Law Commission
Reforming the law

Intermediated securities: who owns your shares?

A Scoping Paper

11 November 2020

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The Law Commission

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Glossary

Term	Definition
Bearer note	A document that embodies a debt security. Ownership of the security is evidenced by physical possession of the bearer note rather than by an entry on a register.
Bitcoin	A type of digital currency which is supported by blockchain.
Blockchain	A method of recording data on a distributed ledger. Data on the ledger is grouped into timestamped “blocks” which are mathematically linked or “chained” to the preceding block on the ledger.
Bonds	A type of debt security (see also “debt securities”).
Central securities depository	An organisation that operates an electronic system for the recording and settlement of uncertificated securities.
Certificated register	See “register of members”.
Charge	A type of security interest that can be taken over an asset. The owner of the asset creates a proprietary interest in relation to that asset in favour of the person who takes the benefit of the charge.
Corporate governance	The policies and processes by which a company is directed and controlled.
CREST	The central securities depository in the United Kingdom.
CREST personal member	An individual who has a CREST account in their own name.

Term	Definition
Custody	The process by which a financial institution holds securities on behalf of a client and assumes responsibility for their safekeeping and administration.
Debt securities	Investment securities which embody an obligation on the issuing company to repay a debt to the holder of the security.
Deed poll	A formal document, executed by one party, which provides rights to another party and creates a binding obligation on the party who has issued it.
Dematerialisation	The issue of securities by companies without paper certificates to evidence title or the transformation of existing paper, certificated securities into electronic form. A dematerialised security is represented by an entry in an electronic register.
Distributed Ledger Technology	A method of recording and sharing data across a network in a decentralised and transparent way. A DLT system comprises a digital database (a "ledger") which is shared (that is, "distributed") among a network of computers (known as "nodes"). Each node holds an identical copy of the ledger on its system, which is updated instantaneously as new data is added. Nodes approve of additions to the ledger through the consensus mechanism.
Equity securities	Investment securities which give the legal owner of the security (the "shareholder") a stake in the company.
Good faith purchaser principle	The principle that a person who acquires securities which are not negotiable may do so free of any equitable claim, right or interest of a third party if they are a good faith purchaser of the legal title to the securities without notice.

Term	Definition
Headcount test	The requirement under section 899 of the Companies Act 2006 that a scheme of arrangement must be approved by a majority in number of the creditors or members (or class of creditors or members) who vote on the compromise or arrangement.
Immediate intermediary	The intermediary with whom the ultimate investor has a contractual relationship.
Immobilisation	The process by which a security is located in a particular CSD, to enable subsequent transfers of interests in that security by book entry.
Institutional investor	An organisation which purchases investment securities, either for itself or to hold for other investors. Examples of institutional investors include pension funds and insurance companies.
Intermediary	An individual or, more commonly, an organisation which holds an interest in investment securities on trust for another, who may be another intermediary or the ultimate investor.
Intermediated securities	Interests in investment securities which are held by participants through a chain of intermediaries.
Investment manager	An individual or organisation to whom the responsibility for the day-to-day management of an investor's assets is delegated. The investment manager will act on the basis of instructions given to them in the investment mandate. Also known as "asset manager" or "fund manager".
Investment mandate	The agreement between an investment manager and their client outlining how the assets of the investor are to be managed.
Investment platform	An online tool or service that facilitates the purchase and sale of securities.
Investment securities	Instruments issued by a company in order to raise money. See "equity securities" and "debt securities".

Term	Definition
ISA	Individual savings account, set up under the Individual Savings Account Regulations 1998, SI 1998 No 1870.
Issuer record	See “register of members”.
Issuing company	The company which issues the investment securities.
Lien	A right to retain possession of a thing until a claim or debt has been satisfied (in the context of financial collateral arrangements, a lien is a security interest).
Majority in number requirement	See “headcount test”.
Majority in value requirement	The requirement under section 899 of the Companies Act 2006 that a scheme of arrangement must be approved by a majority of creditors or members (or class of creditors or members) representing 75% in value of the creditors or members (or class of creditors or members) who vote on the compromise or arrangement.
Negotiability	Negotiability converts an instrument from mere evidence of ownership into an instrument that is legally deemed to constitute the securities. Title to the negotiable instrument is transferred by physical delivery (or, in some cases, by endorsement and delivery) of the paper certificate or document of title, provided that the transferor has the necessary intention to transfer.
“No look through” principle	The principle that an ultimate investor may only make a contractual or trusts law claim against their immediate intermediary and not against the issuing company or intermediaries higher in the chain.
Node	A participant on a DLT system.
Nominee account	See “omnibus account”.

Term	Definition
Open-ended investment company	See “unit trust”. An open-ended investment company operates in a similar way to a unit trust but using a corporate structure.
Operator record	See “register of members”.
Omnibus account	An account which is used to hold the securities of more than one investor (in contrast to a “segregated account”). Also known as a “pooled account” or a “nominee account”.
Permissioned DLT	A DLT system in which nodes cannot participate until they receive permission from a central administrator.
Permissionless DLT	A DLT system in which nodes do not need permission from any entity to participate in the network and propose transactions.
Pooled account	See “omnibus account”.
Pooled fund	Pooled funds collect capital from investors and invest it under the management of a financial professional, often called a fund manager. Investors in pooled funds purchase a “unit” in the fund, which represents a proportion of the assets held by the fund. Examples of pooled funds include unit trusts and open-ended investment companies.
Purchaser	In the context of the good faith purchaser principle, discussed in Chapter 7, by “purchaser” we mean “transferee for value”.
Register of members	A register of all the shareholders in a company, which is required to be kept by section 113 of the Companies Act 2006. It comprises two parts: the “issuer record” or “certificated register” which includes members who hold securities in paper form; and the “operator record” which includes members who hold securities through CREST.
Retail investor	An individual who purchases investment securities in a non-professional capacity.

Term	Definition
Scheme of arrangement	A binding compromise or arrangement between a company and its creditors or members approved by a meeting of creditors or members and sanctioned by the court under section 899 of the Companies Act 2006.
Segregated account	An account which only holds the assets of a particular investor (compare “omnibus account”).
Segregated mandate	A portfolio, or series of portfolios, of investments that are managed for a single client by an investment manager. A segregated mandate is a contractual agreement, with the details set out in the investment management agreement (compare “pooled fund”).
Securities lending transaction	In a securities lending transaction, the holder of securities transfers them to a third party, who undertakes to return securities of the same kind at a later point. The third party will provide collateral, usually cash but sometimes other securities.
Settlement	The process that occurs following a financial securities trade during which the buyer makes payment and ownership of the securities is transferred.
Shares	A type of equity security (see “equity securities”).
Shortfall	In the context of this paper, a shortfall occurs when an intermediary does not have sufficient securities in an omnibus account to satisfy claims made by its account holders.
Ultimate investor	The person with the ultimate beneficial interest in investment securities, at the end of an intermediated securities chain. An ultimate investor may be an individual, an institution holding securities on its own behalf, or a fund which manages investments on behalf of individuals or corporate bodies. For the purposes of this scoping paper, we do not include investors in pooled funds as ultimate investors.

Term	Definition
Unit trust	A “unit trust” is a trust under which assets such as investment securities are held for beneficiaries. The beneficiaries, who are investors, purchase “units” in the trust, which represent their investment. Depending on the terms of the trust, investors can redeem their units and receive back their investment stake, as well as any profits which are attributable to their units.

List of abbreviations

Abbreviation	
ABI	Association of British Insurers
AFME	Association for Financial Markets in Europe
AGC	Association of Global Custodians
AMNT	Association of Member Nominated Trustees
BEIS	Department for Business, Energy and Industrial Strategy
BIS	Department for Business, Innovation & Skills
CA 2006	Companies Act 2006
CASS	FCA Handbook Client Assets Sourcebook
CLLS	City of London Law Society
COBS	FCA Handbook Conduct of Business Sourcebook
COMP	FCA Handbook Compensation Sourcebook
CSD	Central Securities Depository
DLT	Distributed Ledger Technology
ESG issues	Environmental, Social and Governance issues
EUI	Euroclear UK & Ireland
FCA	Financial Conduct Authority
FCARs	Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003 No 3226
FMLC	Financial Markets Law Committee

Abbreviation	
FRC	Financial Reporting Council
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
IA	Investment Association
ICSA	The Chartered Governance Institute (until 2019, the Institute for Chartered Secretaries and Administrators)
ICSD	International Central Securities Depository
LSEG	London Stock Exchange Group
PIMFA	Personal Investment Management & Financial Advice Association
PLSA	Pensions and Lifetime Savings Association
PRIMA	Place of the relevant intermediary approach
QCA	Quoted Companies Alliance
SAR	Special Administration Regime
UKSA	UK Shareholders' Association
UNIDROIT	International Institute for the Unification of Private Law
USRs	Uncertificated Securities Regulations 2001, SI 2001 No 3755

ONLINE CONTENT

All websites referenced in this document were last accessed on 6 November 2020.

References to Law Commission publications

In this scoping paper, we refer often to the following Law Commission publications. We use an abbreviated reference in the footnotes and provide the full reference with website link below.

Abbreviation	Reference
Call for evidence (2019)	Intermediated securities call for evidence (2019), at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2019/08/6.5925_LC_Intermediated-securities-call-for-evidence-web.pdf
Further Updated Advice on Intermediated Securities (2008)	UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury (May 2008), at https://www.lawcom.gov.uk/project/property-interests-in-intermediated-securities/
Fiduciary Duties of Investment Intermediaries (2014)	Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/lc350_fiduciary_duties.pdf
Electronic Execution (2019)	Electronic Execution (2019) Law Com No 386, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2019/09/Electronic-Execution-Report.pdf

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 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, 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. This complex system provides many benefits, including efficiency and convenience, to investors.

1.4 In this paper, we analyse the law underlying intermediated securities, together with concerns of market participants, and possible solutions to those concerns.

BACKGROUND TO THIS PAPER

1.5 This is not the first time that intermediated securities have been subjected to formal scrutiny, including by the Law Commission. Previous work has included:

(1) a report by the Financial Markets Law Committee ("FMLC") (2004);[1]

(2) a series of advices provided by the Law Commission to HM Treasury on the UNIDROIT Convention on Substantive Rules for Intermediated Securities;[2]

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1 FMLC, *Issue 3 – Property interests in investment securities* (July 2004), at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf.

2 Law Commission, The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Interim Advice (October 2006); Law Commission, The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Updated Advice to HM Treasury (May 2007); and Law Commission, The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury (May 2008), all at https://www.lawcom.gov.uk/project/property-interests-in-intermediated-securities/.

(3) a Law Commission report entitled *Fiduciary Duties of Investment Intermediaries*, in which we referred to some of the issues arising in relation to intermediated securities chains;[3]

(4) a research paper by the then Department for Business, Innovation & Skills ("BIS") entitled *Exploring the intermediated shareholding model*.[4]

1.6 Other reports and reviews, including the Cadbury Report (1992)[5] and the Kay Review (2012),[6] have also led to significant changes in the system.

1.7 In 2017, the Department for Business, Energy and Industrial Strategy ("BEIS") acknowledged the issues to which intermediated securities give rise and pledged to keep the model under review.[7] Recent developments in relation to intermediated securities include:

- several high-profile instances, reported in the mainstream press, of ultimate investors being excluded, or apparently excluded, from major corporate decisions relating to proposed takeovers and relocations;[8]
- the launch of the new Financial Reporting Council's Stewardship Code 2020, which places new obligations on signatories to the code (including institutional investors and intermediaries) regarding transparency and engagement through the investment chain; [9]
- rising interest amongst investors in the impact of corporate decisions regarding matters such as climate change and executive pay, meaning that more investors may wish to participate in the decisions of the companies in which they invest; and

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3 Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350 para 11.105 onwards, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/lc350_fiduciary_duties.pdf. We also touched on these issues in a further report, Pension Funds and Social Investment (2017) Law Com No 374.

4 Department for Business Innovation & Skills, *Exploring the intermediated shareholding model* (Research Paper No 216, 2016).

5 *Report of the Committee on the financial aspects of corporate governance* (1992). The committee was chaired by Sir Adrian Cadbury in order to review those aspects of corporate governance relating to financial reporting and accountability.

6 *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012). Professor Kay conducted a year-long review of the UK equity market and was highly critical of the way it worked. He considered that investment chains were too long, with growing numbers of intermediaries between an investor and the company in which they invest. See Fiduciary Duties of Investment Intermediaries (2014) para 1.3 onwards.

7 Department for Business, Energy and Industrial Strategy, *Corporate governance reform: the Government response to the green paper consultation* (2017) para 1.63.

8 See, eg, the proposed Unilever vote and the Sirius Minerals scheme of arrangement, both discussed from para 4.14 below.

9 Financial Reporting Council, *Stewardship Code 2020*, at https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf.

- the increasing interest in blockchain technology as a possible alternative, or partial solution, to the model of intermediated holding.

TERMS OF REFERENCE AND CONSULTATION

1.8 In June 2019, BEIS asked the Law Commission to undertake a "scoping study" into investor rights in a system of intermediated securities. The full terms of reference asked the Law Commission to provide:

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

1.9 Given recent work by the European Commission and HM Treasury, BEIS and the Law Commission agreed that the scoping study would not address conflict of laws issues.[10]

1.10 This paper focuses solely on investments in UK-incorporated public companies whose shares may be purchased and traded by the public. We do not consider private companies.

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[10] See, eg, European Commission, *Securities and Claims Ownership*, at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/post-trade-services/securities-and-claims-ownership_en.

Consultation with stakeholders

1.11 In August 2019, we published a short call for evidence ("the call for evidence"),[11] which was the first step in our work. It 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.

1.12 We received 42 responses from 45 consultees representing all parts of the intermediated securities chain as well as lawyers and academics specialising in this area.[12] These responses were thoughtful and considered, and demonstrated a depth of engagement from consultees. We have read and analysed these responses. We summarise the results of the consultation exercise in this paper; a more comprehensive summary of responses will be published separately.

1.13 As well as the formal consultation exercise, we spoke to consultees in approximately 60 meetings or calls between June 2019 and July 2020.

INTERMEDIATED SECURITIES: AT A GLANCE

1.14 One way to consider the law applying to intermediated securities is to compare the position of a person holding investments directly from the issuing company with the position of a person holding investments through an intermediated securities chain. We discuss this comparison in detail in Chapter 2, but provide an introduction to the issues here.

1.15 When you hold your investments directly (whether by holding the paper certificate or through having your own CREST account), you are the legal owner of your investments. Your name will appear on the register of members of the company. This means that you are a shareholder in the company (the "member" of the company under the Companies Act 2006 (which we refer to as the "CA 2006")). As a member, you will have a direct relationship with the company, which means that you will receive information and correspondence from the company, be able to attend company meetings, and, depending on the type of shares you own, you will usually have voting rights.

1.16 In contrast, when you hold your investments through an intermediary, such as a broker, online investment platform or a bank, you are not the legal owner of your investments. Under the law of England and Wales, this arrangement is classified as "a series of trusts and sub-trusts" between the participants.[13] This classification means

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11 Law Commission, Intermediated securities call for evidence (2019), at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2019/08/6.5925_LC_Intermediated-securities-call-for-evidence-web.pdf.

12 Some consultees – such as the UK Shareholders' Association and ShareSoc, and the Association for Financial Markets in Europe and UK Finance – provided a joint response.

13 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [163]; and see para 2.63 below.

that you own only a "beneficial" interest in the investments. Each intermediary is a trustee or sub-trustee for the person immediately below it in the chain. There is also a contractual relationship between each set of parties in the chain.

1.17 In this paper, we refer to the "ultimate investor", by whom we mean the person (whether an individual or legal person) with the ultimate beneficial interest in the securities.[14] As an ultimate investor, your name will not appear on the register of members and you will not automatically have a direct relationship with the company. You are not a member of the company. Instead, the financial institution (the "CREST member") at the top of the intermediated securities chain will be the legal owner of the investments and the legal shareholder or member of the company. They will receive information and correspondence from the company, be able to attend company meetings and vote in relation to the shares. Often, an intermediary will hold your beneficial interests in securities in an "omnibus" account, pooled with the investments of other clients. One omnibus account may hold millions of shares for ultimate investors.

Pooled funds

1.18 The primary focus of this paper is investors who purchase an interest in securities which they hold through an intermediated securities chain. We do not, for the reasons we set out in Chapter 2, focus on investors who pay money into pooled funds, which are a particular type of investment product distinct from intermediated holdings.[15]

The impact of intermediation

1.19 Our research and consultation with stakeholders have identified that an intermediated holding system provides certain significant benefits.

(1) Increased efficiency and economies of scale (particularly where omnibus accounts are used).

(2) Decreased costs for intermediaries, because of increased efficiency and economies of scale, which may trickle down to ultimate investors.

(3) The ability for ultimate investors to hold a diverse portfolio of investments through a single intermediary.

1.20 The intermediated holding system has made trading significantly quicker, cheaper and more convenient, but at the same time it has been the subject of criticism over issues of corporate governance and transparency. There is also uncertainty as to the legal rights and remedies available to an ultimate investor who holds intermediated securities.

1.21 Some consultees told us that aspects of the current system prioritises intermediaries – which are often large financial institutions – over ultimate investors, whose money is at stake. However, there is not a realistic alternative system of holding investments

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[14] Stakeholders also referred to an "ultimate investor" as an "ultimate beneficial owner", a "beneficial owner" or an "ultimate account holder".

[15] We discuss pooled funds from para 2.18 below.

directly, in particular for retail investors. Although a retail investor may obtain a CREST account, these are offered by only a handful of intermediaries and the cost of having a CREST account has risen significantly in the last five years. Ultimate investors, and particularly retail investors, have no real option but to hold their investments through an intermediated securities chain.[16]

1.22 Two broad themes encompass the specific issues arising from the use of intermediated securities chains to hold investments. The first theme is the effect on investors' rights and corporate governance. The second covers issues which affect legal certainty.

The effect on investors' rights and corporate governance

1.23 Holding investments through an intermediated securities chain can have a profound effect on the ability of ultimate investors to exercise rights. As we point out above, an ultimate investor who holds investments this way is not a "member" of the company under the CA 2006.

1.24 In general, this means that ultimate investors:

(1) cannot exercise the right to vote in relation to their investments or, if their intermediary facilitates voting, they find it difficult to confirm that their vote was received and counted by the company;[17]

(2) are not entitled to attend meetings of the company or receive information from the company;[18]

(3) cannot be easily identified by a company which wants to engage with its ultimate investors;[19]

(4) cannot take advantage of other statutory rights for members, such as the right to challenge a resolution to re-register a public company as a private company;[20]

(5) will not be taken into account if the company is entering a binding compromise between a company and its members or creditors (a "scheme of arrangement")[21]; and

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16 We discuss personal CREST accounts (also called sponsored CREST accounts) from para 2.56 below.

17 We discuss voting in ch 3 below.

18 We discuss meetings and information rights from para 3.26 below.

19 CA 2006, s 793. We discuss s 793 from para 3.127 below.

20 CA 2006, s 98. We discuss s 98 from para 5.12, and from para 5.55 below.

21 CA 2006, s 899. We discuss schemes of arrangement in ch 4 below.

(6) can generally only make a contractual or trusts claim against their immediate intermediary, and not against the company which issues the securities, nor against another intermediary (the "no look through principle").[22]

1.25 Part 9 of the CA 2006 includes provisions which, in theory, enable the participation of ultimate investors in these activities but which, in practice, are rarely used. Additionally, the Government recently implemented the Shareholder Rights Directive II, which included provisions in relation to facilitation of shareholder rights. However, this implementation took place on the basis that the "shareholder" under the Directive is the member of the company, and therefore did not benefit ultimate investors.[23]

1.26 These types of legal issues will also be relevant to the corporate governance of companies. Corporate governance, at its simplest, is "the system by which companies are directed and controlled".[24] Laws which determine who can vote and exercise other corporate rights (such as challenging resolutions) will have a material effect on the governance of the relevant company.

A need for increased legal certainty

1.27 We have also identified several issues in relation to which there is a lack of legal certainty when it comes to intermediated securities.

(1) An ultimate investor's assets will generally be protected on the insolvency of an intermediary due to their being in trust. However, there is some uncertainty as to how losses would be allocated if the assets are held in an omnibus account and there are insufficient assets to meet the claims of all ultimate investors in the account at the point of insolvency.[25]

(2) If intermediated securities are wrongly sold (for example, where the real owner did not consent to the sale), ultimate investors who purchase them will generally be vulnerable to a claim by the real owner. This is the case even if they have acquired the investments in good faith and have no notice of any other claims to them. This is not the case for good faith purchasers of the legal, rather than beneficial, interest in securities. In 2008, the Law Commission recommended a statutory amendment to address this problem.[26]

(3) Where there is a transfer of intermediated securities between investors, it is not certain whether that transaction must be in writing and signed, in accordance with the formality requirements under section 53(1)(c) of the Law of Property Act 1925.[27]

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22 This limitation does not affect claims in tort. The no look through principle is also subject to certain statutory exceptions eg s 90A FSMA. We discuss the no look through principle in ch 5 below.

23 We discuss this Directive from para 3.106 below.

24 Cadbury Report 1992.

25 We discuss insolvency in ch 6 below.

26 We discuss the good faith purchaser principle from para 7.4 below.

27 We discuss s 53(1)(c) of the Law of Property Act 1925 from para 7.41 below.

(4) There is potential uncertainty in relation to whether intermediated securities can be "possessed" and how that might affect an intermediary's ability to take security over these assets to secure a debt owned by an ultimate investor to an intermediary (for example, in relation to unpaid fees). We discuss in Chapter 7 that the Law Commission will consider the question of possession of intangible property in a separate project.[28] There is also uncertainty as to whether an intermediary has sufficient "possession" or "control" of an ultimate investor's intermediated securities under the Financial Collateral Arrangements (No 2) Regulations 2003.[29]

THE LAW COMMISSION'S VIEW ON INTERMEDIATION

1.28 Our view, based on discussions with stakeholders and our own research, is that an intermediated holding system for investment securities provides obvious benefits. However, as we explain throughout the scoping paper, this system can also impact negatively on ultimate investors who, after all, are the individuals and organisations providing money to companies through their investments. They are also the ones who take the financial risk.

1.29 Although some consultees from the investment industry told us that they had not seen any increased demand from ultimate investors to exercise voting rights, there is anecdotal evidence to suggest that there are at least some ultimate investors who do wish to participate as a shareholder in the companies in which they invest.[30]

1.30 One option to improve the position of ultimate investors would be to remove intermediation entirely, making all ultimate investors the legal owners of their investments (discussed below).[31] We think that there would be certain benefits to that model. However, our preferred way forward would be to retain the current system, with further work into certain targeted changes which could alleviate some of the problems caused by intermediation while retaining its benefits. This approach could possibly be supported by the creation of a genuine option for holding dematerialised securities directly for those investors who wish to do so. We think that this approach would be a proportionate response to the issues identified in this paper.

1.31 We also consider that there are several areas in which there is a lack of certainty in the law. We think that it would be beneficial for all market participants if these issues were clarified, potentially through legislation.

A RANGE OF POSSIBLE SOLUTIONS

1.32 Instead of making recommendations for reform, in this scoping paper we set out possible solutions which could be taken forward with additional work, either from the Law Commission or the Government. A scoping paper is therefore distinct from a full Law Commission law reform project, which would consist of a consultation paper with

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28 See paras 7.89 and 7.90 below. See https://www.lawcom.gov.uk/project/digital-assets/.

29 We discuss custodian liens and the Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003 No 3226 from para 7.65 below.

30 See para 2.52 below.

31 We discuss this potential approach in ch 8 below.

detailed options for reform, followed by a report with recommendations to the Government.

1.33 In this scoping paper, we discuss possible solutions which, with further work, could enhance ultimate investors' rights and corporate governance, and increase legal certainty. They include:

(1) the creation of a new obligation on intermediaries to arrange for ultimate investors, upon request, to attend meetings and to vote and receive information that the company sends to its members;[32]

(2) the possible extension of the application of the Shareholder Rights Directive II to enhance the rights of ultimate investors;[33]

(3) potential improvements to the statutory procedure which enables companies to identify ultimate investors;[34]

(4) potential amendments to facilitate the confirmation to ultimate investors that their votes have been received and counted by the company;[35]

(5) targeted solutions to ensure that ultimate investors can take advantage of certain statutory rights and exceptions to the no look through principle, and of the good faith purchaser principle;[36]

(6) clarification of the distribution of omnibus accounts on insolvency;[37] and

(7) consideration of developments in technology, including distributed ledger technology ("DLT"), to support the creation of a direct relationship between investors and companies.[38]

1.34 We also consider whether a potential move to an entirely electronic system for holding securities ("dematerialisation") could or should be used either to replace the system of intermediation altogether, or at least to provide a viable alternative to intermediation for investors who wish to be able to exercise shareholder rights such as voting.[39]

1.35 In the final chapter of this paper, we include a full list of possible solutions, each requiring further work.[40]

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32 See from para 3.81 below.

33 See from para 3.106 below.

34 See from para 3.127 below.

35 See from para 3.137 below.

36 We discuss the no look through principle in ch 5 below; and we discuss the good faith purchaser principle from para 7.4 below.

