs-Kneller agreed that new technology may not remove the need for intermediaries.

7.23 LSEG suggested that the Law Commission’s consultation exercise should:

(1) examine where market participants believe the legal processes create a barrier to the use of technology;

(2) explore whether clarity could be increased within the legislative framework to promote the use of digital voting models by intermediaries.

Certain features of DLT may not be appropriate

7.24 Roger Lawson said that DLT has the potential to cause problems in relation to “very large database sizes and transactions volumes”.

7.25 Mohammed Amin also expressed concerns about the suitability of DLT and its ability to handle a high volume of transactions. He suggested that a potential obstacle to the use of DLT in intermediated securities chains would be the speed of updating. He provided the example of Bitcoin which, he said, “can handle a relatively small number of transactions per minute.”

The legal aspects of DLT require consideration

7.26 The AGC said that there are legal and regulatory aspects of DLT that are uncertain, including the following.

(1) The nature of DLT, spread across a number of “nodes”, means that there could be uncertainties about the applicable law.
The “legal qualification” or legal nature of the issued instrument on the ledger is uncertain. The AGC said that it could be considered "a mere accounting record", as constituting "proprietary rights or even contain the digital (tokenized) asset itself".

The question of whether an issuer would be able to issue securities “under any legislation and independently of the [issuer’s] location”.

Regulatory and legal barriers (such as tax procedures) would continue to apply to “traditional financial instruments”.

The CLLS said that the law on DLT is in its early stages of development in most jurisdictions and that this lack of legal certainty is an obstacle to its adoption. The CLLS observed that even if technological solutions are available, these may not be sufficient:

\[\text{It may also be necessary to ensure that there are clear obligations on those in the chain to pass on information and act in accordance with instructions. These obligations could be at a contractual level between intermediaries and their clients or be imposed by regulation.}\]

The PLSA said that the implementation of DLT could require “significant” regulatory changes, as well as “enhanced security … to ensure its integrity”.

Shepherd and Wedderburn LLP and the Law Society of Scotland both said that it would be necessary to consider how legislation would prescribe the effects of any actions on DLT and how they may be evidenced.

Consultees suggested that we consider the following jurisdictions, which may be experimenting with DLT in the context of financial services markets: NASDAQ; Korea; Luxembourg and Germany; Australia; USA, including the State of Delaware; Estonia; and Russia.

PIMFA raised a general concern that questions of technology have been included in the Law Commission’s terms of reference, saying that it is “not within the Law Commission’s competence to address this issue unless it intends to seek external support”. They said:

The terms of reference fail to recognise that there are already proven and reliable systems in place which allow underlying investors to provide voting instructions and to obtain proxy votes should they wish to attend a company meeting. Some of these systems are an integral part of a firm’s administration system, others are ‘bolt on’ modules, and some firms use a ‘proxy voting service’. Our view is that the first step should be to ascertain what systems are already available before addressing whether or not further technological developments are required.
PIMFA also queried why the question addresses DLT specifically “when the terms of reference refer to a summary of technological developments which may or may not utilise distributed ledger technology”.

**QUESTION 19: OTHER TYPES OF TECHNOLOGY**

Although we focused primarily on DLT in the call for evidence, we also acknowledged that there are other ways in which technology could be usefully applied to solve current problems. We asked consultees for their views on ways in which technology in general might be able to solve problems in the context of an intermediated securities chain.91

**Legislating for technology**

Roger Lawson suggested that technological solutions are hampered by the CA 2006, noting that the Act appears to assume the use of manual processes. He suggested that the CA 2006 should be “revised to support fully electronic communication, rather than as an afterthought.” In this way, “the IT system should be devised first and then the Companies Act and associated regulations then be written to support the adopted IT system.”

Eric Chalker also emphasised that the use of technology should be carefully considered. He pointed out that many intermediaries already use technology to manage their portfolios. He suggested that “if something is to be required, there must be regulations and a regulator”. This would introduce costs and, potentially, affect competition in the industry.

UKSA and ShareSoc agreed, saying that technology will not solve the “fundamental” structural problems in the intermediated securities system: “the aim must be to use technology to enable a significantly simplified system”.

The Registrars’ Group, Computershare and Equiniti all stressed that regardless of the technological approach used, it must “preserve the core principles of integrity, accuracy and auditability”.

**Technology, the shareholder register and simplification of the intermediated securities chain**

Bulkar Sheena suggested that technology could be used to facilitate the creation of a register which is available in three versions:

1. **Full register:** this would contain details of all the parties in an intermediated securities chain, including all intermediaries and ultimate investors. Bulkar Sheena suggested that the CSD, issuer and regulators could have access to this version of the register.

2. **Public register:** ultimate investors could remain anonymous on the public register.

We received 13 responses to this question.
(3) Authorised register: parties could apply to access contact details for ultimate investors on this register “for a legitimate reason” (such as a shareholder campaign).

7.39 Computershare suggested that a “conceivable” use of technology would be to create a system with full transparency of ownership and control of shareholdings, recognising however that such an approach would be “likely very costly”. They urged that any potential changes should be subject to a “rigorous cost/benefit analysis” and that the potential for “incremental improvements to the current environment” should be considered. The Registrars’ Group and Computershare also suggested that we look at Proxymity, which has recently deployed an innovative voting solution for UK meetings.

7.40 The AGC noted that technology can be utilised to promote greater transparency. They said that technology could be used to streamline the proxy voting system, which should “reduce or remedy the incidence of mis- or un-counted votes”.

The use of technology in practice

7.41 The Share Centre described their experience of using technology to facilitate voting by ultimate investors and the provision of information to ultimate investors under Part 9 of the CA 2006. They said that under their systems, “investors are able to choose whether they wish to receive company communication digitally or in hard copy, and they are able to submit their voting instructions from the comfort of their own home securely via the internet”.

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Chapter 8: Dematerialisation

8.1 “Dematerialisation” allows companies to issue securities without a paper certificate to evidence them. It also allows existing paper shares to be transformed into electronic holdings. In initial discussions, stakeholders told us that dematerialisation is generally considered to be a positive step towards greater efficiency. The general trend towards holding shares electronically was formalised by EU legislation in the form of the Central Securities Depositories Regulation (“CSDR”).