37 See from para 6.91 below.

38 See from para 9.67 below.

39 See ch 8 below.

40 See ch 10 below.

COSTS AND BENEFITS OF REFORM

1.36 In our terms of reference, the Government asked for a "summary of the costs and benefits of the potential solutions". However, the scoping nature of our work has meant that we did not provide consultees with specific detailed options for reform for their consideration. As a result, consultees have not provided us with any figures as to the impact of potential reform, preferring to comment in a more general way on potential costs and benefits of changes to the current system.

1.37 Any future work on possible solutions should include:

(1) analysis of the potential costs, including implementation, transitional and ongoing costs; and

(2) analysis of the potential benefits, including increased certainty for investors as to their rights, increased clarity of the current law, increased efficiency in operations and increased confidence in the intermediated holding system.

1.38 We discuss the further work required on a cost-benefit analysis in Chapter 10.

THE STRUCTURE OF THIS PAPER

1.39 This scoping paper is divided into a further nine chapters. Chapter 2 provides an overview of intermediated securities and the different aspects of the intermediated securities chain. We explain how the law characterises the relationships in the chain, and the implications of this characterisation for investors. We describe the scope of the paper and who constitutes an ultimate investor for the purposes of our work. We also consider investors' motivations for investment and why they may wish to vote on company resolutions.

1.40 Chapters 3 to 7 deal with specific legal issues which arise in relation to intermediated securities. For each of these issues, we set out the relevant law, a summary of consultees' views, a consideration whether there appears to be a problem in practice and, if so, possible solutions to that problem.

(1) Chapter 3: voting by ultimate investors (and associated issues such as identification of ultimate investors and confirming that a vote has been received and counted).

(2) Chapter 4: schemes of arrangement and the effect of the headcount test in section 899 of the CA 2006 in relation to intermediated securities.

(3) Chapter 5: the "no look through principle", which limits the ability of ultimate investors to bring a claim against participants in the intermediated securities chain.

(4) Chapter 6: the effect on ultimate investors of the insolvency of an intermediary.

(5) Chapter 7: the application of the "good faith purchaser" principle to intermediated securities; the application of formalities requirements to transfers of intermediated securities; and questions that arise when intermediaries take security, such as a charge or custodian's lien, over securities.

1.41 In contrast to specific issues in earlier chapters, Chapters 8 and 9 consider the broader systemic perspective. In Chapter 8, we discuss whether a potential move to an entirely electronic system for holding securities ("dematerialisation") provides opportunities to enhance the rights of existing ultimate investors. We review two alternative possible solutions. First, we consider a model under which intermediation is removed entirely and replaced with a system under which all securities would be held directly by investors. Secondly, we consider a model under which the intermediated system would be retained, but which would create a new avenue for direct holding of securities for those ultimate investors who wished to do so.

1.42 In Chapter 9, we consider possible non-legislative, "soft law" options for reform. These include a code of practice, consumer education and the potential for technology such as DLT to offer practical "fixes".

1.43 Chapter 10 concludes the paper with a summary of all the possible solutions which could be taken forward, as well as the further work which would be required on a cost-benefit analysis.

DEVOLUTION AND SCOTS LAW

1.44 As we explain above, this scoping study does not include recommendations for reform. This means that questions of legislative competence and devolution do not arise as major issues at this stage. However, it is important to be aware of the devolution settlements and, irrespective of the devolution position, of any relevant differences between the laws of England and Wales, Scotland, and Northern Ireland, at an early stage.

1.45 This paper considers financial markets and services, company law and corporate insolvency law. These are reserved matters under the Government of Wales Act 2006 and the Scotland Act 1998.[41] In relation to Northern Ireland, financial markets and services are reserved under the Northern Ireland Act 1998.[42] Company law and insolvency law are transferred matters within the legislative competence of the Northern Ireland Assembly. In relation to company law, we understand that the Northern Ireland administration has previously agreed that amendments to the CA 2006 should be made in the same terms for the whole of the United Kingdom.

1.46 In the call for evidence we asked for comments on issues of devolution. Two consultees, the Law Society of Scotland and Shepherd and Wedderburn LLP, suggested issues which would merit particular consideration under Scots law in future work.

(1) The legal nature of an intermediated securities chain and the nature of the interests held by participants in the chain.[43] Scots law does not recognise the

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41 Government of Wales Act 2006, s 108A and sch 7A, paras 17 to 18 and paras 65 and 67; Scotland Act 1998, s 30 and sch 5, paras A3 to A4 and paras C1 to C2.

42 Northern Ireland Act 1998, s 4(1) and sch 3.

43 We discuss the legal nature of an intermediated securities chain and the nature of interests under the law of England and Wales in ch 2 below.

concept of equity and therefore rules around equitable interests are not an appropriate way to address issues in a Scottish context. Although trusts do exist, the law which governs them is different. For example, beneficiaries do not have a proprietary interest in trust assets as Scots law does not recognise equitable interests. Beneficiaries therefore hold only a personal right against the trustees. This distinction is relevant when we discuss the nature of the ultimate investor's right in intermediated securities below.[44]

(2) Areas such as proprietary interests (including trusts) and personal insolvency (including the insolvency of a partnership), which are devolved to the Scottish Parliament.

(3) Other areas, such as corporate insolvency and some UK-wide regulatory laws, which contain provisions which apply specifically to Scotland. There are important differences between the law of England and Wales and the law of Scotland in their treatment of property, trusts and contract. This means that it is impossible for corporate insolvency law throughout the UK to be fully harmonised without fundamental changes in the legal principles of England and Wales or Scotland.

Next steps

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

1.48 Throughout this paper we have included text, provided by the Scottish Law Commission, indicating where Scots law diverges from the law of England and Wales. We hope that these paragraphs will serve as markers for any body taking forward further work in this area and ensure that the differences in Scots law are recognised and accounted for. Any legislation brought forward in Westminster relating to these reserved areas will need to address the Scots law implications. The same will also be true for Wales and Northern Ireland, but our understanding is that their laws are more aligned with English law. This is separate from the point, referred to above, about the need for coordination between administrations on areas that are devolved or transferred.

CROSS-BORDER ISSUES

1.49 Intermediated securities chains can be long, with intermediaries located in different jurisdictions. Approximately 70% of equities which are managed in the UK are invested in companies abroad. Over half of assets under management are managed by a firm which is in the UK, but whose parent company is located overseas.[45]

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44 See from para 2.67 below.

45 Investment Association, *Investment Management in the UK 2018-2019: The Investment Association Annual Survey* (September 2019) p 22, at https://www.theia.org/sites/default/files/2019-09/IMS%20full%20report%202019.pdf.

1.50 Cases which have a point of contact with some other system of law (a "foreign element") are dealt with under a part of law which is known as the "conflict of laws" or "private international law". A foreign element may exist, for example, because a contract was made or was to be performed in a foreign country, or because a tort was committed there, or because property was situated there, or because the parties are from another jurisdiction.[46]

1.51 In cases with a foreign element, the first question is whether the court has jurisdiction to hear the case. Where a domestic court does have jurisdiction, the second question is whether the law of England and Wales, or the laws of another jurisdiction (including the law of another UK jurisdiction, such as Scotland), should be applied to the dispute.[47] In the context of an intermediated securities chain which spans multiple countries, these questions can be difficult to answer.

1.52 In some cases, which law is applied may limit the rights of an ultimate investor. Rights and remedies which would have been available to the ultimate investor under the law of England and Wales may not be available under the foreign laws applied by the court (and the converse may also be true).

1.53 Conflict of laws is explicitly excluded from our terms of reference. This means that we will not be dealing in substance with cross-border issues (including, as discussed above, those between the different legal jurisdictions of the UK). However, it is imperative that any further work on any of the possible legislative or regulatory measures considers the potential effect on parties based outside the UK.

ACKNOWLEDGEMENTS AND THANKS

1.54 We are grateful to all those individuals and organisations who responded to our call for evidence, as well as those who have taken time to discuss the scoping paper with us.[48] In particular, many thanks to the Investment Association ("IA") and Interactive Investor, who conducted surveys of their members for the purpose of this scoping paper. Thank you also to the City of London Law Society ("CLLS"), the FCA, and Euroclear UK & Ireland ("EUI"), all of whom provided feedback on our explanation of the current law, and to the Registrars' Group which provided guidance and information on how the registers operate in practice.

1.55 We are also grateful for the feedback and comments from an Advisory Panel of experts, who have commented on draft proposals and shared their expertise and evidence with us. Their names are listed in Appendix 1.

THE TEAM WORKING ON THIS PAPER

1.56 The following members of the Commercial and Common Law team have contributed to this scoping paper: Laura Burgoyne (team manager); Siobhan McKeering (team

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46 *Dicey, Morris & Collins on the Conflict of Laws* (15th ed 2018) para 1-001. Such "other jurisdiction" could be another UK jurisdiction – for example where shares in a Scottish company are held by a person in England who does so under a contract with an investor governed by English law.

47 *Dicey, Morris & Collins on the Conflict of Laws* (15th ed 2018) para 1-003. See, eg, *Secure Capital SA v Credit Suisse AG* [2017] EWCA Civ 1486, [2017] 2 Lloyd's Rep 599.

48 We list these individuals and organisations at Appendix 2.

lawyer) and Daisy van den Berg (research assistant). We have also had additional input from Eleftheria Potamoussi, Caroline Jackson and Matthew Barry (research assistants) and Benedict Turner (doctoral researcher).

Chapter 2: What are intermediated securities?

2.1 In this chapter, we focus on the different aspects of an intermediated securities chain. We start by explaining securities. We set out who the "ultimate investor" is for the purpose of our work, and consider their potential motivations for investing in companies and for wishing to vote on company resolutions.

2.2 We then outline how an ultimate investor may hold securities, or an interest in securities, before describing intermediated securities chains in more detail.

2.3 Our aim is to provide, as clearly and simply as possible, both an overview of the context in which intermediated securities chains arise, and a summary of the key legal concepts relating to intermediated securities. For this purpose, we have drawn on Government publications, discussions with stakeholders, and the recent review of the market conducted by the IA.[1]

2.4 We have also considered the detailed academic literature which considers intermediated securities.[2] The purpose of this scoping paper is not to reproduce that comprehensive work. Instead, our terms of reference from BEIS require the Law Commission to provide "an accessible statement of the current law, including a clear explanation of how shares and bonds are "owned" and held".

A NOTE ON THE RELEVANT SOURCES OF LAW

2.5 At least part of the complexity of the law applying to intermediated securities is due to the following different layers of law which apply to the financial services market.[3]

(1) Agreements between the parties. Parties in an intermediated securities chain will agree the terms and conditions which govern their relationship. Freedom of contract is a fundamental common law concept and the courts are reluctant to interfere with contractual arrangements, especially those entered into by commercial parties. It is crucial to understand that contractual terms and conditions can materially alter the rights of participants in an intermediated securities chain. Although the following paragraphs set out a general statement of the law applying to intermediated securities, the specific situation may be different depending on what particular parties have agreed.

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1 Investment Association, *Investment Management in the UK 2018-2019: The Investment Association Annual Survey* (September 2019), at https://www.theia.org/sites/default/files/2019-09/IMS%20full%20report%202019.pdf.

2 See, for example, L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) and L Gullifer and J Payne (eds), *Intermediated Securities: Legal Problems and Practical Issues* (2010). See also M Yates and G Montagu, *The Law of Global Custody* (4th ed 2013); J Benjamin, *Interests in Securities* (2000). As we set out at para 1.5 above, the Law Commission has also previously published a series of advices to the Government on intermediated securities which set out the relevant law in detail.

3 Fiduciary Duties of Investment Intermediaries (2014) para 3.5.

(2) Primary and secondary legislation. The CA 2006 is the principal source of company law in the UK and provides for the formation and operation of public companies, including voting on resolutions. The Financial Services and Markets Act 2000 ("FSMA") sets up a framework for financial services legislation and regulation in the UK. The Uncertificated Securities Regulations 2001 ("USRs")[4] cover those transactions involving securities which exist only in electronic form.

(3) Case law. Relevant cases may arise in the context of trusts law, contract law or agency. These are all broad areas of law with particular relevance to intermediated securities. In the following chapters, we provide examples of cases in which judges have considered the legal nature of an intermediated securities chain and the duties of participants in such a chain.

(4) Financial Conduct Authority ("FCA") rules. The FCA rules are central to the way UK financial markets work and these rules reflect both domestic and European Union ("EU") policy. These are set out in the various components of the FCA Handbook, which is a complex database of rules and guidance, including rules on general conduct of business and custody of client assets.[5]

(5) Other sources of guidance, such as the Stewardship Code 2020, which sets standards for institutional investors and intermediaries on a "comply or explain" basis. This means that organisations which sign up to the code must either comply with its provisions or explain their non-compliance.[6]

INVESTMENT SECURITIES: NATURE, FORM AND REGISTRATION

Equity securities and debt securities

2.6 Securities play an important role in corporate finance. In order to raise money, a company (the "issuer") may issue securities, which individuals or organisations may purchase. Securities can be divided into two categories:[7]

(1) debt securities, such as bonds, which embody an obligation on the company to repay a debt to the holder of the security; and

(2) equity securities, which are shares in a company, and which give the holder (the "shareholder") a stake in the company itself.

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4 SI 2001 No 3755.

5 FCA Handbook, Conduct of Business Sourcebook ("COBS") and Client Assets Sourcebook ("CASS"), including custody of client assets (CASS 6).

6 Note that FCA Handbook COBS 2.2.3R requires an FCA-regulated firm (apart from a venture capital firm) must disclose "the nature of its commitment" to the Stewardship Code or, where it does not commit to the code, its alternative investment strategy.

7 M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-001 and Law Commission, The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury (May 2008) para 2.1, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/intermediated_securities_advice_May2008.pdf.

2.7 Both shares and debt securities may provide economic and corporate rights in relation to the company. Shareholders' rights will depend on the company's articles of association[8] and any shareholder agreement[9] but may include the right to a dividend, the right to vote at meetings and on written resolutions and the right to participate in the distribution of assets on the winding up of the company.[10] Professor Louise Gullifer QC and Professor Jennifer Payne point out that for "ordinary" shares, there is no automatic right to income or to the return of the investor's capital and these shareholders may be particularly affected by any decrease in their shares' value. This risk means that these shareholders may be especially motivated to engage with the way the company is run, through voting at meetings and on resolutions.[11]

2.8 For holders of debt securities, voting may not always be as important. In contrast with the holder of an ordinary share, a holder of debt securities will be entitled to the payment of the debt. However, the holder of debt securities will generally also have the right to vote in certain situations which may affect their debt, for example, on schemes of arrangement or when the company is in financial distress.[12]

Forms of securities

2.9 Traditionally, securities could be held in two forms:[13]

(1) they could be embodied in a piece of paper (such as in the case of bearer notes) and owned by the holder of the paper ("bearer securities"); or

(2) they could be represented by a piece of paper (such as in the case of shares) and registered. The piece of paper would be evidence of legal title but legal ownership would be conferred by the entry in the register.

2.10 Over the last several decades, the way in which securities are held by investors has moved towards "dematerialisation", which allows companies to issue securities without a paper certificate to constitute or evidence them.[14] A dematerialised security is represented by a book entry in an electronic register and is transferred by amending the register.

2.11 Although securities are increasingly held in dematerialised form, some people still hold paper securities. By "paper securities" we mean securities represented by a physical certificate which are registered (that is, those described in limb (2) above). Stakeholders told us that only around 5% to 10% of shares are held in paper or

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8 CA 2006, s 33.

9 M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-003.

10 G Morse (general ed), *Palmer's Company Law* (2018) para 6.009.

11 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 5.

12 Under Parts 26 and 26A of the CA 2006: see ch 4 below. See L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 5.

13 M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-035 and Further Updated Advice on Intermediated Securities (2008) para 2.2.

14 See Fiduciary Duties of Investment Intermediaries (2014) para 11.107 and Group of Thirty, *Clearance and Settlement in the World's Securities Markets* (1989). See also Further Updated Advice on Intermediated Securities (2008) para 2.6.

"certificated" form, with the rest held electronically. Although we do not have exact numbers, we have been told that fewer debt securities are typically held in certificated form.

Registration

The register of members

2.12 Under the CA 2006, a company has a duty to keep a register of shareholders, which is called a register of members.[15] Most companies outsource the function to a third-party entity, known as a registrar, offering share register administration as part of a wider range of administration services.[16] A register of members has to be maintained by the issuer and is typically comprised of two parts:

(1) the "issuer record" or "certificated register", which comprises members who hold their securities in paper form; and

(2) the "operator record", which comprises members who hold their securities in CREST, an electronic register.

A Central Securities Depository and the CREST system

2.13 A Central Securities Depository ("CSD") is an organisation that operates an electronic system for the recording and settlement of uncertificated securities.[17] In the UK there is only one CSD, called EUI. EUI operates CREST, in which ownership of securities is recorded and electronic transfers are effected.[18] As of August 2020, there were over 6.6 trillion shares held in CREST, for both UK-registered and non-UK-registered companies, with a value of over £5.1 trillion.[19]

2.14 In most countries, a CSD holds securities on an electronic system so that ownership of securities can be easily transferred through a book entry.[20] In the UK the CSD

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15 CA 2006, s 113. This analysis differs for the issue of debt securities. It is most common for debt securities to be issued as a global bearer note held through an international CSD. See para 2.66 below.

16 The registrar acts as the agent of the issuing companies. As part of its services, the registrar may collect proxy votes from proxy advice services or proxy voting agents and pass these to the Chairman of the company prior to a vote. The registrar must count votes and match them against the register of members at a given point in time. For example, a registrar will ensure that a vote on behalf of 1,000 shares ties up with a similar-sized holding on the register.

17 See Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories (EU) No 909/2014, Official Journal L257 of 28.8.2014 p 1, art 2(1). A CSD must also provide either a notary service (initial recording of securities in a book-entry system) or a central maintenance service (providing and maintaining securities accounts at the top tier level): CSDR, Annex, Section A.

18 As well as recording ownership and transfers of securities, the CREST system also provides other services, including messaging services, the ability to instruct the payment of dividends to shareholders and tools to enable CREST members to use securities as collateral for activities such as securities lending transactions. CREST also has the functionality to facilitate corporate actions and voting for general meetings.

19 EUI told us that as at 5 August 2020, there were 6,619,274,929,068 shares held, with a value of £5,117,528,020,181. Most of these shares (6,557,016,551,114) were in UK-registered companies.

20 See FCA, *Central securities depositories* (2020), at https://www.fca.org.uk/markets/central-securities-depositories.

adopts a slightly different role. It operates and maintains the register on which title to securities is registered, but does not hold the securities.[21] EUI does not act as a custodian for securities in the UK, and does not have a legal interest in the assets recorded in CREST.

The effect of registration

2.15 As we explain below, the person or organisation whose name appears on the register of members of the company is the legal owner of the shares.[22] This simple statement has significant practical and legal consequences for investors who hold interests in securities through intermediated securities chains and who are not therefore listed on the register as the member.[23]

2.16 Companies and registrars can only see the top level of the chain: the members. Neither the registrars, nor the companies they represent, know who the underlying investors are.[24]

INVESTORS

The "ultimate investor"

2.17 Our work is concerned with the "ultimate investor", that is, the person with the ultimate beneficial interest in intermediated securities.[25] The ultimate investor may be an individual (usually known as a "retail investor") or an organisation such as a pension fund (an "institutional investor").[26] As we said in the call for evidence, our view was, and remains, that although there may be some differences in policy considerations depending on the type of ultimate investor, their legal position is the same in respect of intermediated securities. There is unlikely to be a reason to distinguish between them in the context of any future reform.

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21 See the Uncertificated Securities Regulations 2001, SI 2001 No 3755 which set out the system for dealing with uncertificated securities, including the approval of operators, the keeping of registers, participation by issuers, conversions of securities from certificated to uncertificated form and from uncertificated to certificated form, new issues of uncertificated securities and dematerialised instructions. Regulation 3 defines "uncertificated".

22 We discuss the legal relationships and interests in an intermediated securities chain from para 2.61 below.

23 We discuss the status of an ultimate investor under the CA 2006 from para 2.92 below.

24 Unless enquiries have been made under section 793 of the CA 2006, as we discuss from para 3.127 below.

25 Under Scots law, "beneficial interest" denotes a personal right against the obligant rather than a proprietary interest in any form.

26 Department for Business Innovation & Skills, *Exploring the intermediated shareholding model* (Research Paper No 216, 2016) p 86 lists the different types of institutional investors, including pension funds, insurance companies, open and closed-ended funds offered to both institutional and retail investors and other investors (including charities, sovereign wealth funds and foundations).

Pooled funds

2.18 Discussions with stakeholders highlighted the need to refine the scope of our work with respect to pooled funds.[27] In this paper we do not, unless expressly stated, include investors who pay money into pooled funds.

Pooled funds contrasted with omnibus accounts

2.19 We start by drawing the distinction between pooled funds and "omnibus" accounts, the latter of which are also sometimes referred to as "pooled" accounts. Intermediaries use omnibus accounts to hold securities for more than one investor. An omnibus account may contain millions of securities for ultimate investors who have purchased their investments through an intermediated securities chain. The majority of intermediated securities are held through omnibus accounts.[28] The opposite of an omnibus account is a "segregated" account, which will hold the assets of one particular investor only.[29]

2.20 In contrast, pooled funds collect capital from investors and invest it under the management of a financial professional, often called a fund manager.[30] The pooling of money from a group of investors enables the manager to purchase a diverse range of investments at a lower cost than an individual investor could achieve.[31] Investors in pooled funds purchase a "unit" in the fund, which represents a proportion of the assets, such as bonds, shares, or even real estate, held by the fund. Examples of pooled funds include unit trusts and open-ended investment companies.[32]

2.21 An investor in a pooled fund agrees in advance how the fund will be managed. Pooled funds may be "actively" or "passively" managed. Active management means that the asset manager will seek out the best-performing investments with a view to exceeding market performance. By contrast, a fund under "passive management" (sometimes referred to as a "tracker" or "index" fund) will be invested in a set way (for example, FTSE 100 companies according to market valuation) with a view to keeping up with market performance.

2.22 Where an institutional investor would prefer not to invest in a pooled fund, they may instead agree a "segregated mandate" with their investment manager. A segregated

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27 We are grateful to members of the Pensions and Lifetime Savings Association ("PLSA") who raised this issue with us at a roundtable meeting in November 2019.

28 We discuss omnibus accounts from para 2.84 below.

29 We discuss segregated accounts from para 2.87 below.

30 A Hudson, *The Law and Regulation of Finance* (2nd ed 2013) para 1-44.

31 P Davies, *Intermediation and Beyond* (2019) p 190. Note that the Trustees Act 2000 s 3 provides trustees with a general power of investment. The trustee must have regard to the need for diversification of investments, in so far as is appropriate to the circumstances of the trust: s 4(3)(b).

32 A "unit trust" is a trust under which assets such as investment securities are held for beneficiaries. The beneficiaries, who are investors, purchase "units" in the trust, which represent their investment. Depending on the terms of the trust, investors can redeem their units and receive back their investment stake, as well as any profits which are attributable to their units. An open-ended investment company operates in a similar way, but using a corporate structure. See A Hudson, *The Law and Regulation of Finance* (2nd ed 2013) paras 52-12 to 52-37; and Financial Services and Markets Act 2000 ("FSMA"), Part XVII (ss 235 to 284).

mandate is a portfolio, or series of portfolios, of investments that are managed for a single client by an investment manager. We discuss segregated mandates further below.[33]

Pooled funds and our current work

2.23 We have considered whether we should or could include pooled funds within the scope of the project. From one perspective, a pooled fund is simply a different, and potentially cheaper, way for an individual or institution to invest in a company, compared to purchasing intermediated securities through an intermediary. Investors in a pooled fund may be considered to have the "ultimate economic interest" in the assets held by the fund, because they provide the money to purchase the assets in the first place. It is also arguable that discussions about the ability of ultimate investors to vote and exercise rights could be considered superficial without consideration of the position of pooled fund investors. For example, around half of pension scheme assets are held in pooled funds.[34]

2.24 Nevertheless, for the purposes of this paper we think that there are legal and policy reasons for distinguishing investors in pooled funds from those who choose to invest in securities of a particular company through an intermediary.

2.25 As we explain below, an individual or institution investing in a particular company through an intermediated securities chain has a proprietary interest in the securities.[35] That may not be the case for an investor in a pooled fund, who has an interest in the fund rather than an interest in the assets of the fund. Whether the investor has a proprietary or contractual interest will depend on the type of fund.[36] There may also be differences in the nature of the relationship between an intermediary holding interests in securities for an ultimate investor and that between an investor and an asset manager managing the property of a pooled fund.

2.26 From a policy perspective, investors usually choose to invest in pooled funds as a way of achieving the equivalent of a diverse portfolio of investments at a lower cost. We think that this approach differs from that of investors who choose to invest in a particular company through an intermediary and may raise different policy considerations. It could, for example, be argued that the trade-off for the lower cost of pooled fund investing may be a less comprehensive set of rights.

2.27 Additionally, the various structures used for pooled funds mean that it is difficult to find approaches that can apply consistently across all such funds, as well as to intermediated securities, within the scope of this current work. Any such solutions would apply to an exponentially larger group of investors and would require further work.

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33 From para 2.36 below.

34 Investment Association, *Investment Management in the UK 2018-2019: The Investment Association Annual Survey* (September 2019) p 98, at https://www.theia.org/sites/default/files/2019-09/IMS%20full%20report%202019.pdf.

35 The position is different in Scotland as we discuss below from para 2.72.

36 See, for example, the difference between unit trusts and open-ended investment companies: see A Hudson, *The Law and Regulation of Finance* (2nd ed 2013) para 52-28; and the FSMA, ss 236 and 237.

Pooled funds and voting instructions

2.28 In response to the call for evidence and during discussions, some stakeholders raised the particular issue of "directed voting" on pooled funds. This involves an institutional investor, such as a pension fund, asking an asset manager to vote in a particular way or in accordance with the pension fund's voting policy on certain issues.

2.29 The Association of Member Nominated Trustees ("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 on a vote match the intermediary's voting policy. Ray Shepherd, a member nominated trustee of The Institute of Cancer Research Pension Scheme, said the scheme had chosen an intermediary which agreed to adopt the voting policy supported by the scheme, but which later refused to do so without charging additional fees.

2.30 Stakeholders told us that there were various reasons why intermediaries are reluctant to allow directed voting. For example, we have been told that it is practically difficult, although not impossible, to enable "split voting" on a pooled fund. By "split voting", we refer to the action of calculating an ultimate investor's interest in the assets of the pooled fund, and then translating that interest into a voting entitlement. Stakeholders have explained that this process potentially requires increased administrative resource and cost to implement for each vote.

2.31 We have also been told that asset managers can exercise greater influence in relation to corporate governance matters if they are able to exercise voting rights in relation to all the interests in securities which they hold for ultimate investors in the same way. If, however, they are required to vote some shares one way, and other shares in the opposite way, there is a risk that some of the votes may cancel each other out. Intermediaries tell us that this may also affect their ability to engage with the company. For example, the IA said:

> Splitting the vote, by voting some shares for and others against at the request of one client in the fund undermines the ability of the investment manager to use voting as a tool to the maximum effect, at the expense of other shareholders in the fund.

2.32 We note that this approach assumes that the decision whether to exercise voting rights to influence a company is one solely for the asset manager, and does not consider the wishes or objectives of an ultimate investor. Although some asset managers may decide to exercise voting rights as a tool to influence corporate governance matters, there may be other asset managers who do not use voting rights in this way.

2.33 Finally, we were also told that there may be a legal barrier to directed voting. As we describe above, pooled funds may be structured as trusts. One consultee told us that directed voting may conflict with the trustee's duty to act in the best interests of the beneficiaries of the trust, where a beneficiary instructs the intermediary to vote in a way which is against the trustee's judgement.[37] However, we have been told that

[37] For a discussion of the duties of investment intermediaries, see Law Com No 350.

some asset managers do permit split voting in relation to pooled funds. This suggests that such legal barriers may be surmountable.

2.34 The Pensions and Lifetime Savings Association ("PLSA") suggested that refusals to accept instructions could be for a number of reasons, including legal issues or as a matter of principle.

Other work on pooled funds

2.35 It is clear from our discussions with consultees that there are important corporate governance and stewardship issues that arise in relation to pooled funds, particularly in relation to voting. We understand that other organisations including the Department for Work and Pensions, the FCA, the Financial Reporting Council and the Pensions Regulator have been conducting work on some of the issues which arise in relation to pooled funds, including voting.[38] We appreciate also that there are barriers – practical, policy and legal – to developing solutions in the context of pooled funds, which may determine the progress that can be made. If the Government wished to explore possible options, and particularly if there was scope for legislative change, we think that this could be appropriate work for the Law Commission.

Segregated mandates

2.36 Where an institutional investor would prefer not to invest in a pooled fund, they may instead agree a "segregated mandate" with their investment manager. In contrast to pooled funds, a segregated mandate is not a structure with a legal personality. It is a portfolio, or series of portfolios, of investments that are managed for a single client by an investment manager. It is purely a contractual agreement, with the details set out in the investment management agreement.

2.37 Generally, using a segregated mandate provides the investor with more control over the actions of the investment manager. For example, an investor in a segregated mandate may contractually negotiate with their fund manager that the fund manager will exercise the right to vote in relation to the shares held by the fund in accordance with the investor's instructions.

2.38 Unlike pooled funds, an institutional investor with a segregated mandate arrangement has a proprietary interest in the securities that form the investment, with legal title held by the CREST member. This analysis is analogous to a retail investor holding intermediated securities through a broker. Accordingly, we consider that interests in securities held through a segregated mandate arrangement fall within the scope of this paper.

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[38] See, for example, FCA, *Building a regulatory framework for effective stewardship: Feedback to DP19/1* Feedback Statement FS19/7 (2019), at https://www.fca.org.uk/publication/feedback/fs19-7.pdf. The FCA, the Financial Reporting Council, the Department for Work and Pensions and The Pensions Regulator held a joint workshop in February 2020 on aligning stewardship objectives across the institutional investment community which considered the questions of terms and conditions, voting and transparency.

Motivations for investment and voting

2.39 It is trite to say that people or organisations invest principally for financial gain. However, financial reward may not be the only reason for investing in and engaging with a particular company.

2.40 Corporate governance is the term used to describe the way in which companies are directed and controlled.[39] The 2018 UK Corporate Governance Code[40] refers to this definition, and notes that this "remains true today, but the environment in which companies, their shareholders and wider stakeholders operate continues to develop rapidly". It continues:

> Companies do not exist in isolation. Successful and sustainable businesses underpin our economy and society by providing employment and creating prosperity. To succeed in the long-term, directors and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders. These relationships will be successful and enduring if they are based on respect, trust and mutual benefit. Accordingly, a company's culture should promote integrity and openness, value diversity and be responsive to the views of shareholders and wider stakeholders.

2.41 There has recently been an increased focus on corporate governance, particularly in relation to decisions companies take on environmental, social and governance ("ESG") issues.[41] For example, institutional investors may sign up to organisations like ClimateAction 100+ or Principles for Responsible Investment, agreeing to engage with companies on ESG issues. Some investors may be motivated to purchase shares in order to obtain the right to vote on company resolutions, thereby influencing the direction of the company.

2.42 In 2019, over one quarter of assets under management were invested using a "responsible approach". The IA said that the factors currently driving the debate on responsible investing include concern about climate change and stronger expectations of what can be achieved in areas of corporate governance including executive pay and diversity.[42] A recent survey by the Department for International Development (as

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39 *Report of the Committee on the Financial Aspects of Corporate Governance* (the "Cadbury Report") (1992) para 2.5.

40 Financial Reporting Council, *UK Corporate Governance Code* (2018) p 1, at https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf.

41 Investors may consider or engage with ESG issues across a range of asset classes and not simply shares. See Pensions and Lifetime Savings Association and The Investor Forum, *Engaging the Engagers* (2020) pp 8 and 9, at https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2020/Engaging-the-Engagers-stewardship-toolkit.pdf.

42 Investment Association, *Investment Management in the UK 2018-2019: The Investment Association Annual Survey* (September 2019) pp 27, 31, at https://www.theia.org/sites/default/files/2019-09/IMS%20full%20report%202019.pdf. The IA measures what a "responsible approach" is using The Global Sustainable Investment Alliance's definitions of categories of responsible investment: p 33.

it then was) found that around two out of three of people would opt for a sustainable investment if given the choice.[43]

2.43 For trustees of pension funds, there is an additional motivation for considering ESG issues. Depending on the type of pension fund, trustees are required to "secure" that a "statement of investment principles" ("SIP") is "prepared and maintained".[44] Regulations prescribe the content of a SIP, which must include a statement of the trustees' policy on a range of issues.[45] These issues include "financially material considerations … including how those considerations are taken into account in the selection, retention and realisation of investments".[46] The term "financially material considerations" includes ESG considerations (including but not limited to climate change).[47] These requirements to report consideration of financially material ESG factors therefore provide a statutory underpinning to trustees' fiduciary duty. There is also a requirement to outline the scheme's voting policy.[48]

2.44 We think it is also worth noting that some pension savers report being interested in knowing that their pension schemes invest responsibly. For example, PensionBee, a pension provider, found in a recent member survey that respondents expressed an interest in transparency as to which companies their pensions are invested in. The majority of respondents also said that they seek to balance making money for their retirement with investing in companies which promote positive social outcomes.[49]

2.45 Stakeholders including the Registrars' Group and Computershare told us that in general the UK has a high voting rate and that shareholders are engaged with corporate governance issues. The voting rights for over two-thirds of shares issued by FTSE 100 and FTSE 250 companies are exercised. This figure has risen steadily over a number of years and then broadly remained static since 2017.[50]

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43 Department for International Development, *Investing in a Better World: Results of UK Survey on Financing the SDGs* (September 2019) p 19, at https://www.gov.uk/government/publications/investing-in-a-better-world-results-of-uk-survey-on-financing-the-sdgs.

44 Pensions Act 1995, s 35. This requirement does not apply to schemes with fewer than 100 members or to local authority or public sector schemes: Occupational Pension Schemes (Investment) Regulations 2005, SI 2005 No 3378, reg 6.

45 SI 2005 No 3378, reg 2.

46 SI 2005 No 3378, reg 2(3)(b)(vi) (inserted by SI 2018 No 988, reg 4, following the Law Commission's work in (2014) Law Com No 350 and (2017) Law Com No 374).

47 SI 2005 No 3378, reg 2(4).

48 SI 2005 No 3378, reg 2(3)(c).

49 Pension Bee, *Summary results of PensionBee survey on consumer investment views* (January 2020), at https://www.pensionbee.com/resources/customer-investment-views.pdf.

50 The current level of voted issued share capital is 74.53% for FTSE 100 companies and 70.92% FTSE 250 companies: Georgeson, *Georgeson's 2019 Proxy Season Review* (2019) p 10, at https://www.georgeson.com/uk/Documents/Georgeson%202019%20Proxy%20Season%20Review.pdf. Ultimate investors may be convincing intermediaries to vote. In addition, and perhaps more significantly in terms of the statistics, intermediaries who market themselves on stewardship grounds will vote so they can demonstrate that they are influencing companies.

2.46 An example of this engagement is the number of "contested resolutions", which are resolutions against which 10% or more of the shareholders vote. In recent years, the most commonly contested resolutions have concerned director elections and director remuneration reports. In 2019, approximately one-third of resolutions concerning pay were contested, twice as many as the year before.[51] Resolutions in relation to directors and the circumstances in which companies pay dividends have also been the subject of recent negative media coverage.[52]

2.47 Other commonly contested resolutions involved proposals which could affect the value of the investor's shares by, for example, allowing the company to issue more shares, which could have a dilutive effect.[53]

2.48 For the purposes of this scoping paper, such contentious topics provide important context to explain, at least partially, why there has been increased interest in voting on company resolutions. As we discuss in later chapters, holding intermediated securities may mean that there are barriers for ultimate investors who wish to have their voices heard, as voting rights generally sit higher up the chain.

Consultees' views

2.49 We note above that the UK has a high voting rate.[54] This rate refers to members exercising their right to vote. However, in relation to ultimate investors, industry stakeholders told us that, in general, they have not seen any increased demand for voting from retail investors nor from most institutional investors. For example, the Association of British Insurers ("ABI") said that their members had not seen a demand from customers to be able to vote and "by some estimates less than 1% of customers chose to exercise their right to vote". Similarly, 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:

> Even 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

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51 See Georgeson, *Georgeson's 2019 Proxy Season Review* (2019) p 11, at https://www.georgeson.com/uk/Documents/Georgeson%202019%20Proxy%20Season%20Review.pdf. We discuss these "pre-emption" rights at para 5.73 below.

52 See eg, The Times, "Taylor Wimpey plans to give boss Pete Redfern £400,000 discount on luxury flat" (22 April 2019), at https://www.thetimes.co.uk/article/taylor-wimpey-plans-to-give-boss-pete-redfern-400-000-discount-on-luxury-flat-rqrqq6gzv; This is Money, "Micro Focus faces a shareholder rebellion over £268m bonuses" (9 March 2019), at https://www.thisismoney.co.uk/money/markets/article-6790573/Micro-Focus-faces-shareholder-rebellion-268m-bonuses.htm; Penningtons Manches Cooper, "Motor company forced to do U-turn in landmark dividend decision" (15 May 2020), at https://www.penningtonslaw.com/news-publications/latest-news/2020/motor-company-forced-to-do-uturn-in-landmark-dividend-decision.

53 For example, resolutions in relation to pre-emptive rights and share issuances. See Georgeson, *Georgeson's 2019 Proxy Season Review* (2019) pp 14 to 16, at https://www.georgeson.com/uk/Documents/Georgeson%202019%20Proxy%20Season%20Review.pdf.

54 See para 2.45 above.

that the majority of clients do not avail themselves of functionality that has been made available to them to exercise their votes.

2.50 The IA said that its members had reported "no significant increase in demand from clients wishing to direct voting in recent years" and that this was the case for both retail investors and institutional investors.[55] The IA also said its members were rarely asked to pass the right to vote to clients, or asked to vote in a particular way:

> One member estimated that those clients expressing a desire to vote their own shares form roughly a tenth of one percent of their client base. Another member noted a small number of segregated clients who make their own arrangements for voting. One member stated that this would be very rare for discretionary clients. For non-discretionary clients, the clients would have to initiate a voting request – this has not happened to date. One member stated they had seen an increasing number of clients asking the manager to vote in a particular way on a small number of company occasions rather than asking to pass back the right to vote in general.

2.51 In relation to retail investors, the UK Shareholders' Association ("UKSA") and ShareSoc acknowledged that the current levels of voting are low. They said that only six out of every 100 retail investors vote their shares and that, for one large platform, they were told the figure is only one out of every 100. 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.[56]

2.52 In contrast, Interactive Investor, an online investment service,[57] told us that they had recently written to customers encouraging them to register to vote on the platform. Over the last 18 months, from a group of 340,000 customers, approximately 78,000 had taken positive steps to engage with the process and there had been an overall increase in the number of customers making use of their votes during that time.

2.53 In support of our work Interactive Investor conducted a short survey of its customers. 1,101 individuals responded to a series of questions about motivations for investing, how often investors vote and the practicalities of voting. Although this was an informal survey, with self-reported and anecdotal results, we note the following points.

(1) 39% of respondents said that they voted on company resolutions at least sometimes. The majority said that they voted rarely or never.[58]

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55 Following a discussion with the Law Commission, the IA circulated a short set of questions to members in its Stewardship Committee and the Stewardship Reporting Working Group. The IA received information in a conversation about the questions with the Stewardship Committee and direct feedback from a few members. The responses do not represent the views of the IA membership as a whole.

56 We discuss consultees' views on the challenges ultimate investors face when they wish to vote from para 3.55 below.

57 Interactive Investor is an online investment company offering execution-only services. We discuss the types of services offered by intermediaries at para 2.80 below.

58 Of 1,077 respondents, 66 said they voted on company resolutions "always", 128 said "often", 221 said "sometimes", 342 said "rarely" and 320 said "never".

(2) 53% of respondents said that they would be interested in voting on all resolutions, 22% said they would be interested in voting on resolutions about executive pay, 17% said they would be interested in voting on resolutions about corporate governance and 8% said they would be interested in voting on resolutions about environmental or social issues.[59]

(3) 30% of respondents said that they would be more likely to invest in a particular company because they could affect the way the company is run through voting.[60]

2.54 As we discuss below, some ultimate investors do not only want to have a say on a company resolution, they also want confirmation that their vote was received by the company and counted. Stakeholders said that vote "confirmation" was particularly important for institutional investors, at least in part so that they can demonstrate that they have met their regulatory obligations.[61] The IA told us that around half of the members it spoke to reported an increased interest in transparency from their clients, asking for "vote related statistics on an increased frequency with greater details", rather than confirmation that a particular vote was received and counted.

HOLDING SECURITIES

2.55 Taking shares as an example, a person who wishes to buy dematerialised shares in a company can hold those shares in one of two ways:[62]

(1) as a sponsored member in CREST; or

(2) through a chain of intermediaries.

Holding as a sponsored CREST member

2.56 If an investor becomes a CREST member, this will mean that they are the legal owner of the securities and the "member" on the company's register.[63] CREST members are often bodies such as banks, brokers and other financial institutions.

2.57 It is possible for an individual to be a CREST member. For this to happen, the investor will need to have a CREST sponsor. The CREST account and securities will be listed in the investor's name, but the operation of the account is undertaken by the sponsor,

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59 Of 1,036 respondents, 546 said that they would be interested in voting on all resolutions, 230 said they would be interested in voting on resolutions about executive pay, 180 said they would be interested in voting on resolutions about corporate governance and 80 said they would be interested in voting on resolutions about environmental or social issues.

60 Of 1,000 respondents, 511 said that they would not be more likely to invest in a particular company because they could affect the way the company is run through voting, 303 said they would and 186 said that they did not know.

61 We discuss voting confirmation from para 3.137 below.

62 The top of the chain differs for debt securities, although the general structure, from the company to the holder of debt securities, is similar. We discuss this at para 2.66 below.

63 See from para 2.56 below.

acting as the investor's agent.[64] The sponsor deals with administrative issues such as putting instructions into CREST for a transaction.

2.58 For retail investors, only a few intermediaries offer personal CREST accounts. Along with fees for transactions, they also charge annual fees to be a sponsor. We understand that there are currently four intermediaries who offer a personal CREST account, with approximate annual fees between £400 and £500.[65] These fees have increased significantly over the past few years.[66]

2.59 In practice, very few individuals are entered on the CREST register. The number of individuals holding securities directly through CREST has decreased from approximately 50,000 members in 2003 to 4,200 members in 2020. As of April 2018, the total value of holdings of individuals on the CREST system was £1.3 billion.[67]

Holding through a chain of intermediaries

2.60 The other, more common, option for an investor wishing to invest is to do so through a chain of intermediaries. We now turn to consider intermediated securities chains in detail.

AN INTERMEDIATED SECURITIES CHAIN

2.61 The following diagram is a simplified example of an intermediated securities chain, demonstrating some of the potential different levels in the chain. In practice, there may be additional layers of intermediation and intermediaries may hold securities for ultimate investors in omnibus and segregated accounts as well as on their own account.

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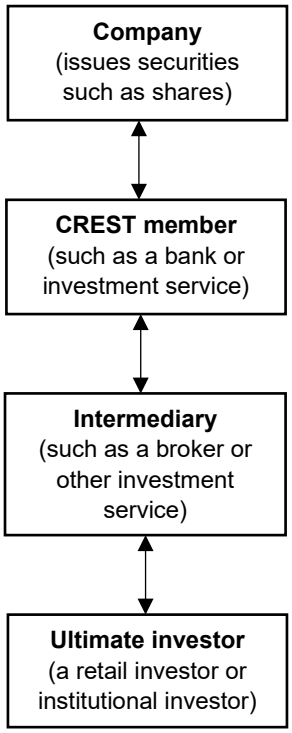
64 CREST Reference Manual (July 2020) Ch 2 Section 2. The sponsor will be an organisation which has met certain requirements set by CREST and has invested in the hardware and software necessary to connect directly to the CREST system.

65 Redmayne Bentley; Charles Stanley; Blankstone Sington; and Killik & Co. Redmayne Bentley charge an annual fee of £495 plus VAT for their CREST Personal Membership. They also "reserve the right to charge" additional costs for segregated accounts. Charles Stanley charge an annual fee of £420 plus VAT. We also sent inquiries about costs to Blankstone Sington and Killik & Co but received no response.

66 E Perryman, "Crest accounts are being washed away but they offer significant shareholder benefits", *Shares Magazine* (July 2015), at https://www.sharesmagazine.co.uk/article/crest-of-a-wave.

67 EUI tells us that as 5 August 2020, there were 4,172 individual members on CREST, and 2,394 corporate members. See also C Twemlow, *Intermediation and Beyond* (2019) pp 86 and 87.



2.62 In order to understand how intermediated securities chains may affect the rights of ultimate investors, we need to consider the legal basis of the relationships between the parties in the chain, as well as the nature of their interest in the securities.

The legal relationships in an intermediated securities chain: a series of trusts

2.63 Under the law of England and Wales,[68] it is now "reasonably well settled" that the arrangements between parties in an intermediated securities chain are characterised as a "series of trusts and sub-trusts"[69]. This may be agreed expressly by the parties or implied.[70] As Mr Justice Briggs (as he then was) said in *Re Lehman Brothers*:[71]

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

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68 We provide a brief discussion of the position in Scots law from para 2.72 below.

69 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [163].

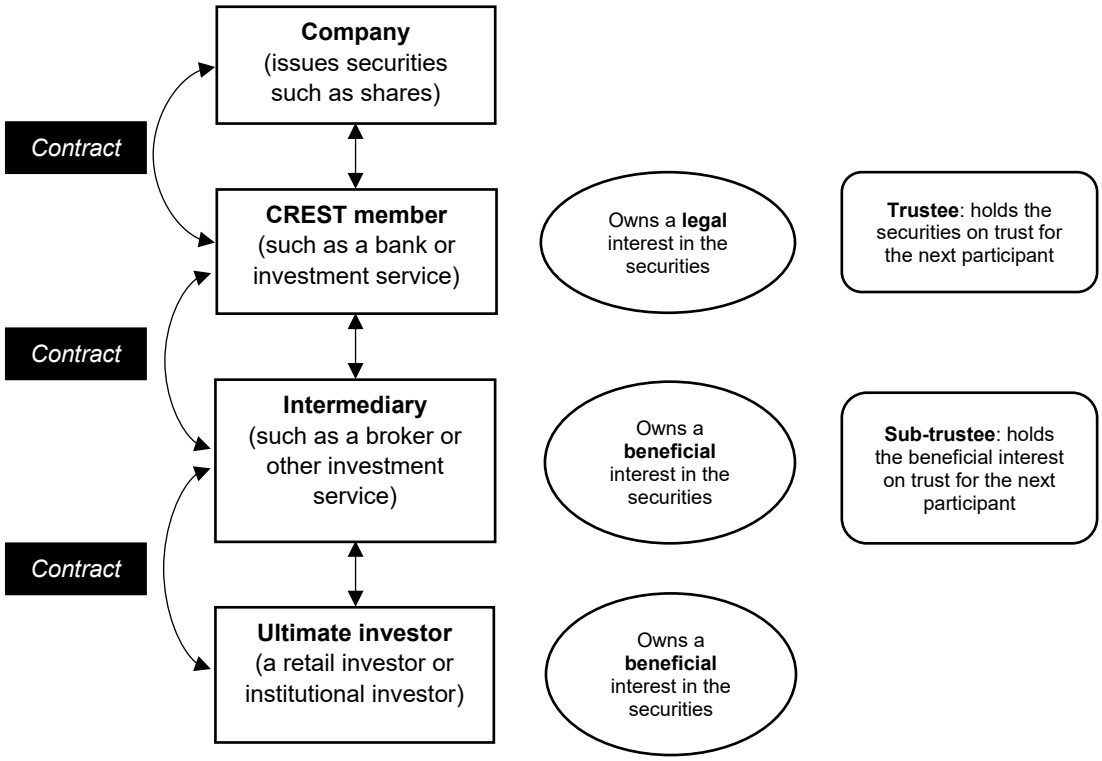
70 R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-08; M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-054. See Further Updated Advice on Intermediated Securities (2008) from para 2.59. See description of the nature of a trust in A Hudson, *The Law and Regulation of Finance* (2nd ed 2013) para 22-01 onwards.

71 *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 (Ch) at [226] and *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [163]. See also *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [6].

ultimate investor. In practice, especially in relation to dematerialised securities, there may be several links in that chain.

2.64 In our simple example above, the company issues shares, which are purchased by the custodian bank, a CREST member. According to the trusts law analysis, the custodian bank is the legal owner of the shares and, as trustee, holds the shares on trust for its account holders, including the broker. The broker is both the beneficiary of the trust with the custodian bank, and a sub-trustee, holding an interest in the shares on trust for the ultimate investor.

2.65 As well as trusts and sub-trusts between the parties, the relationships in the chain are regulated by individual contracts entered into between the relevant parties at each stage in the chain.[72] The more detailed diagram below set outs these relationships. For most investors, the contract will reflect the intermediary's standard terms and conditions, rather than a bespoke arrangement according to the ultimate investor's preferences.



2.66 The two diagrams above depict an issue of shares.[73] For debt securities, the top of the chain differs, although the general structure, from the company to the holder of debt securities, is similar. Where there is a bond or note issue, it is usual for there to

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

73 Some debt securities may be issued through the CREST system if they satisfy certain requirements: USRs, SI 2001 No 3755, reg 19. We have referred to a "contract" between the company and the CREST member. This could take the form of the articles of association (CA 2006, s 33) and any shareholder agreement or agreement under which the debt securities are issued.

be only one global bearer note, which represents the entire issue.[74] That note is physically held by a custodian bank permanently on behalf of an international central securities depositary (this process is referred to as "immobilisation").[75] The chain then proceeds as above, with intermediaries between the custodian bank and the ultimate investors.