8.2 During 2016 and 2017, the Government engaged with industry participants on the process for dematerialising existing paper share certificates. However, that work was suspended in view of the uncertainties about the UK’s approach to the CSDR and other matters after exiting the EU.

8.3 We asked consultees several questions in relation to dematerialisation.

(1) We asked consultees whether the market has started to prepare for the dematerialisation that would be required under CSDR. If so, we asked consultees what steps have been taken and by whom.

(2) We asked consultees whether there are 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.

(3) We also asked consultees whether there are concerns about imposing dematerialisation on long-time shareholders currently holding paper certificates, who may not be confident users of technology.

QUESTION 20: THE MARKET’S PREPARATION FOR DEMATERIALISATION

An industry model for dematerialisation

8.4 It is clear from consultees’ responses that there has already been significant preparation for dematerialisation in the industry. Several consultees referred to the previous work of the Registrars’ Group in consulting with stakeholders and producing specific proposals in relation to dematerialisation, which are referred to as “the industry model”.

8.5 The Registrars’ Group explained the basis for their proposals as follows.


93 We received 14 responses to this question.

94 Computershare and Equiniti both endorsed this statement.
The Industry Model followed a number of key principles laid out by the authorities including:

- Preservation of the registered model of ownership
- Retention of the ability for investors to benefit from direct legal title
- Protection of Issuer and Shareholder rights

8.6 Link Asset Services provided a summary of the industry model, which we quote at some length to ensure accuracy.

The Dematerialisation Working Group was in agreement on an industry solution. The same model is being proposed for the UK and Ireland. Shareholders should have a right to choose how they hold shares, as they do now and, under the proposals, the structure of register and ownership rights does not change:

- Name on register, direct title etc is the same.
- ‘Direct record’ replaces certificated holders, managed by the issuer/registrar
- Paper will be removed in its entirety if and where possible
- Paper certificates are not being replaced by paper in another form
- All paper (certificates and stock transfer forms) will be eliminated over time – in the short term it is likely more transitional processes will remain

Currently, the register is made up of two component parts and this does not change under the new model. An issuer’s total register of members will contain:

- the Direct Record – replaces certificated record; and
- the Operator Record (CREST) – no change

The issuer will continue to have ultimate responsibility under UK and Irish Company Law for the whole register of members.

The main change is regarding evidence of holding. Instead of a share certificate, the shareholder will be issued a unique reference number (their ‘Holder key’), known only to the shareholder and used to support certain transactions. Currently, it is planned that the key will be at company level (i.e. a shareholder will have one holder key per company – one for BP, one for National Grid etc). The key should improve security, identity assurance and eliminate certificate fraud.

This does create a new element to the register database which not only requires a change to the database but also connected and dependent systems, such as CREST messages and portals.

BEIS have been looking at a cost/benefit analysis as part of their analysis of the industry model during 2016. The Working Group’s own cost/benefit work concluded that the recommended approach was the best for the market as a whole:
• Leveraging existing processes and systems
• Minimising disruption to issuers/shareholders
• Potential for efficiencies through better use of electronic channels.

Holder Key – Usage

The Holder Key (HK) replaces (where possible) signatures on paper documents and provides the issuer or the issuer agent a better and more secure authorisation to process a transaction than today.

By itself the HK will not authorise a transaction to be processed but is an integral part of a wider process including other information. This is comparable to the current environment where a transfer form cannot be processed merely with a signature.

The HK replicates processes and practices already common in other parts of the UK market. For example, it has similarities to a credit card number used for managing and authorising cash payments. This is deliberate so as to make transition as easy and efficient as possible, using concepts with which shareholders are familiar in other environments.

8.7 Computershare added that there been “some public misconception” that the CSDR “requires and will result in all securities being held in a CSD”. However, Computershare clarified that:

the CSDR allows for models of book-entry securities held outside the CSD, so long as securities are entered into a CSD prior to settlement. The UK Model leverages this to create an environment where currently certificated holders can continue to be directly registered shareholders and not forced into intermediation.

8.8 The Registrars’ Group said that there remains a “strong appetite … to progress this solution and deliver efficiency to the millions of shareholders holding share certificates today.”

8.9 The Registrars’ Group further said that:

the Model facilitates rapid settlement without the burden of a paper intensive process which offers an attractive alternative for ultimate investors over an intermediated solution. The proposed industry model has also been drafted to utilise existing law to the fullest extent possible, therefore minimising the need for significant legislative changes whilst also retaining existing infrastructure, and minimising the cost implications. The Model could quickly be resurrected given government appetite, and we feel very strongly that no action should be taken in relation to Intermediated Securities, without full consideration being given of dematerialisation.

8.10 Link Asset Services highlighted that a working group of stakeholders including brokers, lawyers and EUI all agreed with and published the industry model. Although it

95 Computershare and Equiniti both endorsed this statement.
was "disappointing" that the project was paused, “significant progress on the model had been made and work continues with Euroclear, the Bank of England and Ireland to implement the requirements of the CSDR regulation prior to the restart following Brexit”.

8.11 The CLLS said that a joint Law Society and CLLS Law Committee working party broadly supported the principles set out above by the Registrars’ Group. However, the CLLS said that:

Important concerns from a legal perspective are to ensure that the dematerialisation model would offer security and protection from fraud for both issuers and shareholders, with legal certainty as to liability and obligations in relation to matters such as fraudulent transfers.

8.12 The CLLS said that such concerns included the following.

(1) As far as possible, the legal model for dematerialised shareholdings should “mirror” the way shares are held and transferred in certificated form or under the Uncertificated Securities Regulations (which were designed to mirror the law for certificated securities).

(2) The use of the “holder key” in the proposed industry model raises potential issues around security and liability which do not appear to have been explored or resolved. Examples of these issues include:

(a) the consequences if a holder key is improperly used by a third party;
(b) how a holder key may be recovered if it is lost or forgotten;
(c) the circumstances in which participants will be liable for losses caused by negligence or fraud; and
(d) the stamp duty and stamp duty reserve tax implications of dematerialisation.

8.13 UKSA and ShareSoc argued that dematerialisation should go ahead. They said that they supported the model suggested by the Registrars’ Group and that dematerialisation is “an opportunity” to treat all ultimate investors equally and provide the same benefits to all ultimate investors, not simply those currently holding paper share certificates. Roger Lawson warned that if an appropriate solution is not implemented, some intermediaries may “simply stuff anyone still holding share certificates into nominee accounts”.

Other comments

8.14 PIMFA said that the dematerialisation process for individuals currently holding paper share certificates has yet to be agreed. They noted that their members which provide custodial services “will already be holding securities in a dematerialised format”.

8.15 EUI said that they had previously engaged with BEIS on the requirements of the CSDR, but that this work had been put on hold.
8.16 LSEG said that they had received “limited feedback from investors” in relation to dematerialisation.

**QUESTION 21: APPROACHES TO DEMATERIALISATION THAT COULD BE APPLIED TO ENHANCE INVESTOR RIGHTS GENERALLY**

8.17 Some consultees said that the move to dematerialisation should lead to a “name on register” system. UKSA and ShareSoc said that this is the “best and most simple answer”.

8.18 Other consultees pointed out that the proposed industry model for dematerialisation could provide a new way to hold securities for ultimate investors. For example, Link Asset Services said that dematerialisation provides an option for shareholding which provides an ultimate investor (who is named on the register) with the best of both worlds: “significantly quicker, cheaper and more convenient trading usually associated with intermediated holdings whilst maintaining all current shareholder rights”. They went on to say that, “problems associated [with] share ownership and control, transparency and governance would also be avoided”. While they said that ultimate investors could choose to change their holding arrangements in favour of this new system, they acknowledged that this might not be “suitable or possible” for all ultimate investors.

8.19 Some consultees were cautious. The Registrars’ Group, Equiniti and Computershare said that development of new systems would come with a “significant cost” and would not eliminate the need for intermediaries. The Registrars’ Group and Equiniti both said:

> Priority has to be given to providing certificated holders with a more efficient solution over resolving any perceived challenges of intermediation and it would not be acceptable to delay dematerialisation for this purpose.

8.20 Computershare said we should be careful not to conflate the issue of dematerialisation of certificated holders of securities and the separate issue of intermediated securities. Instead, they said these issues should be considered “in parallel, with a view to common principles of ensuring integrity, certainty and efficiency in the market infrastructure and shareholder rights”. Computershare drew the following distinction:

> Dematerialisation of currently certificated shareholders, who have specifically determined to not hold their securities via an intermediary, is a necessary and relatively discrete step to deliver greater efficiency and to ensure that these shareholders are not disadvantaged in their access to the market infrastructure. This should not be deferred further due to the differing concerns of intermediated investors who are seeking greater certainty and effectiveness in their access to various shareholder rights.

8.21 The Registrars’ Group, Equiniti and Computershare also pointed out that an ultimate investor is already able to have legal title on the register by having a CREST personal

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96 We received 11 responses to this question.
account. They noted that “this is not widely used (most likely due to costs applied by intermediaries)”.

8.22 PIMFA said that they could not “see the link” between dematerialisation and rights for ultimate investors. They said that “most of the market dematerialised years ago; CSDR in effect mops up the small rump of shares still held in paper format”.

8.23 Similarly, the CLLS (with whom EUI agreed) said that dematerialisation is not relevant to the issue of interactions between companies and ultimate investors. Dematerialisation involves “replacing the legal function of the signed stock transfer form and paper certificate when transferring shares with non-paper based alternatives”. The CLLS said that most other interactions between computers and ultimate investors can be carried out electronically and “it is these communications which need to be improved in the context of chains of intermediaries”.

8.24 Shepherd and Wedderburn LLP warned that there are “significant risks of creating confusion in other parts of property and insolvency law” unless “the CREST model is used [instead] of replacing by legislation the current ownership mechanisms”.

**QUESTION 22: THE EFFECT OF DEMATERIALISATION ON LONG-TERM SHAREHOLDERS**

8.25 The majority of consultees said that there are no concerns about the effect of dematerialisation on long-term shareholders currently holding paper certificates. The Registrars’ Group, Equiniti, Computershare and Link Asset Services said that this accessibility issue has previously been considered in the context of the development of the industry model.

8.26 Link Asset Services said that this issue “has been at the forefront of the discussions about dematerialisation”. Link Asset Services pointed to recent figures from the Office of National Statistics which indicate increasing usage of and access to the internet. Regardless, Link Asset Services said the intention is that “telephone technology will be utilised to enable shareholders to use their Holder Key and other security to trade securities and manage their investments where they are not comfortable using newer technology”.

8.27 The Registrars’ Group, Equiniti and Computershare all said that “there are no such concerns” and agreed that the “use of technology is not a prerequisite” of the industry model. They warned that there are “major concerns about imposing an intermediated – and inevitably more technology driven solution – on such long-time shareholders”. Similarly, Dr Eva Micheler said that the concern is that investors who currently hold their investment securities directly will be “pushed into holding indirectly without fully appreciating that holding indirectly can affect their rights”.

97 The Law Society of Scotland agreed with this view.

98 Of the 18 responses we received to this question, nine consultees said “no”, there were not concerns about imposing dematerialisation on holders of paper certificates. Six consultees said “yes”, and three said “other”.

99 The QCA also said that the concern is whether shareholders who hold paper certificates will be able to retain access to all shareholder rights after dematerialisation.
8.28 Eric Chalker said that dematerialisation itself does not require investors to be confident users of technology because they will still have to use stockbrokers for buying and selling shares. He said:

The means of identifying ownership of shares will not be dissimilar to that required for using bank accounts and credit cards. Just as use of a bank account does not require access to it through the internet or mobile technology, nor will dematerialisation require the use of such means. That said, the law must ensure that shareholders cannot be coerced into using technology, either by issuers or by stockbrokers.