An ultimate investor has both proprietary and personal rights in relation to the securities

2.67 As we have seen, the relationships between the parties in an intermediated securities chain are characterised as trusts, overlaid with contracts agreed between parties at each level of the chain. This analysis has two effects. The first effect is that an ultimate investor does not own securities. Instead, they hold a beneficial interest in securities.[76]

2.68 The second effect is that an ultimate investor has a combination of both proprietary and personal rights in relation to intermediated securities. By "proprietary" rights, we mean that an ultimate investor has a right of ownership in the property held on trust (in this case, the beneficial interest in the securities held by the intermediary, rather than the securities themselves). Proprietary rights are enforceable against third parties.

2.69 For example, as we explain in Chapter 6, if an intermediary becomes insolvent, the interest in the securities will not form part of the insolvent intermediary's estate. Beneficial ownership of the property remains with the ultimate investor.[77] In *SL Claimants v Tesco plc,*[78] Mr Justice Hildyard referred to the position of an investor as:

> owner of "a right to a right" held through a waterfall or chain of equitable relationships which is unaffected by the insolvency of his intermediary, and enables it ultimately, even if indirectly, to enjoy the benefit of the bundle of rights which the securities represent to the exclusion of others (unless the ultimate beneficial owner has transferred them away, for example to a chargee).

2.70 Where an intermediary uses an omnibus account, which may contain millions of intermediated securities, the ultimate investor does not have a proprietary right in respect of specific intermediated securities in that account. Rather, the ultimate

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74 Most bonds are now held through these global custodian arrangements: J Payne, *Intermediation and Beyond* (2019) p 177. Although global notes can be issued as a registered rather than bearer note, commentators say that it is most common for there to be a bearer note issued in Europe. See R Salter, *Intermediation and Beyond* (2019) pp 131 and 132. For a description of the "Classical Global Note" and the "New Global Note" systems, see R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-08.

75 Under the law of England and Wales, the holder of the note would be the legal owner of the securities, although commentators say that it is unlikely that the nature of the interest of the holder would be governed by our domestic law: R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-08.

76 See from para 2.63 above.

77 We discuss the general position that an ultimate investor's assets are protected from para 6.6 below. See also A Hudson, *The Law and Regulation of Finance* (2nd ed 2013) para 22-03; A Hudson, *Understanding Equity & Trusts* (5th ed 2015) p 27.

78 [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [85].

investor has a proprietary right in the form of beneficial co-ownership in the pool of intermediated securities.[79] This means that the ultimate investor cannot point to certain intermediated securities which they own. Instead, they own a proportion of the intermediated securities in the account.[80]

2.71 Along with proprietary rights, an ultimate investor has personal rights. By "personal" rights, we mean that an ultimate investor would be able to claim compensation from an intermediary for breach of their duties under contract or the trust. For example, the intermediary, as trustee, may have a duty to transfer the intermediated securities upon instruction or perform other duties.[81] If the intermediary fails to carry out these duties, the ultimate investor may have a claim against the intermediary. However, unlike proprietary rights, personal rights are not enforceable against third parties. Therefore, an ultimate investor's claim against an intermediary may be worth little or nothing if the intermediary has become insolvent.

The position in Scots law

2.72 As we have said elsewhere, this paper is written from the perspective of English and Welsh law. However, it is helpful to include a brief description of the position in Scots law, under which the same legal characterisation of the chain as a series of sub-trusts could not apply.

2.73 In Scots law, there is no equitable form of ownership. Trustees are the owners of trust assets, and therefore have the only legally recognised proprietary interest (ownership). "Beneficial interest" denotes a personal right against the obligant (the trustee) rather than a proprietary interest in any form. A beneficiary (the ultimate investor in this case) will hold a personal right against the trustee (the intermediary) to have the trust assets administered in a proper manner to fulfil the trust purposes. The insolvency of a trustee in their personal capacity will not make the trust assets available to the trustee's personal creditors.[82]

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79 R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-18; J Benjamin, *Interests in Securities* (2000) para 2.72; and Further Updated Advice on Intermediated Securities (2008) paras 2.63 to 2.72. See also R Goode, "The nature and transfer of rights in dematerialised and immobilised securities" (1996) 4 *Journal of International Banking and Financial Law* 167.

80 *Re Lehman Brothers International (Europe) (in administration)* [2010] EWCA Civ 917, [2011] Bus LR 277; *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), [2014] Ch 196 at [14], *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 (Ch) at [232] to [239] and R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-15.

81 R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-18.

82 Where a beneficiary has a claim against a trustee for damages for breach of trust or for payment back into the trust following an accounting of trust assets, this claim lies against the trustee in their personal capacity. In the insolvency of the trustee in their personal capacity, a beneficiary with such a claim will be no more than an unsecured creditor. A transfer of a share in a company by the registered member trustee to a third party in breach of *fiduciary* duty either gratuitously or where the third party was aware of the breach (in bad faith) will allow the beneficiary to claim the share from the hands of the third party who, in such circumstances, will hold the share in constructive trust for the beneficiary. The same applies if the share is transferred expressly by the trustee as trustee to themselves in their personal capacity. Under Scots law shares can be registered in a company's register as being held expressly in trust (CA 2006 s 126 applies only to English/Welsh companies), although this is not possible for shares entered onto the CREST register.

2.74 Further, in Scots law, these trust relationships will not arise automatically – property and rights have to be put into trust expressly.

2.75 The effect of such differences can be seen in the context of an intermediary's insolvency. Where:

(1) A is the ultimate investor;

(2) B is A's immediate intermediary; and

(3) C is B's immediate intermediary, and the registered member.

2.76 Leaving aside the possibility of trusts, the securities will be included in C's estate in the event of C's insolvency, leaving B to claim in the insolvency as an unsecured creditor. B will hold a possible liability to A. A will lose the benefit of the share. In order for A's financial interest in the share to be protected against the insolvency of C or B, C's share would have to be put deliberately into trust for B, and B's rights against C would have to be put deliberately into trust for A.

2.77 It is also difficult to see how in Scots law a trustee could hold an unidentified "proportion" of intermediated securities in a pool given that the asset being put into the trust has to be identifiable.

2.78 Unless the share itself, B's rights against C, and A's rights against B are all put expressly into trust, A will have nothing but a contractual right against B to have B deal with the share in accordance with A's instruction and B will have a similar contractual right against C. The insolvency of C will leave the share available to C's creditors and A will be left with, at best, an instruction to B to claim in C's insolvency as an unsecured creditor.

The intermediaries in an intermediated securities chain

2.79 When we refer generally to "intermediaries" in this scoping paper, we mean the participants in the chain who sit between the company which issues securities and the ultimate investor who purchases intermediated securities. In the simple example diagrams above, this includes the CREST member and the broker.

Types of service

2.80 Retail investors may invest through an intermediary such as a brokerage firm, bank or online platform. There are three broad categories of service which intermediaries may offer to ultimate investors.

(1) Execution-only service. The ultimate investor makes their own decisions to buy, sell and take other actions regarding their investments. The intermediary merely executes the wishes of the ultimate investor in relation to such investments. In respect of custody services, information is passed (usually electronically) to the ultimate investor and they decide what action, if any, they wish to take. Whether they can, for example, vote on company resolutions will depend on the terms and conditions of their agreement with the intermediary.

(2) Advisory service. The intermediary provides advice on transaction decisions (such as whether to buy or sell assets) to the ultimate investor, who takes the final decision. In relation to voting, the intermediary makes a recommendation on which way to vote to the ultimate investor, and then seeks their instruction as to whether or not to proceed. Under the terms of service, the intermediary has to act in accordance with the ultimate investor's instructions.

(3) Discretionary service. The ultimate investor authorises the intermediary to take investment decisions on the investor's behalf. The intermediary will typically be authorised to buy and sell shares on behalf of the ultimate investor, sometimes within some predetermined strategy, such as a strategy based on the investor's risk appetite. Although the contractual provisions may vary between intermediaries, it will normally be the case that the intermediary has the right to vote in relation to shares and to vote in corporate actions and on schemes of arrangement. The extent to which the intermediary actually exercises this right to vote will vary.

2.81 Stakeholders including PIMFA told us that the level of voting differs according to the level of service offered by the intermediary to the ultimate investor.[83]

2.82 For institutional investors, we have been told that there is an extensive range of available intermediary services, provided by consultants or by platforms, combining investment advice and implementation to varying degrees.[84] Institutional investors like pension funds often use investment managers (also known as fund managers and asset managers), who manage the assets on behalf of the investor.[85] The agreement between the investor and the investment manager as to how the assets will be managed is called an "investment mandate".

The types of accounts in an intermediated securities chain

2.83 Within an intermediated securities chain, intermediated securities can be held in two main types of accounts:[86]

(1) "omnibus" accounts;

(2) "segregated" accounts.

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83 PIMFA told us that where discretionary services are used, it is common for asset managers to vote in corporate actions and on schemes of arrangement, but not on company AGMs, unless there is an issue which directly impacts on the potential value of the securities. Where advisory services are used, PIMFA told us that asset managers will make recommendations in respect of corporate actions and schemes of arrangement, but are less likely to make recommendations in respect of voting at an AGM.

84 The IA told us that at one end of the range of services, there is traditional investment consultant advice and the appointment of managers to manage the portfolio. The other end of the range is full fiduciary management, where the scheme retains control of the overall funding/investment objective but then delegates day-to-day investment decision-making to the fiduciary manager. There are various options in between these.

85 Department for Business Innovation & Skills, *Exploring the intermediated shareholding model* (Research Paper No 216, 2016) p 94.

86 We discuss holding securities directly through a CREST personal account at para 2.56 above.

Omnibus accounts

2.84 "Omnibus" accounts are used to hold the intermediated securities of more than one investor. They are also referred to as "nominee" accounts and "pooled" accounts. In this paper, we use the term "omnibus account" to avoid confusion with "pooled funds" which we discuss above.[87]

2.85 Intermediated securities may be pooled in an omnibus account at different stages, and at multiple stages, of the chain. For example, a CREST member (such as a custodian bank) may hold one million shares in an omnibus account. Those shares may be held on behalf of many different clients of the CREST member, including other intermediaries. Each of those intermediaries may in turn hold thousands of shares on their books in either omnibus or segregated accounts for their own clients, who may include other intermediaries, and so on, until the interests are held for ultimate investors.

2.86 Stakeholders have told us that the majority of intermediated securities are held through omnibus accounts, because of the advantages they provide. We discuss some of the advantages of omnibus accounts in the context of intermediated securities below.[88]

Segregated accounts

2.87 The opposite of an omnibus account is a "segregated" account. A segregated account holds only the assets of one particular investor. It can be registered in the name of the intermediary. In the case of a sponsored CREST account, a segregated account can be registered in the name of the ultimate investor, whilst being operated by the intermediary.

2.88 Stakeholders told us that segregation can be applied at various levels in the chain of ownership, but that segregation at the uppermost tier (the CREST account) can be very expensive.

The number of intermediated securities held in different types of accounts

2.89 Although it is not clear how many intermediated securities are held in omnibus accounts, it is obvious that it is a very large number. EUI provided us with the following information which demonstrates that over a trillion shares, constituting the largest proportion by value of all the shares held in CREST, are held in omnibus accounts:[89]

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87 We discuss pooled funds from para 2.18 above.

88 We discuss the benefits of intermediation and the use of omnibus accounts at para 2.91 and from para 8.57 below.

89 Accurate as at 5 August 2020.

Account type[90]	No of shares	Total balance %	Value GBP	Value GBP %
Omnibus	1,221,197,074,410	18%	2,129,159,994,241	42%
Individually segregated	632,970,764,931	10%	1,182,830,881,038	23%
Own account	684,124,313,770	10%	938,544,969,199	18%
Blank	4,080,982,775,958	62%	866,992,175,703	17%

2.90 As part of our research for this scoping paper, we requested copies of several companies' register of members, under a statutory procedure in the CA 2006. This short sample of registers highlights the extent to which shares are in accounts held by intermediaries.[91]

JD Wetherspoon plc

The register of members (dated June 2020) shows that there were 120,380,155 issued shares, held by 3,782 shareholders. 106 shareholders with "nominee" in their name held 80,062,314 (66.5%) of the issued shares.

Sirius Minerals plc

The register of members (dated January 2020) shows that there were 7,019,632,060 issued shares, held by 4,624 shareholders. 116 shareholders with "nominee" in their name held 6,194,667,754 (88%) of the issued shares.

Unilever plc

The register of members (dated July 2020) showed that there were 1,168,530,650 issued shares, held by 34,005 shareholders.148 shareholders with "nominee" in their name held 496,893,284 (42.5%) of the issued shares.

The benefits of intermediation

2.91 In the following chapters, we consider how the intermediated securities system may negatively affect the rights of ultimate investors. However, there are also aspects of

[90] These account types are entered by the CREST member against their accounts in the CREST system. The account types is "blank" where the CREST member has not populated this information on the account.

[91] These may be omnibus accounts or segregated accounts.

intermediation that are advantageous. We explore these in more detail below.[92] In summary, the key advantages are as follows.

(1) Intermediation, when combined with the use of omnibus accounts, can increase efficiency, because settlement of transactions can take place at the lowest level of the chain (for example, at broker level rather than at CREST member level), which can increase the speed of transfers.[93]

(2) Increased efficiency and economies of scale may decrease costs for ultimate investors.[94] The current intermediated system also opens up opportunities for securities financing, an arrangement by which intermediaries can make additional money from the securities, which may in turn reduce costs for ultimate investors.[95]

(3) Intermediation means that an ultimate investor can hold an entire, diverse, cross-border portfolio through a single intermediary,[96] without having to bear the administrative burden of establishing and maintaining links with companies and intermediaries in a number of other jurisdictions.[97]

The status of an ultimate investor under the CA 2006

2.92 The legal characterisation of the relationship between parties in an intermediated securities chain as a series of trusts and sub-trusts has several consequences for the rights of ultimate investors which we explore throughout this paper. Our starting point is the CA 2006, which is the primary source of companies law in the UK.

2.93 This Act does not use the term "shareholders" and instead refers to the "members" of a company. A "member of the company" is defined as a person who agrees to become a member of the company and whose name is entered in the company's register of members. Every company must keep a register of members. [98]

2.94 The person (whether an individual or institution) entered on the register of members is the person with the legal interest in the shares.[99] Although the member on the register

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92 We discuss the current benefits of intermediation from para 8.56 below.

93 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 361; J Benjamin, *Interests in Securities* (2000) paras 3.34 and 3.35.

94 See eg C Twemlow, *Intermediation and Beyond* (2019) p 98.

95 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 363. We discuss securities lending transactions at para 6.11 below.

96 L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 361 to 363. We understand that registrars will often also provide shareholders with multiple holdings with the ability to administer them collectively and efficiently.

97 Fiduciary Duties of Investment Intermediaries (2014) paras 11.141 to 11.144. See also G Morton, *Intermediation and Beyond* (2019) p 43; and M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 6-053 for a list of the advantages of omnibus accounts.

98 CA 2006, ss 112 and 113.

99 *J Sainsbury plc v O'Connor (Inspector of Taxes)* [1991] 1 WLR 963 at 977 (Nourse LJ): "There is no difficulty in ascertaining the legal ownership of shares, which is invariably vested in the registered holder";

can be a trustee holding shares on behalf of ultimate investors, section 126 provides that no notice of a trust may be entered onto the register of members.[100] The crucial relationship for the purposes of the CA 2006 is between the company and the member.[101]

2.95 As we observe above, in an intermediated securities chain, the person with the legal interest in securities is the trustee at the top of the chain, who will hold the securities on trust for beneficiaries.[102] The trustee will, therefore, be the member listed on the company's register, not the ultimate investor.

2.96 This focus on the member of the company, rather than the ultimate investor, means that certain rights in the CA 2006 and a company's articles of association will only be exercisable by the trustee (the CREST member) unless certain steps are taken. For example, only a member's vote will be counted on a resolution, unless the member takes steps to enfranchise the ultimate investor, for example, by appointing them as a proxy. In a similar fashion, a member has the right to receive certain information from a company,[103] and they can nominate the ultimate investor to receive information from the company. We discuss both these mechanisms in the following chapter, which focuses on the exercise of voting rights.[104] Even where the CA 2006 allows rights to be "passed back" to an ultimate investor, the focus remains on the relationship between the company and its member.

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and M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 26-027.

100 Section 126 does not apply to Scottish companies. Scottish companies do have the trustee status of members entered in their registers. While this does not affect the crucial relationship between the member and the company, it can affect the relationship between the intermediary who is the registered member and the next intermediary in the chain. In particular, it can assist in the creation of a trust which provides some protection in the event of the insolvency of the registered member. Trusts cannot be entered onto the CREST register, which reduces the protection for ultimate investors in Scottish companies.

101 Likewise, trusts cannot be entered on the CREST register: USRs, SI 2001 No 3755, reg 23(3). See also Companies (Model Articles) Regulations 2008, SI 2008 No 3229, reg 4, Sch 3, art 45 and see J Payne, *Intermediated Securities: Legal Problems and Practical Issues* (2010) p 195.

102 Note that securities may be constituted as legal or equitable interests in or in relation to property. In this scoping paper, we have focused on securities constituted as legal interests. However, there are certain types of securities which may be constituted as equitable interests. For example, the issuer of securities may be a trustee of underlying securities held for the benefit of holders, under which the issued securities represent an equitable interest in or in relation to the separately issued and constituted underlying securities (see eg CREST depository interests and bespoke depository interests, which we discuss at para 7.26 below).

103 CA 2006, ss 431 and 432.

104 We discuss proxy appointments under s 324 of the CA 2006 from para 3.19 below. We discuss nominating an ultimate investor to receive information from para 3.26 below.

Chapter 3: Voting

3.1 Ultimate investors may choose to purchase shares for a variety of reasons. Some will do so purely for the chance of financial gain. Others may wish to influence the direction of the company through voting on company resolutions about issues such as climate change, diversity, executive pay and human rights.

3.2 Can ultimate investors who buy shares held through an intermediated securities chain automatically and easily exercise voting rights in relation to those shares? As we state in previous chapters, the answer to that question is often "no".

3.3 In this chapter we consider the legal framework for exercising a right to vote in relation to shares. We start by explaining the general position under the CA 2006 in relation to voting on resolutions. We then set out a number of mechanisms by which an ultimate investor may be able to vote, including by appointment as a proxy to vote or by receiving rights under Part 9 of the CA 2006. This analysis highlights the significance of the terms and conditions of the agreement between the ultimate investor and the intermediary. We also examine the specific position in relation to intermediated securities held in ISAs pursuant to the Individual Savings Account Regulations 1998.

3.4 Having set out the current law, we consider what changes could be made to enhance the ability of ultimate investors to vote in relation to their investments.

ULTIMATE INVESTORS AND VOTING

3.5 In this chapter we consider the barriers which ultimate investors face when they wish to vote in relation to their investments. There is, however, an underlying policy question of whether ultimate investors should be able to be vote in the first place.

3.6 Some consultees have told us that there is an important corporate governance benefit in ensuring that ultimate investors are able to participate if they are motivated to do so. For example, the Quoted Companies Alliance ("QCA") said that engaging with ultimate investors is important, allowing their members (which are small and mid-size companies) to receive feedback on potentially contentious issues. They said:

> The inability to exercise their voting rights is especially troublesome as these votes are often regarding important matters such as how the company operates and on corporate governance issues.

3.7 There is also an argument that investors are funding the company through their investments and should, on that basis, be entitled to influence company decisions. The UK recession caused by the COVID-19 pandemic means that many companies are likely to enter financial difficulty over the next few years, leading to share issues, corporate restructuring and, inevitably, insolvencies. In such times, it may be particularly important that investors, including small investors, whose money is at stake should have their interests represented in company decisions and clarity as to their rights in the event of the insolvency of the company or an intermediary.

3.8 Other consultees said that, from a corporate governance perspective, ultimate investors are unlikely to have a genuine impact through exercising a right to vote. This is particularly the case, we have been told, for retail investors, because of the relative smaller size of their investments compared to institutional investors or intermediaries holding millions of shares. Additionally, it can be argued that shareholder engagement may be appreciably easier, more efficient and cost effective for a company when it only has to manage engagement with members, and not with ultimate investors as well.

3.9 While we are aware of the competing arguments, this policy question does not fall within the terms of reference agreed with BEIS and, therefore, we did not consult on it. This paper is drafted on the assumption that voting by ultimate investors is desirable.

VOTING ON RESOLUTIONS

3.10 As we explain in Chapter 2, when a company issues shares, there may be various bodies in the intermediated chain with an interest in those shares, including custodian banks, other financial institutions and asset management firms, as well as the ultimate investor. However, the issuing company's principal relationship in relation to those shares is with one entity only: the "member" listed on the company's register of members.[1]

3.11 This position is at least partly a result of the structure of the CA 2006 which is focused on the relationship between the issuing company and its members. This approach has a profound effect on the rights of the ultimate investor. Shares usually have rights attached to them, such as the right to vote on company resolutions.[2] However, an ultimate investor does not have a right under the CA 2006 to vote in relation to shares which are held through an intermediated securities chain. Nor does an ultimate investor have a general right under the CA 2006 to receive confirmation that a vote cast has been validly recorded and counted.[3] Susan Sternglass Noble told us that the lack of rights under the CA 2006 is often cited "as an explanation for why investors aren't being offered transparent mechanisms to exert and confirm the exercise of their rights, even large institutional investors".

3.12 Where a share in a company includes a right to vote on resolutions of that company, that right is exercisable in the first instance by the member of the company. Section 284 of the CA 2006 provides the general rules for voting,[4] including:

(1) on a written resolution, or on a resolution on a poll taken at a meeting, for a company with share capital, every member has one vote for each share; and

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1 See from para 2.92 above. A company and its members are each bound by the provisions of the company's constitution: CA 2006, s 33.

2 G Morse (general ed), *Palmer's Company Law* (2018) para 6.007. Article 43 of the Model Articles for Public Companies provides that a company may issue shares with such rights or restrictions as may be determined by ordinary resolution: Companies (Model Articles) Regulations 2008, SI 2008 No 3229.

3 See discussion of the Companies (Shareholders' Rights to Voting Confirmations) Regulations 2020, SI 2020 No 717 at para 3.114 below.

4 Subject to the company's articles: CA 2006, s 284(4).

(2) on a resolution on a show of hands at a meeting, each member present in person has one vote.

3.13 A resolution may be:[5]

(1) an "ordinary resolution", passed by a simple majority of members representing a simple majority of the total voting rights of members; or

(2) a "special resolution", passed by a majority of members representing not less than 75% of the total voting rights of members.

3.14 This focus on "members" means there is no automatic right under the CA 2006 for an ultimate investor to vote on shares that they have purchased, but which are held through an intermediated securities chain.

3.15 It is possible for an investor to be a "member" by holding certificated shares. They may also hold dematerialised securities directly as a CREST member. We discuss above that this can be expensive, requiring an investor to have their own personal CREST account, "sponsored" by an intermediary which provides a link between the investor and CREST. [6]

3.16 However, ultimate investors also may be able to vote through other mechanisms, to which we now turn.

HOW CAN AN ULTIMATE INVESTOR EXERCISE AN ABILITY TO VOTE?

3.17 Below, we explain five possible mechanisms by which an ultimate investor may be able to vote on a resolution, without becoming a "member":

(1) an intermediary may appoint an ultimate investor as a proxy to vote on behalf of the member under section 324 of the CA 2006;

(2) an intermediary may nominate an ultimate investor to exercise voting rights and receive information under Part 9 of the CA 2006;

(3) an ultimate investor may instruct an intermediary to vote in a particular way;

(4) an intermediary may arrange for an ultimate investor to vote in accordance with the Individual Savings Account Regulations 1998 ("ISA regulations"); and

(5) an ultimate investor may benefit from a commercial solution put in place by the issuer company in the form of a company-sponsored nominee.

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5 On a written resolution, the majority must be of the total voting rights of eligible members. In contrast, on a show of hands, the majority must be of the votes cast. On a poll, the majority must be of the total voting rights of members who vote on the resolution: see s 282 (ordinary resolutions) and s 283 (special resolutions).

6 We discuss personal CREST accounts from para 2.56 above.

3.18 Although this scoping paper applies to both retail and institutional investors, it is self-evident that not all of the above mechanisms will apply to all investors. For example, an institutional investor cannot hold investments through an ISA.

An intermediary may appoint the ultimate investor as its proxy

3.19 One way in which an ultimate investor can vote on a resolution is to request that the member (the intermediary) appoints the ultimate investor as their agent (their "proxy") to attend the meeting and vote on their behalf.

3.20 Section 324 of the CA 2006 provides that a member of a company is entitled to appoint another person as a proxy to exercise all or any of the member's rights to attend, speak and vote at a company meeting. This section also states that a member may appoint more than one proxy, provided that each proxy is appointed to exercise the rights attached to different shares.

3.21 The effect of section 324 is that a member who holds an omnibus account containing the shares of multiple ultimate investors may appoint each ultimate investor as their proxy for the particular number of shares held for that ultimate investor. The ultimate investor can then exercise the member's rights to attend, speak and vote at the company meeting.

3.22 Whether in practice an intermediary will facilitate voting by an ultimate investor will depend on the terms and conditions in the service agreement between them.[7]

3.23 We have considered the terms and conditions of seven intermediaries offering an execution-only service to retail investors.[8] We have found that most offer the ability to vote and attend meetings, with some conditions. For example, the terms and conditions for the Share Centre ("TSC") provide:

> For each of your investments … You may … apply for a proxy certificate to attend meetings of shareholders in companies in which you have invested.