8.29 PIMFA agreed that this not a “major issue”, pointing out that many retail investors have already had their shareholding dematerialised. PIMFA also highlighted that:

The key in our view is that there needs to be a consistent approach adopted by all share registrars and common messaging from companies and registrars to shareholders. We note share registrars are not authorised firms but our view is that consideration should be given to setting minimum service standards that share registrars must meet in respect of the dematerialisation process.

8.30 UKSA and ShareSoc said that they wish to discourage use of paper certificates and that they are “strongly supportive of this change”. They explained that currently the “only practical alternative to paper certificates for individual investors to hold shares directly … is the personal CREST account”. UKSA and ShareSoc said that “very few” intermediaries offer these accounts and those that do so impose “very substantial charges”.

8.31 UKSA and ShareSoc said that long-term shareholders are likely to welcome dematerialisation “if they can see that it is easy to use and brings them benefits”. They drew a parallel between dematerialisation and contactless methods of payment, electronic TV licences and email for “routine communications”. Mohammed Amin said that “we are entitled to assume that shareholders have access to a computer with an internet connection”.

8.32 The AMNT said that they strongly oppose any delay in acting on these issues that might arise from nostalgic attachment to paper certificates: those with cognitive difficulties in going digital are rapidly diminishing in number and must, if they need it, secure the requisite help from charities or by paying for it.

8.33 A few consultees said that dematerialisation raised concerns about vulnerable users. The QCA said that dematerialisation may exclude individuals without experience in, or access to, technology. The CLLS (with whom EUI agreed) said that there were concerns “to some extent”, focusing on issues around technology security and liability in the case of fraud. They said that although these issues may be “particularly relevant to more vulnerable shareholders”, cybersecurity risks could affect any shareholder.

8.34 Andrew Turvey emphasised the “significant issue” of “establishing what shares are currently held” by investors. He said that this issue could be both exacerbated and mitigated by both dematerialisation and intermediation:
On the one hand, paper certificates provide a record that the shares were once held - but it is often difficult to confirm whether they have since been sold. Electronic records can be harder to trace, particularly if accounts and passwords have been forgotten or cannot be accessed. On the other hand, electronic records should make it easier and quicker to search and discover the current status of investment holdings. The implementation of dematerialisation should consider implementing industry-wide searching facilities, which could be of particular use to long-term shareholders and their representatives.

8.35 LSEG said that they are “agnostic as to the settlement mechanism used, other than that our rules require shares that are admitted to trading to be eligible for electronic settlement (rather than requiring them to be electronically settled)".

Chapter 9: Devolution

QUESTION 23: RELEVANT ASPECTS OF THE LAW OF DEVOLVED JURISDICTIONS

9.1 Although our work is limited to England and Wales, we asked consultees whether there are aspects of the law of the devolved jurisdictions which would need to be taken into account in the event of future work on intermediated securities.

9.2 Only seven consultees commented on this question. Two consultees highlighted potential problems, and the other three consultees provided comments on the question. The only jurisdiction-specific comments were made in respect of Scots law.

Scotland

Equity does not exist in Scotland

9.3 Shepherd and Wedderburn LLP pointed out that “one of the central differences between Scots and English law is that equity does not exist in Scots law and therefore analysis by way of equitable interests is ineffective under Scots law.” Both Shepherd and Wedderburn LLP and the Law Society of Scotland said that although trusts do exist in Scots law, they operate in a different way from English trusts. For example, trust beneficiaries have no direct proprietary interest in trust assets. They concluded therefore that a solution which involves conferring on the party at the bottom of the chain an equitable interest in the securities at the top of the chain would not work under Scots law.

Personal and proprietary rights

9.4 Shepherd and Wedderburn LLP said that any possible solutions involving proprietary interests (including trusts) or set-off will engage laws in areas which are devolved to the Scottish Parliament. Both Shepherd and Wedderburn LLP and the Law Society of Scotland said that personal insolvency (including the insolvency of partnership) is devolved to the Scottish Parliament and that although corporate insolvency is reserved to the UK Parliament, it contains special Scottish provisions. Shepherd and Wedderburn LLP further noted that the UK-wide regulatory laws also sometimes contain special provisions.

9.5 These stakeholders explained that ultimate investors beneficiaries in Scotland do not have a direct interest in the securities or the rights of the legal owners of the securities. Rather, they have a personal right against the intermediary above them in the chain.

Choice of law

9.6 Shepherd and Wedderburn LLP said that “the PRIMA choice of law rule in relation to intermediated securities probably does not operate in Scotland where it does not require to be applied under para. 19 of the Financial Collateral Arrangements (No.2) Regulations 2003.”
9.7 Both Shepherd and Wedderburn LLP and the Law Society of Scotland said that there is some doubt over whether Scottish securities held by an intermediary based in England will be recognised by Scottish courts as requiring the application of English, rather than Scots, law. They said that in principle courts should, under the Recognition of Trusts Act 1987, recognise that English law applies where the securities are held under an English trust. However, they said that since this Act contains a number of exclusions and uncertainties, it is not possible to rely on it in all circumstances.

9.8 Shepherd and Wedderburn LLP commented:

solutions adopted should not require English law to be used for intermediary chains to the detriment of the devolved jurisdictions and businesses operating there.

Other comments

9.9 Andrew Turvey, a retail investor with shares in several companies domiciled in Scotland, said it is important to ensure, to the greatest extent possible, that there is no divergence between laws in England and Scotland.
Chapter 10: Comparative law

QUESTION 24: OTHER JURISDICTIONS

10.1 We asked consultees what other jurisdictions we should consider as part of our work on intermediated securities. Seven consultees said that other jurisdictions were worth considering. Only one consultee, the AGC, disagreed:

No jurisdiction, to our knowledge, removes all uncertainty or solves all problems. Inevitably, jurisdictions may take different approaches in part because each must make its own decision regarding how best to strike a balance between absolute protection and facilitating efficient capital markets activities. In our view, the UK, like any other jurisdiction, must strike its own balance, hopefully in accord with the requirements of SRD II.

Australia

10.2 Some consultees said that the Australian model of intermediated securities, and the Australian CSD, CHESS, should be considered. UKSA and ShareSoc said that, by international standards, Australian listed companies obtain a high level of transparency of the identity of their shareholder:

This is attributable to the structure of direct legal title at the CSD, CHESS, as well as the legal rights of listed companies to obtain disclosure of their beneficial owners… Holdings in CHESS obtain direct legal title and are disclosed on the issuer’s share register. Under Australian law, a share register is comprised of two sub-registers, which provide equal legal status to shareholders. These are the ‘CHESS sub-register’, operated by a subsidiary of the Australian Securities Exchange; and the ‘Issuer Sponsored sub-register’, operated by the issuer’s share registrar. The CHESS sub-register is reported to the issuer or their share registrar at the end of every business day, so that the total share register is updated and available for public inspection at the issuer’s share registrar.

10.3 UKSA and ShareSoc also noted that holdings in CHESS may also be held in “broker sponsorship”, where the securities account is registered directly in the investor’s name and a broker electronically controls the shareholding. This ensures that the ultimate investor has direct legal title to the securities, whilst allowing the broker to administer the account.

The United States

10.4 Four consultees said that the US model of intermediated securities should be considered. Roger Lawson said that the US system is expensive and vulnerable to “over-voting” (where more shares are voted on than are issued), but that it provides a user-friendly system for retail investors.

10.5 The Share Centre said that the use of “street names” in the US is similar to the use of omnibus accounts in the UK, and has been a key part of widening share ownership. An investor holding shares in a “street name” will be allocated beneficial ownership of
a proportion of an intermediary’s shares in a company and listed as the owner in the intermediary’s records.

10.6 Dr Ewan McGaughey said that the Dodd-Frank Act 2010 should be considered. He explained that this provides a model for voting regulation, which works on the principle that intermediaries follow the voting instructions of ultimate investors.

10.7 The CLLS said, in relation to insolvency issues, that “the English law analysis based on a stock line by stock line trust analysis should be compared against the US law treatment under the Securities Investors Protection Act ("SIPA"). Generally, SIPA produces a swift and high recovery solution.”

Other jurisdictions

10.8 The CLLS said that the Belgian and the Luxembourg models of intermediated securities should be considered.

10.9 Dr Ewan McGaughey said that the Swiss model of intermediated securities should be considered, because it works on the principle that intermediaries vote according to the instructions provided to them by the ultimate investor. Dr Ewan McGaughey said that the German model is also “worth considering on the basis of why requiring instructions are followed (without banning uninstructed votes) is not sufficient.”

10.10 Roger Lawson said that the Swedish model of intermediated securities should be considered.
Chapter 11: Other issues raised by consultees

QUESTION 25: OTHER ISSUES WHICH ARISE IN PRACTICE

11.1 In the call for evidence, we explained that the issues we had highlighted were the result of initial conversations with stakeholders, recent academic work and cases, as well as previous work on intermediated securities.

11.2 We welcomed suggestions from consultees as to other issues which arise in practice which should be included in our work. We asked consultees to provide a summary of the problem, an explanation of and evidence of the effect in practice and suggestions as to what could be done to solve the problem, as well as any evidence of the costs and benefits of the solution.

Corporate governance

Rights and expectations

11.3 A few consultees pointed out that the expectations of ultimate investors do not necessarily match up to the rights they are granted when they buy intermediated securities. For example, Dr David Gibbs-Kneller said that language adds to the confusion over the ultimate investor’s rights, and suggested that the way the products are described to ultimate investors and prospective ultimate investors could be misleading. He said that it often uses the language of “owning shares” or “owning part of the business”, and a “right to say in how [the company] runs its business”. In such cases, he said

the investor is being told what they are purchasing is a share of a business. A share in a business includes some form of participation rights and not just an “interest” measured by a “sum of money”.

11.4 Dr David Gibbs-Kneller noted that there is a lack of understanding amongst ultimate investors about what is being purchased when they buy shares:

Some better language in marketing may well clear this up. Currently, it is an investment without a name and investors do not get what they should reasonably expect. The simple solution to this is better regulation, whether self or mandatory, that commits to clear and transparent information on what is being purchased.

Transparency and information rights

11.5 Several consultees said that there is a lack of transparency in the intermediated securities chain, and that the information rights of the parties in the chain should be strengthened.

11.6 Roger Lawson said that it is difficult for companies or other shareholders to identify and communicate with the ultimate investor in the company. He said this is important for companies in the event of a corporate action such as a take-over bid, and for ultimate investors if they wish to club together to reform the activities of the company, for example through voting on resolutions to remove company directors. Roger
Lawson noted that the current register identifies shareholders reasonably well (aside from omitting their email addresses), but does not identify the beneficial owner of the securities. He acknowledged that information held on the register can be obtained through a statutory request under the CA 2006, but said that such requests are rare and, where they are made, the information obtained is often practically useless, which “totally undermines shareholder democracy”.

11.7 Similarly, Eric Chalker said that the information available under section 793 the CA 2006 is limited to the name of the ultimate investors, and so is useless for communication purposes. Eric Chalker said that intermediaries “flatly refuse” to provide this information voluntarily, and obtaining a court order to seek the identity of the ultimate investor is unduly expensive and impractical.

11.8 The Investor Meet Company said that there is no current mechanism to facilitate engagement with retail investors. Institutional investors, on the other hand, benefit from direct engagement with companies on issues such as voting. The Investor Meet Company explained that retail investors will not understand what they are voting for, or even want to vote in the first place, if they do not have the ability to engage with issuing companies on a regular basis. They highlighted that all investors should be treated equally in being able to access information.

11.9 The CLLS said that even segregated accounts do not guarantee that the ultimate investors’ information is available to the issuing company.

11.10 Several consultees said that the information rights contained in Part 9 of the CA 2006 were not sufficient. For example, Equiniti, Computershare and the Registrars’ Group all said that although Part 9 of the CA 2006 provides for a member to nominate another person to enjoy or exercise the member’s rights,

\[\text{[t]his section has not yet been adopted by companies within their Articles due largely to the efficiency of the existing regime of information rights and proxy appointments, but also due to the complexity of arrangements to administer this provision.}\]

11.11 They explained that an ultimate investor who wishes to receive information has two choices:

\[\text{[T]hey must either utilise the services of an intermediary which offers an information rights service, or request that their appointed intermediary passes Issuer announcements onto them.}\]

11.12 Consultees pointed out that there are also problems with the quality of the information received, such as the accuracy of the data, the frequency of it being updated, and the fact that data feeds do not include the balance of the ultimate investor’s holding.