3.24 The terms and conditions from Hargreaves Lansdown provide:

> A18 … Requests to attend or vote at company meetings should be received at least 7 days before the date of the meeting. Confirmation of your attendance will be sent within 5 days of the meeting date, unless specifically requested.

3.25 If the ultimate investor's immediate intermediary is not themselves the member, then whether this is an option for the ultimate investor will also depend the terms of the agreements further up the chain. Those terms would have to require the

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7 Computershare told us that in a sample of 169 issuer meetings held during 2018, approximately 11% of individuals attending the meetings were proxy appointees representing shareholders. Those same proxy appointees represented nearly 38% of the shares represented by individuals attending the meetings, indicating that proxy appointees generally represented larger shareholdings than the average shareholder attendee.

8 Interactive Investor, the Share Centre, Hargreaves Lansdown, AJ Bell Youinvest, Barclays Smart Investor, Bestinvest and Charles Stanley Direct. For an explanation of execution-only services see para 2.80 above. We have not had the same access to examples of custody agreements for institutional investment.

intermediaries to pass any requests through to the member, and require the member to act in response to any such request.

An intermediary may nominate the ultimate investor to receive rights under Part 9

3.26 When the CA 2006 was enacted, it introduced a new set of provisions in Part 9 (sections 145 to 153) to address the exercise of a member's rights by an ultimate investor. Section 145 provides a mechanism for a member to nominate another person to exercise the member's rights. Section 146 allows a member to nominate another person to enjoy "information rights".

3.27 Section 152 of the CA 2006 addresses the situation where a member of the company holds shares on behalf of multiple ultimate investors. It says:

> (1) Where a member holds shares in a company on behalf of more than one person—
>
> (a) rights attached to the shares, and
>
> (b) rights under any enactment exercisable by virtue of holding the shares,
>
> need not all be exercised, and if exercised, need not all be exercised in the same way.

3.28 This provision has the effect that an intermediary who is the member of the company may vote in different ways on the same resolution and may appoint more than one ultimate investor as their proxy under section 324. Each ultimate investor appointed may vote in different ways. Again, if the immediate intermediary is not the member, the agreements up the chain would need to make provision for this to happen.

Nominating another person to exercise rights of member

3.29 Subsections 145(1) and (2) of the CA 2006 provide:

> (1) This section applies where provision is made by a company's articles enabling a member to nominate another person or persons as entitled to enjoy or exercise all or any specified rights of the member in relation to the company.
>
> (2) So far as is necessary to give effect to that provision, anything required or authorised by any provision of the Companies Acts to be done by or in relation to the member shall instead be done, or (as the case may be) may instead be done, by or in relation to the nominated person (or each of them) as if he were a member of the company.

3.30 The effect of these provisions, which apply to all companies, is that where a company's articles provide that a member can nominate another person to exercise rights, that person can exercise those rights under the CA 2006 as if they were the member.

3.31 Subsection (3) states that this ability "applies, in particular, to the rights conferred by" a range of provisions, including the right to require the circulation of written resolutions, the right to require directors to call a general meeting, the right to require notice of the general meeting and the right to appoint a proxy to act at the meeting.

This list is not exhaustive and could be used to give the right to vote to an ultimate investor.[9]

3.32 Subsection (4) confirms that the provision does not give the nominated person rights which are directly enforceable against the company. It does not, therefore, affect the "no look through" principle, which we discuss below.[10]

3.33 Nevertheless, section 145 seemingly provides the potential for voting rights to be passed back to ultimate investors. However, it is an optional, rather than mandatory, provision, in that:

(1) there must be provision in a company's articles which enables a member to nominate another person to exercise their rights; and

(2) the member must in fact nominate another person to exercise their rights.

3.34 We understand that few, if any, companies have included or amended their articles to allow a member to nominate another person to exercise their rights in accordance with section 145.[11]

Information rights

3.35 Under sections 146 to 151 of the CA 2006, a member of a company may nominate another person to "enjoy information rights". This means that the ultimate investor could be nominated to receive a copy of all communications the company sends to its members.

3.36 When a company sends notice of a meeting to an ultimate investor nominated to receive information, section 149 provides that the notice must furnish the ultimate investor with certain information about the exercise of voting rights, including that:

(a) he may have a right under an agreement between him and the member by whom he was nominated to be appointed, or to have someone else appointed, as a proxy for the meeting, and

(b) if he has no such right or does not wish to exercise it, he may have a right under such an agreement to give instructions to the member as to the exercise of voting rights.

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9 See, for example, J Payne, *Intermediated Securities Legal Problems and Practical Issues* (2010) p 204.

10 We discuss the "no look through" principle in ch 5 below.

11 ICSA, *Annex to Response to BEIS Corporate Governance Reform Green Paper* (2017), at https://www.icsa.org.uk/assets/files/branches/Registrars-Group/Corporate-Governance-Reform---Green-Paper-Response---Appendix-Feb-2017.pdf.

3.37 Although section 149 is designed to encourage voting by ultimate investors, whether that can take place in practice will depend on the terms and conditions between the ultimate investor and their intermediary.[12]

3.38 Section 146 does not require changes to a company's articles to enable a member to nominate an ultimate investor to enjoy information rights. However, even these information rights provisions are optional and depend on the willingness of the intermediary to pass back the relevant rights to the ultimate investor.[13] An ultimate investor does not have an automatic right under the CA 2006 to receive information from the company. Additionally, these provisions apply only to traded companies and do not include companies whose shares are admitted to trading on, for example, the London Stock Exchange's Alternative Investment Market.[14]

An ultimate investor may instruct their intermediary to vote in a particular way

3.39 An ultimate investor may not want to attend a meeting to vote on a resolution. They may simply wish to tell their intermediary that they would like their shares voted in a particular way, or according to a particular policy,[15] and for their intermediary to follow those instructions.

3.40 Must an intermediary follow instructions from an ultimate investor as to how to vote on a particular resolution or resolutions, or can the intermediary refuse? Under trusts law, the general position is that a trustee should not act at the dictation of beneficiaries, although they may consult with the beneficiaries or follow beneficiaries' instructions, provided that the final decision is based on the trustee's' own judgement.[16] Any exercise of the trustee's powers must be a personal and conscious act and not dictated by another: the "law does not permit him to be another's puppet".[17]

3.41 However, depending on the terms of the trust, that general position may be qualified. For example, there is case law which suggests that in some situations, a trustee must vote in relation to shares in accordance with the beneficiary's instructions, but

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12 Note that enjoyment by the nominated person of the rights conferred by the nomination is enforceable by the member against the company (not by the ultimate investor) as if they were rights conferred by the company's articles: s 150.

13 Some consultees, including the Share Centre, told us that they operate systems under Part 9 as a default.

14 Traded companies are companies whose shares are admitted to trading on a UK-regulated market (such as the London Stock Exchange's Main Market) or an EU-regulated market. Section 151 of the CA 2006 provides the Secretary of State with a power to extend this provision to other classes of companies.

15 See, for example, the Red Line Voting Policy: http://redlinevoting.org/. An example of a "Red Line" is: "Vote against the re-election of the chair of the nomination committee if there is no strategy in place to address any under- representation of women at board level and fewer than 25% of the company's board members are female."

16 L Tucker, N Le Poidevin, J Brightwell, *Lewin on Trusts* (20th ed 2020) para 28-116. Trustees may also take advice, for example from professional advisors: *Scott v National Trust* [1998] 2 All ER 705 at 717. See *Snell's Equity* (34th ed 2019) para 29-029.

17 P Finn, *Fiduciary Obligations* (1st ed 1977) para 42. The Law Commission previously discussed this issue in Fiduciary Duties of Investment Intermediaries (2014) paras 3.51 to 3.54.

commentary suggests that at least one of these decisions should be confined to its own particular facts.[18]

Terms and conditions governing the relationship

3.42 Even where there is a duty on the intermediary to follow instructions, that duty is not absolute. There is a general principle that parties are free to agree their obligations under a contract, particularly in a commercial context.[19] This principle is subject to various restrictions, including legislation regulating the relationship in certain circumstances.[20] It is also qualified by the fact that, in practice, parties are unlikely to negotiate each term of the agreement individually, and instead are likely to agree to the intermediary's standard terms and conditions.[21] These terms and conditions are likely to limit any right of the ultimate investor to instruct the intermediary as to voting, or may impose conditions of the exercise of any right to vote. For example: [22]

> If you Instruct us to vote as proxy for you, we may refuse or agree on payment of a fee.

3.43 Therefore, even when the legal relationship between the ultimate investor and intermediary is such that there is a duty to follow instructions as to voting, the terms and conditions may exclude this duty. Where the immediate intermediary does not have the voting rights, the position will also depend on the agreements up the chain.

An ultimate investor can request the ability to vote under the ISA regulations

3.44 The Individual Savings Account Regulations 1998 ("the ISA Regulations")[23] provided for the establishment of ISAs. ISAs provide a way in which an individual can save up

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18 See, in relation to bare trusts, *Kirby v Wilkins* [1929] 2 Ch 444, which was followed in *Re Castiglione's Will Trusts, Hunter v Mackenzie* [1958] Ch 549. Most recently it was applied in the First-tier Tribunal (Tax) in *McLaughlin v Revenue and Customers Commissioners* [2012] UKFTT 174 (TC) at [72]. The authors of *Lewin on Trusts* (20th ed 2020) para 1-039 suggest the position is not as clear as it seems. In particular, the authors point to *Hotung v Ho Yuen Ki* 5 ITELR 556, where the Court of Appeal held that a beneficiary could not insist on performing the role of trustee itself, but instructions on how to vote were an exception to this: see [31]. See also *Butt v Kelson* [1952] Ch 197 at 207 in relation to special trusts. The Court of Appeal held that the beneficiaries were entitled to be treated as if they were the registered shareholders and could compel the trustee-directors to vote, but later commentary suggests that *Butt v Kelson* should be confined to its own particular facts: *Thomas on Powers* (2nd ed 2012) p 512. See also L Tucker, N Le Poidevin, J Brightwell, *Lewin on Trusts* (20th ed 2020) para 22-032 and P Finn, *Fiduciary obligations* (1977) para 47. See also *Dickinson v NAL Realisations (Staffordshire) Ltd* [2019] EWCA Civ 2146, [2020] 1 WLR 1122 at [25] and [26].

19 *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 at 848; *Chitty on Contracts* (33rd ed 2019) para 1-032.

20 See, eg, FCA Handbook Collective Investment Sourcebook ("COLL") in the context of collective investment schemes (pooled funds) and FCA Handbook COLL 3.2 which deals with the instrument constituting the fund and provides in 3.2.6R a list of matters which must be included in the instrument constituting the fund.

21 This is likely to be the case regardless of whether the contract is business to consumer or two commercial parties: *Chitty on Contracts* (33rd ed 2019) para 1-039.

22 Barclays Smart Investor Terms (September 2018) para 3.2.

23 Individual Savings Account Regulations 1998 ("ISA Regulations"), SI 1998 No 1870.

to a specified amount each year, without paying tax on any interest earned.[24] There are different types of ISAs which, in general, can be divided into two categories – ISAs which are cash savings accounts and those which are investment accounts.[25] This scoping paper focuses on ISAs which have an investment component and may be used to hold shares.

3.45 An account must satisfy certain general requirements in order to be an ISA. These conditions are set out in regulation 4. The following conditions are particularly relevant.

(1) Paragraph (5) provides that an ISA must "at all times" be managed by an account manager "under terms agreed in a recorded form" between the account manager and the investor. Effectively this means that there must always be an intermediary.

(2) Paragraph (6) provides that such agreed terms "shall secure":[26]

(a) that investments shall be in the beneficial ownership of the investor;

(b) that title to investments shall be vested in the account manager or their nominee or jointly with the account investor;

(c) where a share certificate is issued, it shall be held by the account manager or as the account manager may direct.

3.46 Paragraph (6) also provides voting rights to an ultimate investor, saying that the terms "shall secure" that, in relation to certain investments:[27]

> the account manager shall be under an obligation (subject to any provisions made under any enactment and if the account investor so elects) to arrange for the account investor to be able–
>
> (i) to attend any meetings of investors in companies, unit trusts, open-ended investment companies and other entities in which he has account investments,
>
> (ii) to vote, and

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24 For example, for a cash ISA, an individual can save up to £20,000 each year without paying tax on the interest: SI 1998 No 1870, reg 4ZA.

25 For example, an individual can have a cash account ISA, or a stocks and shares ISA, or a Lifetime ISA or an innovative finance account.

26 SI 1998 No 1870, reg 4(6)(a), (b).

27 These investments include a "stocks and shares component" of an ISA, which includes shares issued by a company (reg 7), and which may be a "qualifying investment" for a stocks and shares ISA or a Lifetime ISA component (reg 8ZA).

(iii) to receive, in addition to the documents referred to in sub-paragraph (c),[28] any other information issued to investors in such companies, unit trusts, open-ended investment companies and other entities;

3.47 Therefore, paragraph (6) provides that investments held through an ISA must be held in a nominee account and that the ultimate investor must be the beneficial owner of the investments. Although an ultimate investor can hold title to the investments, it must be held jointly with an intermediary. Paragraph (6) also requires an intermediary to arrange for an ultimate investor to vote, attend meetings and receive information and does not allow this obligation to be excluded by contract terms and conditions.

3.48 These provisions provide a clear obligation on an intermediary to make arrangements to enable an investor to vote, attend meetings and receive information. Paragraph (6) says that the agreement entered into between the intermediary and the ultimate investor "shall secure" that the intermediary "shall be under an obligation", if requested by the ultimate investor, to make such arrangements.

3.49 In his response to the call for evidence, Eric Chalker, a retail investor, observed that that, while the rights under these regulations are more comprehensive than rights provided under Part 9:

> 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.

3.50 We note that this obligation to make arrangements extends to "companies, unit trusts, open-ended investment companies and other entities in which [the investor] has account investments". It does not extend to arrangements in relation to investments (such as shares in a company) which are held by a pooled fund such as a unit trust.

3.51 If an account manager outsources any of their functions or responsibilities under the terms agreed with the investor to a third party, the account investor must be satisfied that the third party "is competent to carry out those functions or responsibilities".[29]

The ultimate investor may benefit from a commercial solution put in place by the issuing company

3.52 In response to the call for evidence, Link Asset Services and the Share Centre referred to an approach using sponsored nominees. Link Asset Services said that they operated a number of such nominees on behalf of issuer companies.

3.53 Under this approach, the company-sponsored nominee is named on the share register and ultimate investors are maintained 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

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[28] Sub-paragraph (c) provides that the investor may choose to receive a copy of the annual report and accounts issued to the investor by every company, unit trust, open-ended investment company or other entity in which the investor has investments: SI 1998 No 1870, reg 4(6)(c).

[29] SI 1998 No 1870, reg 4(6)(e).

Services said that such an approach works well to deliver shareholder rights to ultimate investors.

3.54 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. We do not have any information on how common, or otherwise, such arrangements are. In any case, it is a commercial rather than legal solution and we do not therefore consider it in further detail. However, companies which wish to enable voting by small investors may wish to consider this option.

CONSULTEES' VIEWS ON VOTING

Do ultimate investors find it difficult to exercise the right to vote?

3.55 In response to the call for evidence, a significant majority of consultees agreed that it is difficult for ultimate investors to exercise voting rights in practice.[30] They gave various explanations for and qualifications to this, including the type of investor, the terms and conditions of the intermediary, and practical barriers such as timing constraints and complicated processes. We explore these further below.

3.56 As we discuss in Chapter 2, some consultees doubted that any actual or perceived difficulty in voting was a problem in practice, suggesting that most investors are focused on economic returns and are not interested in voting in any case. However, it is clear that some ultimate investors do wish to vote, and therefore barriers to voting are still highly relevant.

3.57 A small 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:

> [I]n 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.

A distinction between retail and institutional investors

3.58 Several consultees said exercising voting rights is more difficult for retail as opposed to institutional investors. The CLLS said the latter would be "well advised and unlikely to face difficulties in putting in place arrangements with … intermediaries to facilitate the exercise of voting rights". Equiniti provided figures which indicated a high level of voting, but accepted that voting was generally by, and easier for, institutional rather than retail investors:

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30 Of the 33 consultees who responded to this question, 25 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 answered "Other".

> Despite this investor engagement, exercising of voting rights is high with levels of Issued Share Capital (ISC) voted averaging 74.53% for FTSE 100 and 70.92% FTSE 250. This number rose steadily to 2017 since when it has largely remained static. The majority of ISC is held by institutional investors and private investors holding via the intermediated route may experience more difficulty in exercising their voting rights.

Terms and conditions, including fees

3.59 Consultees confirmed 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.

3.60 Dr David Gibbs-Kneller said that, even where terms and conditions provide that the intermediary will arrange for the ultimate investor to attend meetings, vote and receive shareholder information, this is likely to be "buried" in the terms and conditions and not advertised to the ultimate investor. Dr Eva Micheler raised the problem that the responsibility to pass on votes may not be passed on to the intermediaries further up the chain.

3.61 Some consultees also said that fees for voting were a problem. The Registrars' Group, Equiniti and Computershare said that, while they had seen "a continued increase" in ultimate investors representing their own investment interests at meetings:

> … we understand that such appointments may come at a cost which in some cases we understand could be prohibitive.

Unwillingness on the part of intermediaries

3.62 We were told that that some intermediaries are unwilling to vote or to enable an ultimate investor to vote. For example, the London Stock Exchange Group said that intermediaries managing assets on behalf of a number of ultimate investors abstain from voting rather than passing back rights. 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". The Share Centre suggested that there should be a "comply or explain" regime in regard to Part 9 information rights.

3.63 The Association of Member Nominated Trustees ("AMNT") said that, at least in the context of pooled funds, 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 on a vote match the intermediary's voting policy.

Timing and process

3.64 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. UKSA and ShareSoc said that they had heard of instances of members not being sent a voting form or a link to online voting.

3.65 There may be a complex process which the ultimate investor must follow in order to vote, such as providing specific instructions to an intermediary, which Roger Lawson, a retail investor, said is "tedious" and "deters investors from voting". London Stock Exchange Group ("LSEG") said 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".

3.66 Link Asset Services noted that ultimate investors will have less time to consider information, given delays in passing it through the chain. Eric Chalker, a retail investor, contrasted the requirements of the CA 2006 to provide information to members with the varied processes for providing information to ultimate investors:

> At best, nominee account users will receive the information later than would be the case if they were registered as the shareholders 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).

Does the type of vote affect the availability of voting rights?

3.67 Ultimate investors may have the opportunity to exercise voting rights at various times, including at general meetings and in relation to corporate actions such as takeovers, bonus issues and rights issues. In the call for evidence, we asked whether the type of vote affects the extent to which ultimate investors can exercise voting rights. [31]

3.68 Around half of consultees who responded to this question thought the type of vote makes a difference.[32] There was no consensus as to which types of vote were easier or harder to participate in.

Corporate actions compared with general meetings

3.69 Some consultees said that it is easier to exercise voting rights for general meetings 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. UKSA and ShareSoc said that it depends on whether the ultimate investor receives information rights and, if not, the ultimate investor is only likely to be aware of high profile upcoming votes on corporate actions.

3.70 By contrast, other consultees said it is easier to exercise rights for corporate actions than general meetings. For example, Computershare and the Registrars' Group both

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31 Call for evidence (2019) para 2.14.

32 Of the 19 consultees who responded to this question, nine consultees said that the type of vote affected the ability to vote, seven said it did not and three answered "Other".

said that votes on corporate actions[33] were more likely to be "communicated and actioned in a timely, accurate and effective manner" compared to general meetings, commenting that this:

> 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.

3.71 Similarly, the CLLS said that information is frequently passed on to ultimate investors about restructurings of debt securities, because intermediaries may be at risk of claims if they do not make proper efforts to obtain instructions from the ultimate investors.

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

3.72 Just under half of consultees said that the type of vote does not affect the extent to which ultimate investors can exercise voting rights. The QCA said that all types of votes are difficult to exercise because of the intermediated securities chain.

3.73 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 investors to make elections or choose options, the intermediaries and the ultimate beneficial holders have established processes to enable elections to be actioned.

3.74 EUI observed that voting on special resolutions or in favour of a corporate event may generate more interest, but that the same mechanics are available in CREST regardless of the type of vote. From a functional perspective, ultimate investors will be able to exercise their voting rights through the CREST system where this is facilitated by intermediaries.

Comment

3.75 The combination of a range of factors mean that ultimate investors are often not able to vote, or instruct their intermediaries to vote, in the way they wish. While not all ultimate investors are motivated to participate, it is clear that those who are face a variety of hurdles.

3.76 Representatives from UKSA and ShareSoc have emphasised that the ability to participate may be particularly important in the coming months and years, when the recession caused by the COVID-19 pandemic forces more companies towards corporate and debt restructures, share issues or administration. Where the value of an ultimate investor's investment is at risk, their interests should be represented and voting is one clear way to ensure that representation.

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[33] Examples of corporate actions include a merger or acquisition and a rights issue, when a company offers new shares to existing shareholders at a discount.

3.77 Below, we consider potential reforms to facilitate voting by ultimate investors.

POSSIBLE SOLUTIONS TO ENHANCE THE ABILITY OF ULTIMATE INVESTORS TO VOTE

3.78 In the following paragraphs, we consider possible solutions to facilitate the exercise of voting rights by ultimate investors. In particular, we consider:

(1) placing a new obligation on intermediaries to facilitate voting; and

(2) extending the application of certain obligations in the Shareholder Rights Directive.

3.79 We also set out other amendments which could be made to the CA 2006 to improve the existing framework, including the ability of a company to discover its ultimate investors, and the ability of an ultimate investor to confirm that their vote has been received and counted.

3.80 Consultees advocating for increased shareholder rights, including UKSA and ShareSoc, point out that if all intermediation were to be removed, there would be no need for other legislative reform to enhance the rights of ultimate investors, because they would be the "member" on the register. We discuss the removal of intermediation, and a move to a "name on register" system, in Chapter 8. According to that argument, the following solutions do not go far enough because they do not give the ultimate investor the legal interest in the securities. However, in the face of obstacles to more fundamental change, we think that they may offer more immediately achievable solutions.

A NEW OBLIGATION TO FACILITATE VOTING

3.81 One response to some of the issues outlined above could be the creation of a new provision which requires intermediaries to facilitate the exercise of certain rights by ultimate investors. Such a provision could impose an obligation on intermediaries to arrange, upon request, for an ultimate investor to:

(1) attend meetings;

(2) vote; and

(3) receive information that the company sends to its members.

"ultimate investors"

3.82 We have considered this potential new obligation on the basis that it would benefit ultimate investors as defined in this scoping paper, that is, both institutional and retail investors who invest through an intermediated securities chain. However, we do not think this particular obligation could be extended to benefit people who pay money into pooled funds, without further investigation and analysis. As we discuss above, there are legal and policy reasons that pooled funds should be considered separately and there may be other solutions which are more appropriate to this type of investment approach.

"intermediaries"

3.83 There are two options as to how the obligation could apply to intermediaries. The first option is that there could be a requirement on the intermediary with whom the ultimate investor has an agreement (their "immediate intermediary"). It would be up to the immediate intermediary to ensure that the ultimate investor could attend meetings, vote and receive information from the company. We think that this could be achieved through the commercial agreements made between the immediate intermediary and the other intermediaries in the chain.

3.84 The second option is to place an obligation on all intermediaries in the chain. Each intermediary subject to the obligation (noting the cross-border nature of intermediated securities chains) would be under an equal obligation to ensure, upon request, that the ultimate investor has the ability to attend meetings, vote and receive information from the company.

3.85 Whilst either option could achieve the required result, we prefer the second approach. All participants in an intermediated securities chain benefit from the ultimate investor's decision to invest. We think all of the parties in an intermediated securities chain should be under a duty to facilitate the exercise of these rights.

3.86 We have considered whether, instead of placing an obligation on intermediaries, there should be an obligation on companies to enable voting by ultimate investors. We have decided not to develop this idea. There does not currently appear to be a way in which a company can discover its ultimate investors in a way that is accurate and which provides "real-time" results.[34] The latter would be necessary because of the fast-paced nature of the financial services market. Without it, there could be a risk that ultimate investors exercise a vote when they are no longer entitled to do so.

3.87 An approach which placed obligations on companies to "look through" the chain could also lead to increased costs because companies would inevitably need to engage with intermediaries to gather the necessary information to confirm the ultimate investor's entitlement to vote. A more cost-efficient approach would be for the member on the register and other intermediaries to arrange for ultimate investors to exercise these rights.

"an obligation"

3.88 The provision would place an obligation on intermediaries to facilitate the exercise of rights by ultimate investors. We consider that parties should not be allowed to contract out of this obligation. Creating an optional requirement to facilitate voting rights would maintain the current position, rather than enhancing ultimate investors' rights.

3.89 An optional requirement would also be more difficult to implement effectively. For example, an immediate intermediary may agree with the ultimate investor to facilitate the exercise of their rights, subject to the intermediary's own agreement with other intermediaries in the chain. However, in practice other intermediaries higher in the chain may wish to contract out of the obligation to facilitate the exercise of an ultimate investor's rights. This problem may occur particularly in chains with a cross-border

[34] We discuss section 793 of the CA 2006 and whether it is fit for purpose from para 3.127 below.

element. An intermediary higher in the chain and in another jurisdiction may desire to contract out of the obligation.