**Management of intermediated securities**

11.13 UKSA and ShareSoc and Eric Chalker said that intermediaries do not always manage intermediated securities appropriately for retail investor clients.

11.14 Eric Chalker said that there are several problems which arise from the ways in which intermediaries manage securities on behalf of ultimate investors.
(1) Intermediaries are able to refuse access to an ultimate investor’s securities “until they comply with a demand for new information, whether or not this is allowed by the terms and conditions”.

(2) Intermediaries do not guarantee that their clients’ intermediated securities “won’t be lent, or voted without ultimate investor consent.”

(3) There are potential issues around whether an intermediary will allow an ultimate investor “to take dividends in the form of scrip” or to “participate in a company’s DRIP (dividend reinvestment plan).”

(4) An intermediary who holds intermediated securities in an omnibus account may not be able to “bid for excess shares when an open offer is made, because of the way these offers are made by issuers.” This limits the ultimate investor’s ability to benefit from the low price of open offers. UKSA and ShareSoc also pointed out that, unlike institutional investors, retail investors are often excluded from placings, which are usually offered at a discount.

(5) Intermediated securities “can only be sold through the stockbroker used to buy them and only transferred to another stockbroker for a fee.” UKSA and ShareSoc agreed that it is “anti-competitive” that ultimate investors “cannot sell the shares via another broker/platform or the brokers services of a registrar, because he/she does not own the shares.”

11.15 Eric Chalker suggested that the solution to these problems may be further regulation, or to abolish omnibus accounts for private investors and “turn service providers into agents for their clients instead of being the legal owners of the shares.” UKSA and ShareSoc agreed that a “name on register” system could solve these problems.

The rights of the legal owner of securities

11.16 A few consultees suggested that in certain situations there are areas of legal uncertainty as to the rights of the legal owner of securities.

The Financial Collateral Arrangements Regulations 2003

11.17 The AGC said that there may be uncertainty over the legal effectiveness of a security interest granted to an intermediary over the investment securities it holds for the ultimate investor. They said that it is unclear whether the Financial Collateral Arrangements Regulations 2003100 (“FCARs”) would apply to an arrangement where:

(1) the intermediary is granted a security interest (such as a floating charge) over the investment securities; but

(2) the ultimate investor retains the ability to exercise legal rights in respect of the investment securities, such as the right to vote and the right to receive dividends.

11.18 This is because the FCARs require a “collateral-taker” (here, the intermediary) to have “possession or control” of the collateral (that is, the investment security). Put another

100 Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003 No 3226.
way, the “collateral-provider” (here, the ultimate investor) must be “dispossessed” of the collateral. There is a theory that the ultimate investor is not sufficiently “dispossessed” of the collateral if they retain legal rights in respect of the investment security.

11.19 The AGC said that this uncertainty is undesirable for two reasons. First, it undermines confidence in security arrangements which are widely used in the financial markets. Second, it may cause intermediaries to take steps to prevent ultimate investors from exercising their rights. Accordingly, the AGC said that the law should be amended to clarify that the exercise of legal rights (such as the right to vote or receive dividends) by the ultimate investor does not disqualify an arrangement from the FCARs.

The custodian’s lien

11.20 AFME and UK Finance said that it has been suggested that it is not possible to have a custodian’s lien over dematerialised securities. The argument is that because dematerialised securities cannot be physically held, as they were in the days of paper certificates, they cannot be retained. AFME and UK Finance explained the implications if this argument is correct.

This question is significant, because the custodian’s lien supports the credit afforded to investors by custodians. As the legal holder of securities for investors, custodians bear significant risks, including taxes, settlement risks, and the risks of claims by third parties concerning ownership of securities or rights flowing from them. The mechanics of fixed and floating charges are generally not suitable to secure such credit, since they require registration or positive acts to maintain them. The ancient custodian’s lien provides the custodian with the ability to take full control of the assets registered in their name or the name of their agents, should the investor default in its obligations towards the custodian or expose it to risks that would otherwise be unsecured.

11.21 If a lien over a dematerialised security is not possible, custodians may be exposed to significant risks on an unsecured basis. AFME and UK Finance suggested that this issue has not been clarified because it has not reached a court yet. They suggested that:

the academic hostility to the custodian’s lien overlooks the possibility of constructive possession. There is no reason why a court could not rule that a custodian has constructive possession of dematerialised or immobilised securities.

The definition of “control” in other legislation

11.22 David Pollard from Wilberforce Chambers said that certain pieces of legislation refer to a party having “control” of the securities. He provided the examples of section 435 of the Insolvency Act 1986 (which provides how to determine if a person is “an associate” of another person for the purposes of the Act) and the statutory powers of the Pensions Regulator under the Pensions Act 2004.

11.23 Under section 435 of the Insolvency Act 1986, a person is taken to be having “control of a company” if they are entitled to exercise “or control the exercise of” one-third or
more of the voting power.\textsuperscript{101} David Pollard noted that as a result of the recent Court of Appeal decision in \textit{Granada UK Rental & Retail Ltd v The Pensions Regulator},\textsuperscript{102} it now seems that the legal holder of securities will be treated as being able to control the exercise of the relevant voting power, even where the legal holder is a bare trustee or depositary. He said that “it is difficult to see the legal justification for this approach. It could, if it became wider known, cause intermediaries and trustees to move away from taking up such registered ownership positions.”

\textbf{Proprietary interests}

11.24 Shepherd and Wedderburn LLP said that, if the Law Commission is considering changes to ownership/trust interests, set off and insolvency, other proprietary interests (such as creditor attachments) and the priority of competing proprietary interests should also be considered. The Law Society of Scotland agreed that “it will be necessary to consider all (or at least all competing) proprietary interests as a whole if changes to any specific set of proprietary interests is in contemplation.”

\textsuperscript{101} Insolvency Act 1986, s 435(10)(b).

\textsuperscript{102} [2019] EWCA Civ 1032.
Chapter 12: Assessing the impact of possible reform

12.1 In the call for evidence, we noted that our terms of reference require us to consider the costs and benefits of any potential solutions to the issues identified in the call for evidence.\(^\text{103}\) We noted that potential solutions might include facilitating guaranteed voting rights, ensuring legal remedies for ultimate investors, and ensuring that ultimate investors are protected against insolvency events within the chain of intermediaries.\(^\text{104}\) We also noted that changes to the current system could involve “unintended consequences”, such as increased complexity and expense.\(^\text{105}\)

12.2 We sought consultees’ views on the costs and benefits of both the current system and of any potential solutions.\(^\text{106}\)

QUESTION 26: THE BENEFITS AND COSTS OF THE CURRENT INTERMEDIATED SYSTEM

12.3 We asked consultees about the benefits – financial or otherwise – of the current system of intermediation. We also asked about the costs or disadvantages.

Benefits of the current system

Increased privacy for ultimate investors

12.4 Several consultees said that while the current system of intermediation lacks transparency, it protects the privacy of ultimate investors. For example, Link Asset Services said that “some investors may welcome the privacy offered by intermediation as their details will not appear on the accessible share register of the issuer”.

12.5 The Registrars’ Group commented that a “primary benefit” for ultimate investors under the current system is the increased level of privacy they enjoy by not being entered on the register. Investors who invest in companies perceived as “controversial” may wish to avoid the potential harassment that would result if their names were recorded on the register.

12.6 Equiniti and Computershare also described increased privacy as a “primary benefit” of the current system.

Efficiency and convenience

12.7 Several consultees said that the current system of intermediation is convenient and efficient. For example, PIMFA said that the system is efficient and effective, proven and trusted. Many firms offer automated services for electronic voting and corporate actions processing at little or no cost to the investor.

\(^\text{103}\) Call for evidence (2019) para 2.111.
\(^\text{104}\) Call for evidence (2019) para 2.112.
\(^\text{105}\) Call for evidence (2019) para 2.113.
\(^\text{106}\) Call for evidence (2019) para 2.113.
Thousands of investors use these services successfully every day - they are familiar and comfortable with the processes.

12.8 Andrew Turvey said that the current system “provides considerable benefits regarding cost savings and convenience, facilitating small retail investors to make the investments they want”. Similarly, John Hunter said that the current system allows investors to “take advantage of equity investment without undertaking the governance obligations that the whole legal structure envisages”.

12.9 The QCA said that the current system has made trading significantly quicker, lowered transaction costs, simplified voting processes and reduced the administrative burden for issuing companies.

12.10 ShareSoc and UKSA identified the low cost of holding and transferring securities, the recording of share trades, and electronic access to up-to-date portfolio analysis and evaluation as benefits of the current system. However, they said that these benefits could be preserved in a system where the ultimate investor was the legal owner of the shares.

12.11 The Share Centre said pooled nominee administration (that is, using omnibus accounts) is the only way to deliver the “low-cost, very scalable operations” which facilitate popular share ownership and democratic capitalism. It said that requiring investors to hold shares directly would increase costs and discourage investment in personal share ownership.

12.12 However, Eric Chalker commented that the efficiency of the current system is primarily attributable to “computerisation, readily available software and the internet”, not to intermediation.

Costs of the current system

The use of omnibus accounts prioritises the interests of intermediaries

12.13 Several consultees said that the use of omnibus accounts prioritises the interests of intermediaries over the interests of ultimate investors.

12.14 Roger Lawson said that intermediaries have a vested interest in the current system because it “locks” the ultimate investor into using their services. Similarly, Equiniti commented that ultimate investors suffer a “loss of choice” because they are generally required to use the brokerage services of the intermediary.

12.15 UKSA and ShareSoc said that it is difficult for ultimate investors to switch to a different intermediary and that the current system of intermediation is potentially anticompetitive, benefiting intermediaries by reducing “client churn” and increasing the income from fees and charges. The QCA also said that the current system enables intermediaries to pass on custody and administration costs to the ultimate investor, who would not incur these costs if they held their securities directly on the register.

12.16 Computershare said that intermediaries impose “unofficial deadlines” on ultimate investors which reduces their ability to make last-minute decisions during corporate actions. Similarly, Equiniti and the Registrars’ Group said that intermediaries impose
“false deadlines” for voting on corporate actions, leading to “reduced decision-making time and reduced flexibility” for ultimate investors.

12.17 ShareSoc and UKSA commented that a “huge disadvantage” of the current system is that the ultimate investor bears the risk of the intermediary collapsing. They said that ultimate investors typically invest over a 20- to 30-year period and it is important that the intermediary is financially secure over the long term. However, they were concerned that some intermediaries are “thinly capitalised”, which exposes ultimate investors to risk.

12.18 Dr Ewan McGaughey said that the current system delivers “very considerable benefits” for the intermediaries at “tremendous cost” to everyone else. He gave examples of costs including a lack of competition in investment markets, neglect of long-term corporate governance issues such as climate change, and the concentration of power among asset managers.

12.19 Some consultees commented that the current system of intermediation does not deliver any benefits.

Lack of transparency around share ownership

12.20 Some consultees said that the current system of intermediation has led to a lack of transparency around share ownership. Consultees questioned whether section 793 of the CA 2006 currently provides an effective method for discovering the identity of ultimate investors.

12.21 For example, The Registrars’ Group commented that this statutory process imposes a burden in terms of cost and administrative arrangements. It also only provides a snapshot of ownership at a given point in time and there are wide variances in terms of timeliness of data provision and accuracy, resulting in significant reconciliation challenges.

12.22 Similarly, Link Asset Services said that section 793 is “not an easy or cost-free route to go down” for issuing companies who wish to identify ultimate investors. Equiniti also commented that the process under section 793 is not sufficient to provide transparency of share ownership.