3.90 We think that the most appropriate approach would be to place all intermediaries subject to UK law under an obligation to facilitate these rights. We note that the SRD II places a similar requirement on intermediaries to facilitate shareholder rights, which may apply to overseas intermediaries. Even where an overseas intermediary does not have such an obligation, their counter-party intermediaries subject to UK law would need their commercial arrangements to take account of the UK legal obligation to facilitate the exercise of these rights by ultimate investors.

Fees

3.91 We have also considered whether intermediaries should be entitled to charge a fee for facilitating the exercise of rights by an ultimate investor, as for other services they provide. Such fees could discourage ultimate investors from seeking to exercise these rights. For example, in response to the call for evidence, one retail investor said that his intermediary charged £20 for a letter of representation, which allowed him to attend an AGM.[35] It is easy to see how a fee of £20 for each AGM could discourage ultimate investors, particularly retail investors, from requesting the ability to vote.

3.92 We have found it difficult to discover the potential cost of facilitating the exercise of shareholder rights. We asked stakeholders what the costs would be of a legal requirement to allow ultimate investors to vote in relation to shares (in omnibus accounts only, rather than pooled funds) but have received no concrete figures.

3.93 If the Government were minded to take forward this approach, we think that this is one area in which further research would be required.

Services offered by intermediaries

3.94 In Chapter 2, we explain that intermediaries offer different types of services.[36] For retail investors, intermediaries may offer an execution-only service, where the ultimate investor makes their own decisions about their investments, and the intermediary merely executes their wishes. Or they may offer a discretionary service, which involves the ultimate investor authorising the intermediary to take investment decisions on their behalf.[37] For institutional investors, we have been told that there is an extensive range of available intermediary services, provided by consultants or by platforms, combining investment advice and implementation to varying degrees.[38]

3.95 We have been told that the services offered by an intermediary may affect how difficult it is to facilitate the exercise of voting rights. For example, PIMFA told us that

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35 This is consistent with the previous findings that the average charge to the client to attend an AGM was "in the region of £20": Department for Business Innovation & Skills, *Exploring the intermediated shareholding model* (Research Paper No 216, 2016) p 74.

36 PIMFA and the Share Centre also highlighted this point in their responses to the call for the evidence.

37 An intermediary may also offer an advisory service to the ultimate investor, although we understand that this service is not as common as an execution-only or discretionary service. We describe the different services at para 2.80 above.

38 See para 2.82 above.

execution-only firms are more likely to have automated systems which facilitate the exercise of voting rights, compared to firms which only offer discretionary services, which may have to handle the exercise of voting rights manually.

3.96 On the one hand, there may be an argument that the suggested obligation should not apply to certain types of services, such as discretionary services, which are structured in such a way that an ultimate investor authorises the intermediary to take decisions on their behalf. This may also decrease the implementation costs to industry. On the other hand, if the obligation were to be applied consistently regardless of the service offered, this would provide certainty for ultimate investors.

3.97 We think that any further investigation by the Government as to costs should include the difference in cost to firms based on the services that are offered. Any such work would also have to consider how such a distinction could be maintained if the obligation were to be applied to every intermediary in the chain, as we suggest above. For example, whether the obligation would apply could depend on the type of services offered to the ultimate investor at the end of the intermediated securities chain.

"upon request"

3.98 We envisage that intermediaries would only be required to make arrangements for those ultimate investors who request it. For example, the suggested change would not require intermediaries to arrange for all of their clients to receive information from companies. We think that this is a proportionate response and recognises the current position that, although some ultimate investors wish to engage actively in relation to their investments, many do not.

3.99 Stakeholders have told us in discussions and in response to the call for evidence that the majority of ultimate investors, particularly retail investors, do not desire to vote or engage with the companies in which they invest.[39] If that is the case, then the potential cost to industry of processing the requests they receive will be limited.

"arrange for the ultimate investor to attend meetings, vote and receive information"

3.100 We envisage that any requirement to arrange for an ultimate investor to attend meetings, vote and receive information would mirror the existing obligations in the ISA regulations.[40] We consider that it is important to include more than a simple requirement to arrange for an ultimate investor to vote. An ultimate investor must be able to request a copy of all the information that a company sends to its members. Without this information, an ultimate investor may not even know that there is an upcoming vote in which they have an interest.

3.101 For traded companies, there is already a procedure in place for nominating ultimate investors to enjoy information rights in Part 9 of the CA 2006. Intermediaries could use this procedure for the purposes of fulfilling their obligations. If the Government decided

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39 We discuss the motivations for investing and voting from para 2.39 above.

40 We discuss the ISA regulations from para 3.44 above.

to go ahead with this approach, then we think it would be appropriate to consider extending the application of Part 9 to other types of companies.[41]

3.102 As to voting, we think that this should be interpreted broadly to encompass various approaches. For example, it might involve the intermediary appointing the ultimate investor as their proxy under section 324 of the CA 2006. Alternatively, it might involve an intermediary asking for voting instructions from an ultimate investor and then voting on their behalf.

What legal changes would need to be made?

3.103 This obligation could be imposed through a variety of mechanisms. For example, primary legislation such as the FSMA, the main piece of legislation which governs UK financial markets regulation, could impose the obligation, or could provide Government with a power to impose the obligation by statutory instrument. Another option would be to amend the FSMA to provide a power to the FCA to regulate in relation to these matters.[42]

Advantages and disadvantages

3.104 Creating a new obligation on intermediaries would enhance the rights of ultimate investors and address stakeholder enfranchisement concerns, whilst retaining the benefits of the current system of intermediation.[43] It is a proportionate response because it would only apply upon the ultimate investor's request, recognising that only some ultimate investors wish to engage in this way.

3.105 As with most of the possible solutions considered in this paper, the main disadvantage to this approach would be the cost of implementation and the resources required to respond to requests from ultimate investors. However, our suggested provision mirrors an existing requirement in the ISA regulations, with which any intermediaries offering ISA-based investment products already have to comply. Put simply, the suggested provision is a targeted solution that builds on the existing system.

EXTENDING THE APPLICATION OF THE SRD II, CHAPTER IA

3.106 In the call for evidence, we noted the relevance of Chapter Ia of the revised EU Shareholder Rights Directive II ("SRD II"). SRD II applies to companies with voting shares being traded on EU-regulated markets. Chapter Ia and our scoping work consider similar issues, including the identification of shareholders, transmission of information and facilitation of shareholder rights. We explained that the Government was bringing forward plans to transpose Chapter Ia by 3 September 2020 and that our

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41 UKSA and ShareSoc, LSEG and the Share Centre pointed out that Part 9 of the CA 2006 does not apply to companies listed on the Alternative Investment Market. The Secretary of State has a power to amend or restrict the classes of companies to which section 146 applies: s 151.

42 Part 9A of the FSMA gives the FCA powers to set rules and guidance (which appear in the FCA Handbook and elsewhere). These rules are legally binding and the FCA has a range of powers to investigate and to impose disciplinary sanctions, including public censure and financial penalties. See Part 14 of the FSMA, especially see ss 205 and 206 and FCA Handbook Enforcement Guide.

43 We discuss the benefits of intermediation from para 8.56 below.

work would be carried forward separately from the Government's work on transposition. Accordingly, we did not intend to focus on SRD II in our scoping work.

3.107 Since the call for evidence, the Government has implemented Chapter Ia by statutory instrument.[44] As we explain below, this implementation took place on the basis that the "shareholder" in SRD II is the member on the register of members of a UK company (not the ultimate investor).

3.108 Notwithstanding the Government's recent implementation of Chapter Ia, a number of consultees, both in discussions and in responses to the call for evidence, have encouraged us to consider whether its application should be extended to ultimate investors.

What is SRD II and what does it cover?

3.109 The Shareholder Rights Directive ("SRD") is a 2007 directive of the European Parliament and the Council of the European Union.[45] In 2009, it was implemented in the UK as part of the CA 2006.[46] SRD aims to improve corporate governance and to enhance shareholders' rights.[47] SRD II is a 2017 directive of the European Parliament and the Council of the European Union, which amends the SRD.[48] It focuses on enhancing investor engagement and improving transparency between investors and companies.[49]

3.110 SRD II amends SRD in relation to shareholder rights, transparency of institutional investors, asset managers and proxy advisors, and remuneration policies.[50] As indicated above, we focus on Chapter Ia, which includes provisions bearing on the issues which consultees have highlighted in relation to intermediated securities.

(1) Identification of shareholders (article 3a). This article provides companies with the right to identify their shareholders. Where intermediaries are involved, they must pass on information about the identity of shareholders without delay to the company.

(2) Transmission of information (article 3b). This article provides that member states must require intermediaries to pass on information from the company to

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44 The Companies (Shareholders' Rights to Voting Confirmations) Regulations 2020, SI 2020 No 717, which came into force on 3 September 2020.

45 Shareholder Rights Directive 2007/36/EC, Official Journal L 184 of 14.7.2007 p 17 ("SRD").

46 Companies (Shareholders' Rights) Regulations 2009, SI 2009 No 1632.

47 SRD, recitals (2) and (3). The SRD is a "minimum harmonisation" directive, which means that member states may provide more protection to shareholders than the SRD requires, but they may not provide less: SRD, art 3, recital (4).

48 Shareholder Rights Directive II 2017/828/EU, Official Journal L 132 of 20.05.2017 p 1 ("SRD II").

49 SRD II, recital (3).

50 Most of these provisions have already been implemented through changes to the FCA Handbook, as well as through the Proxy Advisors (Shareholders' Rights) Regulations 2019, SI 2019 No 926, and the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019, SI 2019 No 982. See Explanatory Memorandum to The Companies (Shareholders' Rights to Voting Confirmations) Regulations 2020, SI 2020 No 717, at https://www.legislation.gov.uk/uksi/2020/717/pdfs/uksiem_20200717_en.pdf.

the shareholder or their nominee and from the shareholder to the company, "without delay".

(3) Exercise of shareholder rights (article 3c). This article provides that member states must ensure that intermediaries facilitate the exercise of shareholder rights, including the right to participate and vote in general meetings. An intermediary can do so by enabling the shareholder either to exercise the rights or to instruct the intermediary to exercise the rights. This article also provides for confirmation of receipt of votes, as well as confirmation that votes have been validly recorded and counted by the company.

(4) Costs (article 3d). This article requires intermediaries to publish charges for the services provided under Chapter Ia and that member states must ensure that such charges are "non-discriminatory and proportionate in relation to the actual costs incurred for delivering the services".

3.111 Chapter Ia of SRD applies to:

(1) companies that have their registered office in a member state and the shares of which are admitted to trading on a regulated market[51] within a member state;[52]

(2) intermediaries which provide services in relation to shares of companies which fall under the SRD, including intermediaries which have neither a registered office nor a head office in a member state;[53] and

(3) "shareholders".

3.112 Article 2(b) provides that "shareholder" means "the natural or legal person that is recognised as a shareholder under the applicable law". It therefore leaves the question of the extent of the application of SRD for member states to decide. As we explain above, SRD II has been implemented in the UK with "shareholder" meaning the member on the register of the members of a UK company (not the ultimate investor). The result of this approach is that the provisions of Chapter Ia only apply to the member on the register under the CA 2006, and do not benefit ultimate investors.

How has Chapter Ia been implemented in the UK?

3.113 Most provisions of Chapter Ia of SRD II did not require transposition because of the UK's approach to the definition of "shareholder". For example, article 3a(1) provides that "Member States shall ensure that companies have the right to identify their shareholders". Given that "shareholder" is defined under UK law as "member", article

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51 "Regulated market" is defined in MiFID 2014/65/EU, Official Journal L 173 of 12.06.2014 p 349. See also CA 2006, s 360C.

52 SRD, art 1(1).

53 SRD, art 1(5). An intermediary is defined as a person which "provides services of safekeeping of shares, administration of shares or maintenance of securities accounts on behalf of shareholders or other persons": SRD, art 2(d).

3a(1) was already satisfied by the CA 2006, which requires a company to have a register of members.[54]

3.114 However, the Companies (Shareholders' Rights to Voting Confirmations) Regulations 2020, which came into force on 3 September 2020, implemented provisions which were not already covered by the existing UK companies law, in relation to the voting confirmation. These regulations inserted two new provisions into the CA 2006:[55]

(1) section 360AA, which provides that a traded company must provide a confirmation of receipt of votes which are cast electronically; and

(2) section 360BA, which provides that a member may request information from a company which enables them to determine that their vote has been validly recorded and counted.

Comparisons with other jurisdictions

3.115 The Association of Global Custodians ("AGC") and the AFME told us that EEA countries have taken several general approaches when defining "shareholder" for the purposes of implementing SRD II. For some jurisdictions, including the UK, the "shareholder" is the entity named in the CSD or share register.[56] However, in certain jurisdictions which adopt this approach, the ultimate investor typically is visible at CSD level, which increases transparency.[57] Other jurisdictions define "shareholder" to include the clients of the CSD participant, but not the ultimate investors.[58] Finally, some jurisdictions define "shareholder" as the ultimate investor in the securities.[59]

3.116 Of course, these categories are general and do not reflect the subtleties of the different legal systems involved. Additionally, the position in some jurisdictions is not yet confirmed. However, we note that some countries appear to have extended the scope of certain SRD II provisions without amending the domestic definition of shareholder.[60] For example, although some jurisdictions, such as Ireland, Spain, Denmark, Austria and Hungary, define "shareholder" as the entity named in the register maintained by the CSD, they have stipulated that for the shareholder

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54 See para 2.12 above and see Transposition Note, at https://www.legislation.gov.uk/uksi/2020/717/pdfs/uksitn_20200717_en.pdf.

55 SI 2020 No 717, regs 4 and 5.

56 We have been told that a similar approach is taken in other jurisdictions, including Malta, Luxembourg, Liechtenstein, Latvia, Ireland, Hungary, Germany, Austria and Croatia.

57 These are referred to as "direct" or "registration" markets: we have been told that Slovenia, Poland, Greece and the Czech Republic take this approach, which requires segregated accounts (rather than omnibus accounts).

58 We understand this approach is common where a foreign ultimate investor uses a domestic intermediary to obtain shares from a domestic CSD participant. The domestic intermediary may be considered the "shareholder". We have been told that Portugal, Slovakia and Denmark take this approach.

59 This approach has been taken by Romania, the Netherlands, Lithuania, France, Sweden, Finland, Estonia, and Belgium. Bulgaria has adopted a dual approach where both the ultimate investor and the CSD participant are considered "shareholders".

60 This appears to be the case particularly in civil law jurisdictions that do not provide for separation of legal and beneficial ownership, and where there is a presumption under national law that the name on the register is considered the "shareholder" under company law.

identification aspects of SRD II, disclosure obligations should extend to ultimate investors.

Consultees' views

3.117 In our discussions with consultees, and in response to the call for evidence, several consultees representing a range of positions in the market suggested that the Government should revisit its implementation of SRD II. They suggested that the application of SRD II in the UK should be extended to ultimate investors and not simply members, for whom SRD II makes little change compared to the position as it already was under the CA 2006. Consultees with this view included UKSA and ShareSoc, the Association of Global Custodians and the Association for Financial Markets in Europe, as well as Susan Sternglass Noble and Sir John Dermot Turing.

Advantages

3.118 Following discussions with stakeholders, we think that there are two main advantages to extending the application of SRD II to ultimate investors. The first advantage is that extending the application of SRD II would be a comprehensive approach, solving several problems identified by consultees, whilst retaining the current intermediated system and its benefits. In particular, SRD II provides potential solutions in relation to the transmission of information, the exercise of rights by ultimate investors, confirmation of voting, improved identification of ultimate investors and increased transparency in relation to fees and charges. This could also be seen as a proportionate response, enhancing the rights of ultimate investors, increasing transparency for companies and providing voting confirmation to institutional investors, without upending the entire system for holding securities.

3.119 SRD II is also accompanied by an implementing regulation which provides minimum requirements and standardisation in relation to shareholder identification, the transmission of information and the facilitation of the exercise of shareholder rights.[61] This regulation prescribes standardised formats of information and minimum types of information.[62] For example, Table 6 in the Annex to the implementing regulation lists the type of information that must be included in a "voting receipt", such as a unique identifier of the general meeting event, the date of the meeting, the name of the issuer, the name of the confirming party, the name of the person that casts the vote and the name of the shareholder.

3.120 The procedures in the implementing regulation have the potential to streamline and simplify existing procedures under the CA 2006 which are used to identify ultimate investors, such as the procedure under section 793, which we discuss below.[63] If the Government were to extend the framework set out in SRD II, it could consider creating new obligations on intermediaries which incorporate the content of the implementing regulation.

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61 Commission Implementing Regulation 2018/1212/EU, Official Journal L 223 of 4.9.2018 p 1 ("Implementing Regulation").

62 Implementing Regulation, art 2 and Annex.

63 See from para 3.127 below.

3.121 The second advantage is that extending the application of SRD II would increase the level of harmonisation with other jurisdictions. Consultees have told us that this is particularly important given the cross-border nature of intermediated securities holdings. It would mean that the same rights and obligations would apply across the chain and there would be faster and more effective transmission of information.

3.122 The AGC highlighted "the importance of effective transposition of SRD II requirements to give effect to these rights on a harmonized basis across the EU (including, we hope, the UK post- Brexit)." They said that, along with market standards, the implementation of SRD II was the "most important step" that could be taken to improve the ability of ultimate investors to exercise their ownership rights fully.

3.123 An approach which is consistent with EU-regulated markets could be important for cross-border transactions and could help attract business and maintain the competitiveness of this jurisdiction. For example, an EU investor may be disinclined to invest in UK-listed shares if they are not entitled to the rights and potential benefits under SRD II. In any case, Sir John Dermot Turing told us that where a UK-based intermediary "has an internationally active business there will be a strong business case for voluntary compliance regardless of the UK legal position".

Disadvantages

3.124 We have been told that there would be significant costs implications which Government would need to consider carefully. For example, the implementing regulation, discussed above, prescribes standardised formats of information and minimum types of information. Bringing these types of changes into effect would incur both implementation costs and transitional costs for market participants, which could lead to additional costs for ultimate investors.

3.125 Extending the application of SRD II would also involve substantial changes to the CA 2006 and the FSMA, which would involve implementation costs including the usual costs for businesses and lawyers to update their knowledge and engage in training. However, these costs may be considered to be justified, given the advantages of this approach set out above.

3.126 The comprehensive nature of SRD II may make the option of extending its application attractive. However, it is arguable that a targeted approach, identifying particular problems such as confirmation of voting, transparency and facilitation of voting, and creating bespoke solutions, may be more effective and proportionate. The Government could consult with stakeholders to implement proposals which would be tailored for the UK market.

SECTION 793 OF THE CA 2006

3.127 Although it is not expressly about voting, it is also useful to consider section 793 of the CA 2006 here. This section provides a process under which a public company can request information about its ultimate investors. Under this section, a public company has the power to give a notice to any person who is "interested in the company's

shares". That notice may require a person to confirm their interest and to provide additional information within a reasonable time[64] including:[65]

(1) particulars of the interest in the company's shares and particulars of others' interests in the shares, such as:

(a) the identity of the person interested in the shares; and

(b) whether there is an agreement/arrangement relating to the exercise of rights under the shares or a share acquisition agreement;

(2) where the person who receives the notice has a past interest in the securities, particulars of the identity of the person who held the interest immediately subsequently.

3.128 The company must exercise its powers under section 793 if it receives requests from members of the company holding at least 10% of the paid-up capital of the company that carries a right to vote.[66] A company must also keep a register of information received by it under section 793, which must be kept available for inspection.[67]

3.129 Section 793 appears under Part 22 of the CA 2006, which concerns a public company's right to investigate who has an interest in its shares. Lord Justice Briggs (as he then was) has referred to Part 22 as "a remarkable exception to the general principle that companies are only concerned with legal owners of their shares".[68]

Is section 793 fit for purpose?

3.130 In response to the call for evidence, consultees told us that some companies wish to engage with ultimate investors and require a method of discovering their identity and contact details. UKSA and ShareSoc also told us that some retail investors may sometimes wish to join forces and vote together on a particularly controversial or significant issue. Both issuers and ultimate investors have argued for a way to discover the identity and contact details of ultimate investors. Andrew Turvey, a retail investor, 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.

3.131 At first glance, section 793 provides a method of discovering the identities of the ultimate investors of a company. Members of the company can require the company to exercise its powers under this section and the company must make a register of this information available for inspection.

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64 CA 2006, s 793(7). Where a notice was served on a person outside of the UK, it was held that two clear working days to provide the information was a "reasonable time": *Lonrho plc v Edelman* (1989) 5 BCC 68 at 73.

65 CA 2006, s 793.

66 CA 2006, s 803. Section 803(3) sets out the form requirements for any such request.

67 CA 2006, ss 808 and 809.

68 *Eclairs Group Ltd v JKX Oil & Gas plc* [2014] EWCA Civ 640 at [36] and see CA 2006 Explanatory notes, para 1115, at https://www.legislation.gov.uk/ukpga/2006/46/notes/data.pdf.

3.132 However, there are three potential problems with section 793.

(1) It does not require the provision of contact details for ultimate investors, which means that the company may have immediate access to names of ultimate investors only. We have been told that intermediaries sometimes refuse to provide contact details for ultimate investors, potentially as a way of protecting the personal data of investors. In correspondence, UKSA and ShareSoc have said that it is "well nigh impossible" to obtain information about who owns shares in a way and format that makes correspondence possible.

(2) Computershare pointed out that it provides only a "snapshot of ownership at a given time". Depending on the level of transactions, the list of beneficial owners may change significantly. It is also imposes a costly administrative burden on companies.

(3) Only members of a company can require it to use its powers under section 793. Ultimate investors do not have the right to require the company to use its powers.

Potential solutions

3.133 We think that the first issue highlighted above could be resolved by an amendment of section 793. Currently, a company may request a person to provide "particulars" about an interest in a company's shares. Subsection (5) defines "particulars" as including:

> (a) the identity of persons interested in the shares in question, and
>
> (b) whether persons interested in the same shares are or were parties to—
>
> (i) an agreement to which section 824 applies (certain share acquisition agreements), or
>
> (ii) an agreement or arrangement relating to the exercise of any rights conferred by the holding of the shares.

3.134 This subsection does not exclude the possibility of the contact details being provided, but it does not require it. The subsection could be amended to include a requirement that a person who receives a notice under section 793 must provide the identity and the contact details of the person interested in the shares.

3.135 We cannot see an equally simple legal fix to the second issue outlined above. We think that the "snapshot in time" problem would require a technological solution of a register of beneficial ownership of shares, which could update in real time or sufficiently frequently to be accurate. Such a register would have the obvious benefit of allowing companies to identify their ultimate investors accurately.[69] It would also

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69 We note that Part 21A of the CA 2006 requires certain companies to keep a register of people with "significant control" over the company. "Significant control" includes "indirectly" owning more than 25% of shares in the company: s 790C; Sch 1A, Pt 1. This register is focused on enhancing corporate transparency to tackle the misuse of companies and companies are required to update the register within 14 days of obtaining certain information. In contrast, the purpose of a register of all beneficial owners would be to

enable intermediaries and ultimate investors to identify the ultimate investors in a company. However, it is clear that the creation of such a register would not be possible without significant investment in technology and changes to the current system because investors' positions change rapidly and often.

3.136 Similarly, we do not think that there is an obvious solution to the third issue. Currently, only members can require a company to exercise its powers under section 793.[70] We have considered whether to extend this provision to ultimate investors, or even to members of the public. There are, however, two obstacles.

(1) Cost – if a company was required to exercise its powers under section 793 more often than is currently the case, then it is possible that the costs of doing so could outweigh the benefits. For example, if section 793 were amended to allow ultimate investors holding 10% of the issued share capital to make such a request, then it is possible that such requests would be made more often (because ultimate investors would not be required to convince their intermediaries, as "members", to bring such a request). Companies would also be put to the cost of verifying that ultimate investors were entitled to bring a request in the first place.

(2) Verification – if section 793 were extended to allow ultimate investors (and not general members of the public) to request a company to exercise its powers, how would a company know whether someone claiming to be an ultimate investor had standing to make such a request?

CONFIRMATION OF VOTING

3.137 Consultees have told us that it is difficult for ultimate investors to confirm that their votes have been received and/or counted, or that their intermediary has voted in accordance with their policy or instructions.[71] It appears that it is also difficult for intermediaries themselves to confirm that their votes have been received and counted. 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.

3.138 Consultees have also told us that confirmation of voting is important because:

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enhance the rights of ultimate investors. Such a register would need to be updated in real time or sufficiently frequently to ensure its accuracy.

70 CA 2006, s 803.

71 Of the 23 consultees who responded to this question, 19 agreed that it was difficult for ultimate investors to obtain voting confirmation, 3 disagreed and 1 answered "Other".

(1) there are potential legal consequences for institutional investors, such as pension schemes, which have reporting requirements under the Stewardship Code 2020 and the laws applying to pensions;[72]

(2) there are potential commercial consequences for intermediaries who might wish to demonstrate their commitment to stewardship and ESG issues, but cannot trace their vote higher up in the chain; and

(3) the inability to confirm whether votes have been counted, or even received, by companies, may result in reduced confidence in the system.

3.139 The recent changes to the CA 2006 to allow for confirmation of voting, which we discuss above, apply in limited circumstances.[73]

(1) Section 360AA provides that a traded company must provide a confirmation of receipt of votes which are cast electronically, to the person who cast the vote, which could be the member, the proxy or the representative of the corporation.

(2) Section 360BA provides a member with the right to request information from the company which enables them to determine that their vote has been validly recorded and counted. This section covers votes on a resolution at a general meeting where a poll has been taken.[74] A member may nominate another person, such as an ultimate investor, to exercise this right, under the section 145 procedure which we describe above. However, the section 145 procedure requires a company to amend its articles of association in order to allow a member to make such a nomination. We understand that this provision has not yet been used in this way.

3.140 Consistent with the general approach of the CA 2006, these new provisions are limited to a company's members. An ultimate investor may only receive confirmation of their vote under section 360AA if they have been appointed as the member's proxy and their vote was cast electronically. Under section 360B, they are not entitled to request confirmation.

3.141 Therefore, an ultimate investor who is not appointed as a proxy, but who instructs their intermediary to vote on their behalf, may not request confirmation that the vote has been validly recorded or counted, under either section. Nor is an intermediary, such as an asset manager, who may have voting rights under their agreement with a custodian bank, but who is not a member, entitled to confirm that their vote has been validly recorded and counted.

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72 The PLSA raised this point, saying that "the lack of vote confirmation can have a very real implication for schemes when trying to comply with the new requirements". There are reporting requirements under Principle 8 and Principle 12 of the Stewardship Code 2020 as well as under the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019, SI 2019 No 982, which amends the Occupational Pension Schemes (Investment) Regulations 2005, SI 2005 No 3378.

73 See para 3.114 above.

74 See para 3.12 above.

3.142 The Registrars' Group, Computershare and Equiniti said, in response to the call for evidence, 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 in the hands of those in the investment chain, who should be able to provide the relevant confirmation.

3.143 Consultees representing both institutional and retail investors, including UKSA and ShareSoc, the Investor Forum, the IA, UBS and Aviva, have told us that confirmation of voting is an important issue. As we discuss above, there appear to be industry-led developments in relation to technology, such as the new Proxymity product, which may circumvent some of the practical problems in relation to confirmation of voting. However, if these industry-led initiatives do not result in a widespread voluntary adoption of a system of voting confirmation which resolves the issues raised above, we think that it would be appropriate for the Government to lead further work in this area.

3.144 This work could take the form of a combination of both legislative and regulatory reform. For example, the CA 2006 could be amended to include an obligation on all companies to provide, upon request, information to a member which enables them to determine that their vote has been validly recorded and counted. Alongside this legislative amendment, there could be a corresponding regulatory obligation on the member, and other intermediaries in the chain, to pass that information to other intermediaries or to the ultimate investor, upon request and within a reasonable time. Given the developments already taking place in the industry, we think a technological solution would be found if the law was changed to require vote confirmation.

Chapter 4: Schemes of arrangement

4.1 In the previous chapter, we discussed the general difficulties faced by ultimate investors who wish to exercise the voting rights associated with intermediated securities. In this chapter we discuss schemes of arrangement, in which ultimate investors face particular barriers in relation to voting.

4.2 A scheme of arrangement is a binding compromise or arrangement between a company and its creditors or members.[1] 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.[2] They can also be used to effect a merger or takeover of the company.[3]

THE STATUTORY PROCESS

4.3 Schemes of arrangement are governed by Part 26 of the CA 2006, which sets out a three-step process.[4]

(1) The company or another party[5] must apply to the court under section 896 of the CA 2006 for an order that a meeting of creditors or members (or classes of members or creditors) be summoned.

(2) The company convenes a meeting or meetings. Sections 897 and 898 of the CA 2006 set out the information that must be provided to creditors and members before the meeting. At the meeting, the creditors or members must vote on whether to approve the scheme. We discuss the majority required to approve the scheme below.

(3) After the meeting/s, the company, creditors, members, liquidator or administrator must apply to the court for an order sanctioning the compromise or arrangement.[6]

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

2 CA 2006, s 895(1).

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

4 In *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241, [2002] 2 BCC 300 at [12], Chadwick LJ explained that each of the stages "serves a distinct purpose".

5 Section 896 provides that the application may be made by the company, any creditor or member of the company, the liquidator (if the company is being wound up) or the administrator (if the company is in administration).

6 CA 2006, s 899.

4.4 Unlike other resolutions in the CA 2006 which we discuss above, a vote on a scheme of arrangement has two limbs.[7] Section 899 provides that a court may sanction an 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) 75% in value of the creditors or members (or class of creditors or members) (the "majority in value requirement").

4.5 These requirements are based on the number of creditors or members who are present and who vote on the compromise or arrangement, rather than on the total number of creditors or members. There is no minimum participation level.

The court's discretion

4.6 The court has an unfettered discretion when considering an application to sanction a scheme of arrangement: it does not provide a mere rubber stamp to schemes. In exercising its discretion, the court will consider whether:[8]

(1) the requirements of Part 26 of the CA 2006 have been met;

(2) the class of members or creditors was fairly represented by those who attended the meeting and that the majority of those voting did so in good faith and not coercing the minority in order to promote interests adverse to those of the class they purport to represent;

(3) an intelligent and honest person who is a member of the class acting in their own interests might reasonably approve the scheme; and

(4) there is any blot on the scheme[9]. A blot, or "defect", refers to a technical or legal issue in the drafting of the scheme.

SCHEMES OF ARRANGEMENT AND INTERMEDIATED SECURITIES

4.7 In this scoping paper we focus in particular on the requirement in section 899 of the CA 2006 for approval of the scheme at a meeting of creditors or members and how that requirement may affect the ultimate investors holding intermediated securities.

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7 We discuss special and ordinary resolutions at para 3.13 above.

8 *Re TDG plc* [2008] EWHC 2334 (Ch), [2009] 1 BCLC 445 at [30]; *Re Dee Valley Group plc* [2017] EWHC 184 (Ch), [2018] Ch 55; *Re Rhythmone plc* [2019] EWHC 967 (Ch) at [11]; *Re Equitable Life Assurance Society* [2019] EWHC 3336 (Ch). See G Morse (general ed), *Palmer's Company Law* (2018) paras 12.070 to 12.072.

9 A blot is also referred to as a "defect" on the scheme and refers to a technical or legal issue in the drafting of the scheme. It may not work "according to its own terms" or may infringe "some mandatory position of law": see *Re The Co-Operative Bank Plc* [2017] EWHC 2269 (Ch) at [22] and G Morse (general ed), *Palmer's Company Law* (2018) para 12.072.4. The court will only generally sanction a scheme if satisfied that it will achieve its purpose: *Re Noble Group Ltd (Scheme Sanction)* [2018] EWHC 3092 (Ch) at [102] to [103]. For a recent example, see *Re Steris Plc* [2019] EWHC 751 (Ch), [2019] BCC 924 at [35] to [37], where the draft scheme stipulated an incorrect date for attribution of entitlement. The court permitted the scheme to be amended to reflect shareholder expectations.

The majority in numbers ("headcount") test

4.8 The first limb is the headcount test. A scheme of arrangement must be approved by a majority in number of members or creditors who vote on the scheme. Each member or creditor will count as one vote.

4.9 The headcount test has been part of the law applying to schemes of arrangement for over a century.[10] Its aim is the protection of small shareholders and creditors. In 2001, the Company Law Review Steering Group said:[11]

> The requirement for a majority in number originated when the procedure applied only to compromises or arrangements with creditors, presumably to place a check on the ability of creditors with large claims to carry the day. When the section was extended to compromises with members in 1900 the composition of the required majority remained unchanged … No other meeting of members of a company requires a majority otherwise than by reference to value or voting powers.

4.10 For schemes of arrangement involving shares in a company, only a person listed on the company's register of members will count as a "member".[12] As we discuss in Chapter 2, the registered owners of the shares are likely to be intermediaries, holding shares for ultimate investors through omnibus accounts. An intermediary, regardless of the number of shares held for its account holders, will count as only one shareholder for the purposes of the headcount test. It is arguable that this approach does not reflect the current commercial reality of intermediaries holding shares for hundreds or thousands of ultimate investors in omnibus accounts. It may also lead to manipulation of the vote by "share-splitting" or to a situation where a majority in number cannot be reached. We discuss these potential problems below.[13]

4.11 The headcount test may also cause problems for schemes of arrangement involving debt securities. In particular, where there is a global note,[14] it is possible that there will be only one legal owner, and thus only one creditor. In that situation, it would be impossible to apply the headcount test.[15]

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10 It was first introduced in the Joint Stock Companies Act 1870, s 2. See J Payne, *Intermediation and Beyond* (2019) p 181.

11 Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure* (2000) para 11.34, at https://webarchive.nationalarchives.gov.uk/+/http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/clr-review/page25080.html/.

12 See *Re Abbey National plc* [2004] EWHC 2776 (Ch), [2005] 2 BCLC 15 at [13]: "Where an individual has invested money with an institution to acquire shares for his benefit that institution will be the shareholder in the relevant company and it will be that institution which will be consulted over any scheme of arrangement."

13 See from para 4.45 below.

14 See para 2.66 above.

15 J Payne, *Intermediation and Beyond* (2019) p 180; R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-21. See para 4.45 below.

The majority in value test

4.12 The second limb of the requirement in section 899 is the majority in value test. Under this limb, the majority voting in favour of the scheme must represent 75% in value of the creditors or members (or class of creditors or members) who vote on the scheme.

4.13 This limb raises the same issues as we discuss in relation to voting on resolutions.[16] Namely, an ultimate investor who holds shares through an intermediated securities chain does not have an automatic entitlement to vote under the CA 2006. Instead, the ultimate investor will need to rely on the terms of their agreement with their intermediary and use one of the mechanisms set out in Chapter 3 in order to vote on the scheme.[17]

Examples of schemes of arrangement: Unilever and Sirius Minerals

4.14 The effect of section 899 of the CA 2006 on ultimate investors in an intermediated securities chain can be seen in two recent examples.

4.15 The first example is that of Unilever plc. In October 2018, shareholders in Unilever plc were due to vote on a scheme of arrangement related to the company becoming a subsidiary of a new Dutch holding company, together with the relocation of the company's London headquarters to Rotterdam. The impending vote received considerable media attention and was expected to be controversial.

4.16 The headcount test might have been expected to make the votes of individual holders of small numbers of shares important to the passing of the vote. However, many such shareholders held their shares through brokers and other intermediaries, who were the legal owners of the shares. As such, an intermediary holding shares for 20,000 ultimate investors would only count as a single "member" for the purposes of the headcount test, diluting the voting power of such ultimate investors. This dilutive effect of intermediation was criticised by shareholder advocacy groups. The vote was ultimately cancelled, although we understand that several factors led to the cancellation.[18]

4.17 The second example is that of Sirius Minerals plc, which was a mining company with a mine in North Yorkshire. Sirius Minerals required more funds in order to avoid insolvency. A bid for its entire share capital by Anglo American Projects UK Ltd was put before shareholders by way of a scheme of arrangement under section 899.

4.18 Following an initial application, the meeting to approve the scheme was held in March 2020. At the meeting, 812 out of the 1,314 members present voted to approve the scheme, with 502 members voting against the scheme. The votes in favour represented over 80% of the value of shares voted. Both the headcount test and the majority in value test were satisfied.[19]

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16 See the review on consultees' views from para 3.55 above.

17 We discuss the different mechanisms for voting from para 3.17 above.

18 Unilever, *Statement of the Board of Unilever* (5 October 2018), at https://www.investegate.co.uk/unilever-plc--ulvr-/rns/statement-from-the-board-of-unilever/201810050700030963D/.

19 *Re Sirius Minerals plc* [2020] EWHC 1447 (Ch) at [17].

4.19 The proposed scheme was controversial because some ultimate investors had purchased their shares in 2019 for more than 20 pence for each share and the offer was for 5.5 pence for each share. When the company applied to the High Court to sanction the scheme under section 899, concerns were expressed that individual ultimate investors were not able to vote on the scheme, because they were not included on the company's register of members.

4.20 In February 2020, the company had approximately 7 billion ordinary shares, held by 4,628 members on the company register. Mr Justice Fancourt said that it was clear that the number of registered members concealed the fact that "it is believed that tens of thousands of small investors acquired a beneficial interest in shares in the company held by … nominees."[20]

4.21 In April 2020, the Law Commission requested a copy of the register of Sirius Minerals plc (as at 1 January 2020) under the procedure in section 116 of the CA 2006. On the face of the register, it was apparent that the majority of shares – approximately 6.2 billion – were held by intermediaries.

4.22 In sanctioning the scheme and considering whether the class of members was fairly represented at the meeting by those who attended, Mr Justice Fancourt said the fact that many ultimate investors did not have the opportunity to vote was not "directly relevant to an assessment of fair representation of members, because beneficial shareholders are not members". He said further:[21]

> If sufficient numbers of beneficial shareholders had given instructions to their nominees to vote against the scheme, the outcome of the vote might have been different, but the company cannot be blamed for that. As the law stands, it had no obligation to communicate with the beneficial owners of its shares.

4.23 These two cases are recent examples of schemes of arrangement on which ultimate investors wished to have their voices heard but were prevented by the tests in section 899.

NEW PART 26A OF THE CA 2006

4.24 In June 2020, the Corporate Insolvency and Governance Act 2020 inserted, in Part 26A of the CA 2006, a new type of scheme for a company in financial difficulties which affect its ability to carry on business.[22]

4.25 The new type of scheme is modelled on schemes of arrangement in Part 26. The procedure is as follows.

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20 *Re Sirius Minerals plc* [2020] EWHC 1447 (Ch) at [2].

21 *Re Sirius Minerals plc* [2020] EWHC 1447 (Ch) at [22].

22 CA 2006, s 901A. Part 26A came into force on 26 June 2020.

(1) The company, creditors, members, administrator or liquidator may propose a compromise for the purpose of addressing the company's financial difficulties.[23]

(2) Upon application, the court orders a meeting or meetings of the creditors or members (or classes of creditors or members) to vote on the compromise.[24] Sections 901D and 901E set out the information that must be provided to the creditors and members before the meeting.

(3) After the meeting/s, the company, creditors, members, liquidator or administrator must apply to the court for an order sanctioning the compromise or arrangement.[25]

4.26 Unlike section 899, a vote approving a scheme under section 901F must only satisfy the majority in value test. Section 901F does not include an additional requirement that the scheme must be approved by a majority in number of members or creditors who vote on the scheme.

4.27 When the Department for Business, Energy and Industrial Strategy consulted on this new statutory compromise scheme, some consultees submitted that the headcount test should not form part of the new provisions.[26] However, in the Government response to the consultation, the Department noted that although "attracted by respondents' reasoning on why a majority in number of creditors should not be needed", they were "concerned that minority creditor interests be adequately safeguarded".[27] The Department suggested that the headcount test could be replaced with a requirement that more than half of the total value of "unconnected creditors" voted in support of the scheme.[28]

4.28 Ultimately, the new provisions included neither the headcount test nor an "unconnected creditors" test. Instead, the new provisions rely on the court's discretion to protect small creditors or members.[29]

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23 CA 2006, s 901A(3).

24 CA 2006, s 901C.

25 CA 2006, s 901F.

26 The Insolvency Service, *Summary of Responses: A Review of the Corporate Insolvency Framework* (2016), responses from Professor Jennifer Payne, the Loan Market Association and PricewaterhouseCoopers LLP, at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/578524/Summary_of_responses_26-10-16_Redacted.pdf.

27 Department for Business, Energy and Industrial Strategy, *Government response: Insolvency and Corporate Governance* (2018) paras 5.154 and 5.155, at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version__with_Minister_s_photo_and_signature__AC.pdf.

28 A "connected" party under the Insolvency Act 1986 is a person who is a director or shadow director of the company or an associate of such a director or shadow director or who is an associate of the company: s 249. Section 435 of that Act defines "associate".

29 Corporate Insolvency and Governance Act 2020, Explanatory Notes, para 190.

CONSULTEES' VIEWS

4.29 In response to the call for evidence, consultees generally agreed that the headcount test in section 899 could be problematic in the context of intermediated securities.[30]

The current system does not work

4.30 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 [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".

4.31 Consultees told us that sometimes ultimate investors wish to "rematerialise" their investments from an electronic to a paper, certificated, holding. An ultimate investor who rematerisalises their investments holds securities directly and becomes the member. Ultimate investors may wish to do this temporarily for a scheme of arrangement vote, or permanently. It is one way to circumvent the problems caused by the headcount test. However, UKSA and ShareSoc also told us that ultimate investors find it difficult to rematerialise their holdings and that intermediaries are reluctant to facilitate this process.

4.32 PIMFA said that rematerialising is "cumbersome, expensive and … dependent on the share registrar being geared up to process transactions very quickly and efficiently". PIMFA noted that there will be a period of time between the "rematerialisation" and returning to dematerialisation, during which it is difficult to effect transactions because of "uncertainty as to when the stock can be delivered for settlement".

4.33 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 for over a century, and it is "hardly surprising" that the current wording does not take ultimate investors and intermediation into account.[31]

The headcount test is unfair to ultimate investors

4.34 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.[32] John Hunter, a retail investor, observed that the headcount test was "clearly designed with creditors in mind". He said that the result of the test was that it has allowed the approval of schemes of arrangement "despite being clearly unfair to a majority of ultimate investors".

4.35 Andrew Turvey, a retail investor, said that ultimate investors who purchase shares through an intermediary have a "legitimate expectation" that their rights will be

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30 Of 19 consultees who answered question 7, 12 agreed and 7 answered "other". No consultees disagreed.

31 L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 377 and 378.

32 These consultees included the CLLS, Dr Ewan McGaughey, Eric Chalker, Roger Lawson, John Hunter, Andrew Turvey, and the QCA.

"substantially identical" to their rights if they bought shares directly, and noted that this is not the case with the application of the headcount test.

4.36 Eric Chalker, a retail investor, said that the "mistreatment of ultimate investors" through the application of section 899 of the CA 2006 is "nothing short of scandalous", especially when a scheme of arrangement relates to a takeover. 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", and that it "effectively disenfranchises many ultimate investors".

Other responses

4.37 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 arrangement 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".

4.38 Shepherd and Wedderburn 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". Shepherd and Wedderburn and the Law Society of Scotland each said that resolution of voting rules generally would not address those separate policy issues.

4.39 Computershare and the Registrars' Group both also 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".

A POSSIBLE SOLUTION: REMOVING THE HEADCOUNT TEST

4.40 If the Government were to remove the headcount test from section 899 of the CA 2006, a court could sanction a scheme where there had simply been approval by a number representing 75% in value of the members or creditors of the company.

4.41 This approach would require a relatively simple amendment to section 899, by removing the words which we have italicised:

> If a *majority in* number representing 75% in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting summoned under section 896, agree a compromise or arrangement, the court may, on an application under this section, sanction the compromise or arrangement.

4.42 This is not the first time that this amendment has been suggested. The Company Law Review Steering Group referred to the requirement for the headcount test as

"irrelevant and burdensome." The Steering Group further explained the background to the test:[33]

> The requirement for a majority in number originated when the procedure applied only to compromises or arrangements with creditors, presumably to place a check on the ability of creditors with large claims to carry the day. When the section was extended to compromises with members in 1900 the composition of the required majority remained unchanged. A number of recent developments have resulted in shareholders in listed companies consisting to such a great extent of nominees, that the decisions of the true owners bears little or no relation to whether or not a majority in number is attained. No other meeting of members of a company requires a majority otherwise than by reference to value or voting powers.

Removing a test that is "irrelevant and burdensome"

4.43 This approach could provide significant advantages, particularly in relation to corporate governance. Under the current position an intermediary will only be counted once, regardless of the number of ultimate investors for which it holds intermediated securities. This means that the general position is that an intermediary's vote may not be representative of the views of all of its ultimate investors who wish to have their voices heard. A court may allow an intermediary to split their vote, so that one intermediary votes both for and against a scheme. However, these votes will cancel each other out, which may cause problems, particularly in relation to creditor schemes, which we discuss below.[34]

4.44 If the headcount test were to be removed, the scheme could be approved by members or creditors (or class of members or creditors) holding 75% in value of the relevant issued shares or debt, regardless of how many members voted. An ultimate investor who had an agreement with their intermediary which allowed them to vote or instruct their intermediary on voting could have their views represented. The amendment would, for example, avoid the situation where ultimate investors holding shares in nominee accounts have to "rematerialise" these shares, so they appear on the share register and are able to be counted (which we understand happened in advance of the proposed Unilever vote).[35]

4.45 This approach would also remove the possibility of members manipulating the vote by splitting their holdings of shares. This risk was raised at the time of the CA 2006, where the Attorney General said:[36]

> The noble Lord tempts us by painting a picture of abuse taking place, with people splitting their shareholdings up into a series of nominee companies. It may be that

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33 The Company Law Review Steering Group, *Modern Company Law For a Competitive Economy: Completing the Structure* (2000) paras 11.9, 11.34, at https://webarchive.nationalarchives.gov.uk/+/http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/clr-review/page25080.html/.

34 See para 4.48 below. See J Payne, *Schemes of Arrangement Theory, Structure and Operation* (2014) p 67; and *Re Equitable Life Assurance Society* [2002] EWHC 140 (Ch), [2002] BCC 319 at 327.

35 We discuss the proposed Unilever scheme of arrangement from para 4.15 above.

36 *Hansard* (HL), 16 May 2006, vol 682, col 217.

> he has evidence that that takes place; if so, it is not evidence that has reached me and I note that the noble Lord shakes his head—so it seems that he does not have evidence of that, either. That theoretical possibility is not a good enough reason to do away with the protection which this provides.

4.46 Nevertheless, Professor Jennifer Payne has said it "is accepted that share splitting is a common occurrence."[37] We also have a relatively recent example. In *Re Dee Valley Group plc*,[38] an employee of the company that was the subject of the scheme bought a number of shares and gave one share each to over 400 individuals, as a way of manipulating the headcount test. The chair of the meeting disallowed the votes of those individuals, with the result that the majority in number of the members did approve the scheme. Sir Geoffrey Vos, Chancellor of the High Court, held that the chair was right to reject those votes, because the chair was entitled to protect the integrity of the meeting against "manipulative practices such as share-splitting that would frustrate its statutory purpose".[39]

4.47 In the context of debt securities, the CLLS said in response to the call for evidence that:

> One of our members can evidence a recent scheme of arrangement meeting 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.

4.48 Removing the headcount test would also solve the problem of satisfying that test when there is only one, or two, members or creditors. This is not as far-fetched as it may seem. For credit schemes involving bonds, it is not clear who the "creditors" will be. The term "creditor" is not defined in the CA 2006.[40] Depending on how bonds are issued (and particularly where they are issued as a "global note"), it is possible that there will be only one legal owner, and thus only one creditor. In that situation, it would be impossible to apply the headcount test.[41] In the context of equity securities, a similar example arose recently in Jersey in *Atrium European Real Estate Limited v NB (2019) BV*,[42] where only two shareholders were able to attend and vote on the scheme.

A protection for small shareholders and creditors

4.49 The principal disadvantage of amending section 899 of the CA 2006 to remove the headcount test is the risk that it would remove a protection for small shareholders or

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37 J Payne, *Schemes of Arrangement Theory, Structure and Operation* (2014) p 65.

38 [2017] EWHC 184 (Ch), [2018] Ch 55.

39 [2017] EWHC 184 (Ch), [2018] Ch 55 at [58].

40 J Payne, *Intermediation and Beyond* (2019) pp 175 and 176.

41 J Payne, *Intermediation and Beyond* (2019) p 180. When bonds are issued as a "global note", only one note is issued, representing the whole of the bond issue, regardless of the number of ultimate investors. That global note is held by an international central securities depository, which holds the note for its account holders (which may be the ultimate investors or may be intermediaries for the ultimate investors): L Gullifer and J Payne, *Corporate Finance Law: Principles and Policy* (2nd ed 2015) pp 376, 385.

42 [2019] JRC 198 (Royal Court, Jersey).

creditors. Currently, the headcount test equates the vote of a retail investor holding 100 shares with the vote of a large, potentially corporate or institutional, shareholder holding 1 million shares in the company. In this way, small shareholders or creditors can effectively influence a scheme of arrangement.

4.50 Schemes of arrangement may be used to effect significant changes which will affect the value or nature of an investor's shareholder or a creditor's debt. Such changes may include a takeover by another company (such as occurred when Anglo-American plc acquired Sirius Minerals plc),[43] a merger of companies under a new holding company, or a debt restructuring, changing the amount or payment terms of a company's debts. It is therefore important to ensure that small shareholders and creditors have adequate protection.

4.51 However, even if the headcount test were to be removed, small shareholders and creditors would not be left wholly without protection. The court does not provide a mere rubber stamp to schemes and will consider several factors before exercising its discretion to approve a scheme.[44] One factor is whether:

> the class of members or creditors was fairly represented at the court meeting by those who attended and that the majority of those voting did so in good faith and not coercing the minority in order to promote interests adverse to those of the class they purport to represent.