**QUESTION 27: THE BENEFITS OF ENSURING THE RIGHTS AND REMEDIES OF AN ULTIMATE INVESTOR IN AN INTERMEDIATED SECURITIES CHAIN**

12.23 We asked consultees what the benefits – financial or otherwise – could be of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain.

**Improved corporate governance**

12.24 Several consultees said that a benefit of providing rights and remedies to the ultimate investor in the intermediated securities chain would be improved corporate governance.
12.25 John Hunter said that such a reform would “restore the fundamental assumption on which current governance arrangements are based”. Eric Chalker said that the closer the relationship between the ultimate investor and the issuing company, “the better the prospect of greater investor involvement in corporate governance”. The QCA commented that providing rights and remedies to the ultimate investor would open a “channel for communication” between ultimate investors and the issuing company on a host of governance issues, including company resolutions and the election of directors.

12.26 The AMNT said that increased engagement by ultimate investors would improve “the quality of investee companies’ contributions to the economy and society of the UK”. They referred to a study they conducted which found a substantial misalignment between the voting policies of asset owners and asset managers. The AMNT said that increased involvement by ultimate investors would reduce this misalignment and lead to a “closer focus [...] on issues of growing importance to asset owners and society at large”, such as climate change.

12.27 ShareSoc and UKSA commented that “long-term” corporate governance would be improved by extending rights and remedies to retail investors who hold their shares through an intermediary, because retail investors (in contrast to institutional investors and fund managers) tend to have a long-term focus. They argued that greater involvement of retail investors in corporate governance would mitigate the risk of corporate governance “disasters”. Similarly, Andrew Turvey said that extending rights and remedies to retail investors would lead to “improved long-term corporate governance”.

12.28 Dr David Gibbs-Kneller commented that extending rights and remedies to ultimate investors would lead to greater “trust” between investors and issuing companies. He thought that the current system of intermediation can seem “daunting” and “opaque” to individual retail investors, which discourages them from investing. He said that providing rights and remedies would increase trust and confidence in the system, leading to increased investment in UK companies.

12.29 In contrast, the CLLS (with whom EUI agreed) said that the current system already enables investors to exercise rights and remedies, either by directly registering their securities on CREST or by holding their securities through an intermediary in a designated account. They said rights and remedies can be made available to ultimate investors through “regulation and education” at a reasonable cost, whereas “wholesale reform” would come at a huge cost without providing commensurate benefits.

**Reduced cost of exercising rights**

12.30 UKSA and ShareSoc said that providing rights and remedies to the ultimate investor would lower the transaction costs of holding and transferring intermediated securities and enhance competition for intermediation services. They estimated that transaction costs would be reduced by 25%, putting the UK on a par with the US. They said this

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would lower the cost of capital for UK businesses and lead to increased investment in jobs and businesses in the UK.

12.31 Similarly, Andrew Turvey said that “the costs and inconvenience” of exercising shareholder rights would be reduced if they were made available to the ultimate investor.

**QUESTION 28: THE COSTS OF ENSURING THE RIGHTS AND REMEDIES OF AN ULTIMATE INVESTOR IN AN INTERMEDIATED SECURITIES CHAIN**

12.32 We asked consultees what the costs – financial or otherwise – could be of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain.

**Implementation costs**

12.33 Some consultees said that the cost of providing rights and remedies to ultimate investors would outweigh the benefits.

12.34 Computershare said that it would be difficult to deliver rights and remedies to ultimate investors without a “full-scale overhaul of the existing post trade infrastructure” at significant cost. Similarly, Eric Chalker said that the administrative and regulatory costs of ensuring that rights and remedies were made available to ultimate investors would be “significant”.

12.35 The CLLS said the cost of wholesale reform of the intermediated securities system would be “immense” because it would require reform of large parts of UK securities, company, trust and contract law. They said it would also lead to legal uncertainty and undermine the efficiency and convenience of modern securities trading, and could harm the UK’s reputation as a financial centre and reduce GDP.

12.36 Dr David Gibbs-Kneller said that making rights and remedies available to ultimate investors could increase the cost of holding intermediated securities as intermediaries would pass on these costs to the ultimate investor. However, he also pointed out that competition between intermediaries may lower these costs.

12.37 In contrast, the AMNT said that the costs arising from changes to the system of intermediated securities would be “very small relative to costs overall”. Similarly, John Hunter said that intermediaries could adjust “quite cheaply” to a system that made rights and remedies available to the ultimate investor.

12.38 Andrew Turvey said that intermediaries would inevitably incur costs in adjusting to the new system but that these costs would be outweighed by the benefits of improved corporate governance.
Appendix 1: List of consultees

The following list shows the businesses, organisations and individuals who responded to the call for evidence.

Professional membership organisations
Association for Financial Markets in Europe
Association of British Insurers
Association of Global Custodians
Association of Member Nominated Trustees
Law Society of Scotland
Pensions and Lifetime Savings Association
Personal Investment Management & Financial Advice Association
The Quoted Companies Alliance
The Chartered Governance Institute Registrars Group
The City of London Law Society
UK Finance
UK Shareholders’ Association and
ShareSoc – UK Individual Shareholders Society

Businesses
Ario Advisory
Chancery Advisors Limited
Computershare
Equiniti
Euroclear UK & Ireland Limited
Investor Meet Company
Link Asset Services
London Stock Exchange Group
The Share Centre

**Retail investors**
Mohammed Amin
Eric Chalker
Barry Collins
Thiebald Cremers
Ali Haouas
Mark Holland
John Hunter
Roger Lawson
Bulkar Sheena
Andrew Turvey

**Academics**
Dr David Gibbs-Kneller, University of East Anglia
Professor Louise Gullifer QC (Hon), University of Cambridge
Dr Ewan McGaughey, King’s College London
Dr Eva Micheler, London School of Economics
Professor Jennifer Payne, University of Oxford
Sir John Dermot Turing, University of Oxford

**Other**
Financial Conduct Authority
The Institute of Cancer Research Pension Scheme
Principles for Responsible Investment
ShareAction
Shepherd and Wedderburn LLP
David Pollard

**Confidential**
We received two confidential responses.