4.52 Professor Jennifer Payne has said that the court's discretion can operate as a "real protection" for minority shareholders.[45] In its response to the call for evidence, the CLLS suggested that if the headcount test were removed, the court could take ultimate investors into account when exercising its discretion. Parties could:

> [rely] on the court's general 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.

4.53 The potential for reliance on the court's discretion to safeguard the interests of small shareholders and creditors was rejected during the debates on the CA 2006, when it was suggested that the headcount test should be removed from the draft Bill. The Attorney General said:[46]

> It could be said, "Well, we could rely upon the court's discretion to protect those members". That is not a satisfactory answer—why should the court have a better

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43 We discuss the Sirius Minerals scheme of arrangement from para 4.17 above.

44 See para from 4.6 above.

45 J Payne, *Schemes of Arrangement Theory, Structure and Operation* (2014) p 75 and see *In the Matter of the British Aviation Insurance Company Ltd* [2005] EWHC 1621 (Ch), [2006] BCC 14 at [118].

46 *Hansard* (HL), 16 May 2006, vol 682, col 217.

view of the interests of those persons than they have themselves? So, in principle, I could not accept the amendment.

4.54 However, we note that the headcount test was not included in an equivalent provision in the recent Corporate Insolvency and Governance Act 2020, which inserted the new Part 26A in the CA 2006. As we discuss above, Part 26A is a new type of scheme for a company in financial difficulties which affect its ability to carry on business.[47] Section 901F, which deals with approval of the scheme, does not include the headcount test. The explanatory notes say:[48]

> Drawing on well-established principles in schemes of arrangement, the court has absolute discretion over whether to refuse to sanction a plan even though the necessary procedural requirements have been met. This may be, for example, because a plan is not just and equitable.

4.55 This suggests that the Government's thinking may have moved on since the 2006 Act.

What else could be done to protect small shareholders and creditors?

4.56 We think that there is a strong argument for removing the headcount test in section 899 of the CA 2006. Although there is also a good argument that the court's discretion is sufficient, there may be other amendments which could be made to section 899 if the Government wished to bolster the protection of small shareholders and creditors.

4.57 Other common law jurisdictions have also considered whether the headcount test, or an equivalent test, is required to protect small shareholders and creditors. Below we consider two approaches, which were suggested by the CLLS in its response to the call for evidence.

A requirement that votes cast against the arrangement do not exceed a certain %

4.58 One option for providing a safeguard for small shareholders and creditors would be to replace the headcount test with another threshold. For example, in Hong Kong, following instances of share splitting, the headcount test has been replaced in certain circumstances.[49] Where a scheme of arrangement concerns a general offer to buy back shares or a takeover offer of a company, section 674 of the Hong Kong Companies Ordinance provides that the scheme must meet two requirements:[50]

(1) members representing at least 75% of the voting rights of the members present and voting must vote in favour of the scheme; and

(2) the votes cast against the scheme must not exceed 10% of the total voting rights attached to all "disinterested" shares in the company.

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47 CA 2006, s 901A. Part 26A came into force on 26 June 2020.

48 Corporate Insolvency and Governance Act 2000, Explanatory Notes, para 190.

49 See eg *Re PCCW Ltd* [2009] 3 HKC 292 (Hong Kong Court of Appeal) and S H Goo, "Headcount test and scheme of arrangement" (2010) 126 (Oct) *Law Quarterly Review* 517.

50 Companies Ordinance, Cap 622, s 674(2) (Hong Kong).

4.59 This second requirement provides small shareholders with some protection from being bound to a scheme by majority shareholders. Subsection (3) sets out a comprehensive definition of "disinterested shares". In summary, it excludes shares owned by the offeror or parties to an acquisition (or their agents or associates) from the calculation.

4.60 In practice, an amendment such as that included in the Hong Kong Companies Ordinance would enable minority shareholders to prevent the sanction of a scheme if they own 10% of the shares in the company. Without this safeguard these shareholders would need to own more than 25% of the company in order to influence the scheme.[51]

Making the headcount test discretionary

4.61 Another option to provide additional protection to small shareholders and creditors would be to retain the headcount test, but to allow a court to dispense with it in certain circumstances.

4.62 This approach has been taken in Australia, where section 411(4)(a)(ii) of the Corporations Act 2001 (Cth) provides that a compromise or arrangement is binding on members if a resolution in favour is:

> (A) *unless the Court orders otherwise*—passed by a majority in number of the members, or members in that class, present and voting (either in person or by proxy); and
>
> (B) if the body has a share capital—passed by 75% of the votes cast on the resolution; and
>
> … approved by an order of the Court. (Emphasis added.)

4.63 Paragraph (A) allows the court to depart from the headcount test. This power was included by amendment in 2007 to address concerns about share splitting to manipulate the vote.[52] However, in *Re Boart Longyear Limited*,[53] the Australian Federal Court found that the court's power to dispense with the headcount test was not limited to preventing share splitting. Instead, it was Parliament's intention that it should be used, albeit rarely, where the vote had been "unfairly influenced":[54]

> I do not agree that Parliament intended that the Court should not exercise the dispensing power (and deny shareholders the benefits of a scheme) where the outcome of a vote has been unfairly influenced by conduct, disclosure or circumstances affecting *how* members or creditors voted. In my view, it is open to

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51 It is also in line with the requirement set out in the Hong Kong Code on Takeovers and Mergers for approving takeover and privatisation schemes: Rule 2.10.

52 Corporations Amendment (Insolvency) Act 2007 (Cth); see Explanatory Memorandum 4.179 and 4.181, at http://www.austlii.edu.au/cgi-bin/viewdoc/au/legis/cth/bill_em/cab2007390/memo_0.html.

53 [2019] FCA 62.

54 [2019] FCA 62 at [155] to [160]. Justice Farrell said that Parliament's intention was that the headcount test should only be dispensed with "rarely" to avoid undermining the test, which protects the interests of minority shareholders.

the Court to make an order dispensing with the headcount test where there is evidence that the integrity of the vote at the scheme meeting has been impugned due to activities which unfairly influenced it.

4.64 If the Government were to decide to take this approach, we think that a similar provision could be interpreted widely. The court should have a broad discretion to dispense with the headcount test, to cover the following potential problems:

(1) in the common situation where an intermediary holds many shares in an omnibus account, the headcount test could be dispensed with so that the intermediary's vote would accurately represent the views of ultimate investors, particularly where a vote is particularly controversial;

(2) manipulation of the vote by share splitting; and

(3) where the test cannot be satisfied because a majority is impossible.

4.65 Such an application to the court to dispense with the headcount test could be made during the initial application for a scheme of arrangement under section 896.[55] This approach would mean that everyone involved in the scheme would know in advance whether the headcount test would be applied, which would enable them to plan for the vote accordingly. An application to dispense with the headcount test could be made by a member, the company, or a liquidator.

4.66 Regardless of the outcome of the application to dispense with the headcount test, the court would still exercise its discretion when considering whether to sanction a scheme of arrangement at the second court hearing under section 899.[56]

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55 See para 4.3 above.

56 See para 4.6 above.

Chapter 5: The "no look through" principle

5.1 An ultimate investor's ability to bring proceedings against an intermediary or an issuing company could have the potential to serve as an important tool of corporate governance and might, for example, deter the board of directors from acting otherwise than in investors' interests. The ability to sue could also enable an ultimate investor to seek redress for any damage or injury caused to them by the actions of the company or intermediary. However, the ultimate investor's rights against the issuing company and intermediaries are limited significantly by a legal concept known as the "no look through" principle.

5.2 In this chapter we consider the practical effects of the no look through principle, and set out possible solutions to the issues to which it can give rise.

THE EFFECT OF THE NO LOOK THROUGH PRINCIPLE

5.3 Under the law of England and Wales, an ultimate investor in an intermediated securities chain 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. In *Secure Capital SA v Credit Suisse AG,*[1] Lord Justice David Richards explained:

> The system operates on the basis of a "no look through" principle, whereby each party has rights only against their own counterparty.

5.4 This approach is consistent with trusts law, under which there is a general rule that a beneficiary of a sub-trust may not have recourse against the head trustee.[2] Similarly, an ultimate investor cannot bring an action for breach of contract against a higher-tier intermediary or an issuing company because they only have a contract with their immediate intermediary.[3]

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1 [2017] EWCA Civ 1486, [2017] 2 Lloyd's Rep 599 at [10]. See also the first instance decision in which Mr Justice Hamblen, when considering counsels' submissions in the Court of Appeal, referred to "the unanimous views of the commentators relating to intermediated securities, which, for good reason, is to the effect that all rights to sue the issuer under a bearer note are held and exercisable only by the bearer, not an intermediary and certainly not the ultimate investor": [2015] EWHC 388 (Comm) at [58].

2 *Hayim v Citibank NA* [1987] AC 730 at 747 to 748; *Parker-Tweedale v Dunbar Bank plc* [1991] Ch 12 at 19; R Goode, "The Nature and Transfer of Rights in Dematerialised and Immobilised Securities" (1996) 4 *Journal of International Banking and Financial Law* 167 at 172; FMLC, *Issue 3 – Property interests in investment securities* (July 2004), at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf. The authors of *Lewin on Trusts* (20th ed 2020) say (at 41-077, 47-006) that where an interest is settled into a separate trust, it is unclear whether the beneficiaries of the sub-trust have standing to sue the trustees of the head-trust "in the absence of special circumstances". In *Hayim v Citibank NA* [1987] AC 730 at 747 to 748, the Privy Council said: "when a trustee commits a breach of trust or is involved in a conflict of interest and duty or in other exceptional circumstances a beneficiary may be allowed to sue a third party in the place of the trustee."

3 This is known as privity of contract: see *Chitty on Contract* (33rd ed 2019) para 18-003. Subject to certain exceptions, the Contracts (Rights of Third Parties) Act 1999 allows a third party to enforce a term of a

5.5 One advantage of the no look through principle is that each party in the chain can be certain of their rights and obligations. As we explain above, neither an issuing company nor intermediaries higher in the chain will be aware of the identity of the ultimate investors. Similarly, the fast-moving nature of the market may make it difficult for participants to ascertain the identities of their ultimate investors.[4] Professor Louise Gullifer QC has said that: "the benefits of the no look through principle are structural and contribute greatly to the efficient operation of the system and, to a large extent, to legal certainty."[5] However, as Richard Salter QC points out, the ultimate investors are the ones who have taken the economic risk by investing in a company, yet they "get the downside of the advantages that this principle confers on others".[6]

5.6 The effect of the no look through principle is that if a higher-tier intermediary loses or disposes of intermediated securities, the ultimate investor will have no right to bring a claim against them directly.[7] Nor will an ultimate investor have the right to bring an action against an issuing company if, for example, it defaults on its obligations to its members.

5.7 The no look through principle does not bar a claim in tort, such as a claim for negligence. In *Secure Capital SA v Credit Suisse AG*,[8] Lord Justice David Richards said, in relation to a contract claim and the no look through principle, that it was "not suggested that a claim in tort, if sustainable, would be similarly barred". However, it may be difficult on such facts to establish a duty of care in negligence, given the proximity requirements for a claim in pure economic loss.[9]

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contract in its own right if: (1) the third party is specifically mentioned in the contract as someone authorised to enforce it; or (2) the term "purports to confer a benefit" on that third party. However, the operation of the Act may be excluded by the terms of the contract, preventing third parties from relying on it. In practice, the Act is usually excluded by the terms of the contracts between intermediaries in the chain.

4 FMLC, *Issue 3 – Property interests in investment securities* (July 2004), at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf.

5 R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-21.

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

7 The claim we refer to is one based in either contract or trusts law. See also Fiduciary Duties of Investment Intermediaries (2014) paras 11.115 to 11.117.

8 [2017] EWCA Civ 1486 at [56]. We discuss this case in detail from para 5.15 below.

9 See *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465; *Playboy Club London Ltd v Banca Nazionale del Lavoro SpA* [2016] EWCA Civ 457, [2016] 1 WLR 3169; and M A Jones (general editor), *Clerk & Lindsell on Torts* (23rd ed 2020) para 9-12 onwards. In response to the call for evidence, Sir John Dermot Turing said: "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." Similarly, in response to the call for evidence, Dr David Gibbs-Kneller suggested that an ultimate investor may be able to bring a claim against the directors of a company for breach of fiduciary duty. However, this would require the ultimate investor to establish a "special factual relationship" between the ultimate investor and director: see the Court of Appeal discussion in *Peskin v Anderson* [2001] 1 BCLC 372 at [33] and [34] in relation to the relationship between a director and former member of the company. This relationship "must be something over and above the usual relationship" between a director and shareholder, and it will not be enough that the actions of directors have the potential to affect the shareholder: *Sharp v Blank* [2015] EWHC 3220 (Ch) at [12],

5.8 There are also some statutory exceptions to the no look through principle. For example, an ultimate investor may bring an action against a company under certain provisions in the FSMA. Section 90A of the FSMA allows a person who has acquired "any interest" in securities to bring an action against a company for including misleading information in a company prospectus or other published information. The drafting of this section is broad and has been interpreted as giving an ultimate investor, as well as a member, standing to bring a claim.[10]

5.9 In theory, depending on the circumstances, the ultimate investor could claim against their immediate intermediary, encouraging them to claim against the next intermediary, and so on up the chain. Larger institutional investors could also use their commercial position to persuade their immediate intermediary to take action, or to influence other intermediaries in the chain.

5.10 Such action or litigation would be complex and time-consuming because of the need for each intermediary in the chain to sue the one above it, in order to reach the issuer. In practice, intermediaries often include a term in their contract with an ultimate investor which allows them to sue the next intermediary in the chain at their discretion. In some circumstances, which we discuss below, the intermediary may be precluded from bringing an action against the issuer by the CA 2006.[11]

RECENT CASES

5.11 The following recent cases have highlighted the effect that the no look through principle can have on the ability of ultimate investors to challenge the actions of an intermediary or issuing company and how ultimate investors may attempt to circumvent its effect.

Eckerle v Wickeder Westfalenstahl GmbH

5.12 In *Eckerle v Wickeder Westfalenstahl GmbH*,[12] the ultimate investors in an intermediated securities chain were prevented from challenging a special resolution under section 98 of the CA 2006.

5.13 Section 98 provides that a special resolution to re-register a public company as a private limited company can be challenged by "the holders of not less … than 5% in nominal value of the company's issued share capital". Although the ultimate investors held more than 5% of the value of the company's issued share capital, Mr Justice Norris held that they were not entitled to bring proceedings under this section. Mr Justice Norris emphasised that "holder" in section 98 means the person whose name is on the register of members, and that there would have to be an "extremely strong reason" to read section 98 differently from "the orthodox understanding of company law".[13]

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10 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250, which we discuss from para 5.24 below.

11 See para 5.14 below.

12 *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), [2014] Ch 196.

13 *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), [2014] Ch 196 at [17] to [23].

5.14 Mr Justice Norris considered whether the member on the register, the Bank of New York ("BNY"), could be joined to the proceedings. However, an application under section 98 may not be brought "by a person who has consented to or voted in favour of the resolution".[14] BNY had split its vote to represent ultimate investors who wanted to vote in favour of the resolution, and ultimate investors who wanted to vote against the resolution. The intermediary had therefore "voted in favour of the resolution" and was barred from bringing an application. Mr Justice Norris noted:[15]

> I am conscious that my reading of the Act does deprive the claimants as indirect investors of the sort of protection which those who formulated the 2006 Act thought ought to be extended to minority shareholders. That is not a particularly comfortable conclusion at which to arrive …

Secure Capital SA v Credit Suisse AG

5.15 In *Secure Capital SA v Credit Suisse AG*,[16] the ultimate investor, Secure Capital, acquired an interest in bearer notes issued by Credit Suisse AG through a private placement (that is, an issue of securities not offered to the public). They acquired the interest through an intermediary, RBS Global Banking (Luxembourg) SA. The bearer notes were represented by a global bearer security which was deposited with Bank of New York Mellon ("BNYM").

5.16 Secure Capital claimed that Credit Suisse had failed to disclose certain information that would render the notes worthless, in breach of a term in the documents governing the notes in relation to misleading statements.[17] Credit Suisse applied to strike out the claim or, in the alternative, for summary judgment, on the basis that under the law of England and Wales, only BNYM, as holder of the notes, could bring a claim for breach of a term of the notes.

5.17 The Court of Appeal held that Secure Credit's claim was of a contractual nature. Because the notes were held by a CSD in bearer form, Secure Capital, as the ultimate investor, had no contractual relationship with the issuer. [18] Therefore, summary judgment was awarded to Credit Suisse.[19]

5.18 Secure Capital pointed out that if it could not bring a claim for breach against Credit Suisse, then no one could: BNYM, the holder of the notes, had no economic interest

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14 CA 2006, s 98(1).

15 *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), [2014] Ch 196 at [30] and [31].

16 [2017] EWCA Civ 1486.

17 As the misleading statements were made in contracts rather than in "published information relating to the securities", section 90A of the FSMA was not available to the claimant.

18 The notes were subject to conditions which excluded the operation of the Contracts (Rights of Third Parties) Act 1999.

19 Commentators consider that this case is important because it contains authoritative endorsement of the no look through principle, referred to by David Richards LJ: *Secure Capital SA v Credit Suisse AG* [2017] EWCA Civ 1486, [2017] 2 Lloyd's Rep 599 at [9] to [11]. See R Salter, *Intermediation and Beyond* (2019) pp 134 to 138.

in the note and therefore could prove no loss.[20] It is arguable that this meant that there was a gap in the protection afforded to both the ultimate investor and the intermediary in relation to a contractual claim. However, Lord Justice David Richards pointed out that if it had been intended that parties lower down the chain could be entitled to sue in contract for breach, "the documents could and would surely have so provided". His Lordship also noted that it had not been suggested that "a claim in tort, if sustainable, would be similarly barred".[21]

Privatbank

5.19 *Re Public Joint-Stock Company Commercial Bank "Privatbank"*,[22] demonstrates the lengths that parties must go to ensure that ultimate investors have rights in relation to an issuer. The question in *Privatbank* was whether the ultimate investors, who were the ultimate noteholders in a debt security arrangement, were "creditors" for the purposes of voting on a scheme of arrangement under section 899 of the CA 2006.[23]

5.20 The notes were issued by ICBC Standard Bank plc ("ICBC") and were held by a CSD. The proceeds of the notes issue were used to make a loan from ICBC to Privatbank. The notes were secured by a charge over all the rights (such as the right to repayment) under the loan made to Privatbank. The charge was granted by ICBC in favour of a security trustee for the noteholders (that is, the ultimate investors).

5.21 Under the terms of the security arrangement, the noteholders had a direct right of recourse against Privatbank in certain circumstances.[24] Additionally, Privatbank entered into a deed poll stating that, if it failed to make any payment under the loan, it would be liable directly to the noteholders.[25]

5.22 On the face of the facts before the court, the noteholders were not creditors of Privatbank, because it was not the issuer of the notes. However, the court held that the noteholders were contingent creditors of Privatbank on two bases. First, they were contingent creditors by virtue of the deed poll Privatbank had entered into. Secondly, even without the deed poll, the noteholders had been given a right of direct recourse against Privatbank. The court held that that right was sufficient to make the noteholders contingent creditors of Privatbank. Therefore, on either basis, the noteholders were creditors for the purposes of section 899 of the CA 2006 and were able to vote on the scheme of arrangement.[26]

5.23 In this case the ultimate investors were able to vote on the proposed scheme of arrangement. However, commentators have emphasised that various steps had to be

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20 R Cox, *Intermediation and Beyond* (2019) p 117.

21 *Secure Capital SA v Credit Suisse AG* [2017] EWCA Civ 1486, [2017] 2 Lloyd's Rep 599 at [56].

22 *Re Public Joint-Stock Company Commercial Bank "Privatbank"* [2015] EWHC 3299 (Ch).

23 We discuss schemes of arrangement in ch 4 above.

24 That is, where the security trustee became bound to proceed against Privatbank, but failed to do so in a reasonable time.

25 *Re Public Joint-Stock Company Commercial Bank "Privatbank"* [2015] EWHC 3299 (Ch) at [11].

26 *Re Public Joint-Stock Company Commercial Bank "Privatbank"* [2015] EWHC 3299 (Ch) at [10], [13], [15].

taken in order to ensure that they were "creditors" for the purposes of the CA 2006.[27] In summary, these steps included the company giving the ultimate investors an express right of direct recourse against the company in certain circumstances, and the company entering into a deed poll creating direct liability to the ultimate investors. It does not appear that companies routinely take such steps outside the context of large commercial transactions.

SL Claimants v Tesco plc

5.24 In *SL Claimants v Tesco plc*,[28] a group of ultimate investors brought a claim under section 90A of the FSMA, alleging loss in connection with false and misleading statements made by Tesco regarding its commercial income and trading profits. Tesco brought an application to strike out the claim on the basis that the claimants did not have standing to bring a claim under section 90A.

5.25 Section 90A refers to schedule 10A, which sets out the liability of issuers of securities to pay compensation to persons who have suffered loss as a result of a misleading statement or dishonest omission within the meaning of section 90A. Schedule 10A, paragraph 3(1) provides for compensation to be paid to a person who acquires securities, continues to hold securities or disposes of securities and has suffered loss as a result of a misleading statement or dishonest omission. Paragraph 8 provides that references to the acquisition or disposal of securities include "acquisition or disposal of *any interest* in securities". (Emphasis added.)

5.26 Tesco argued that, as there were multiple intermediaries in the chain, the claimants only had a beneficial interest in the rights held by the intermediary. In other words, the claimants had a "beneficial interest in a beneficial interest", rather than a beneficial interest in the securities themselves. On this basis, Tesco alleged that the claimants had not acquired "any interest in securities"[29] within the meaning of schedule 10A of the FSMA.

5.27 The High Court dismissed the application, holding that the claimants had standing to claim under section 90A. After considering Mr Justice Briggs' analysis in *Re Lehman Brothers*,[30] Mr Justice Hildyard said that an ultimate investor is:[31]

> the owner of "a right to a right" held through a waterfall or chain of equitable relationships which is unaffected by the insolvency of his intermediary, and enables it ultimately, even if indirectly, to enjoy the benefit of the bundle of rights which the securities represent to the exclusion of others.

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27 See R Salter, "Intermediated securities and the rights of the ultimate investor" (2016) 3 *Butterworths Journal of International Banking and Financial Law* 153 at 154; T Keijser and C W Mooney Jr, *Intermediation and Beyond* (2019) p 316.

28 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250.

29 FSMA, Sch 10A, para 8(3)(a).

30 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch).

31 [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [81], [85].

5.28 Mr Justice Hildyard concluded that the "right to a right" which an ultimate investor enjoys is an "equitable property right in respect of the securities", which is sufficient to establish standing under the FSMA.[32] Therefore, the ultimate investors had standing to bring a claim against Tesco under 90A of the FSMA.

CONSULTEES' VIEWS

5.29 In the call for evidence we asked consultees whether they considered 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. We also asked what were the benefits, in practice, of the no look through principle.[33]

Is there a problem in practice?

5.30 Some consultees agreed that the no look through principle restricts the rights of ultimate investors to bring actions against issuing companies.[34] However, some consultees pointed out that the principle is a fundamental aspect of the English law of contract and trusts. They warned that any interference with the principle may result in far-reaching and unintended consequences. The majority of consultees also noted that the principle has benefits in practice.[35] These benefits include consistency with the law of trusts and privity of contract; facilitation of cross-border intermediation;[36] and efficient and certain securities issuance and settlement.[37]

5.31 Only one consultee, EUI, said that the no look through principle does not restrict the rights of ultimate investors.

5.32 Professor Louise Gullifer QC and Professor Jennifer Payne said that, as well as preventing the ultimate investor bringing an action against parties up the chain, the no look through principle leads to 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 exercising the right to vote in relation to shares and taking part in corporate actions, the possibility of shortfalls, and the fact that information about beneficial ownership –

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32 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [79] and [85]. We note that *SL Claimants* was decided on principles of equity which do not exist under the law of Scotland, where ultimate investors cannot hold a beneficial interest in any proprietary sense. See our discussion from para 2.72 above.

33 Call for evidence (2019) paras 2.37 and 2.38.

34 Of the 21 consultees who responded to this question, eight said that the no look through principle restricts the rights of ultimate investors to bring actions against issuing companies. Two said that it did not, and 11 answered "other".

35 Of the 13 consultees who responded to Question 9, 11 agreed that the no look through principle has benefits in practice; one consultee said that the no look through produces no practical benefits and one consultee answered "other".

36 The no look through principle aligns with other approaches, for example under the EU PRIMA approach, which we discuss at para 5.43, and under the Hague Securities Convention, Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (2006).

37 For a discussion of the benefits of the no look through principle, see D Livingston, "Intermediated Securities: the "no look through" principle will work alongside necessary changes" (2020) 3 *Butterworths Journal of International Banking and Financial Law* 152 at 153.

which may be required in cases of money laundering and terrorist financing and investment – is not readily available.

5.33 The QCA said that 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 because it has to go through the chain:

> 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.

5.34 UKSA and ShareSoc said that in certain circumstances ultimate investors should be able to claim against companies directly, rather than relying on nominees to bring claims on their behalf, because as "it is not their money that is at stake [nominees] have little interest in pursuing a claim." [38]

Alternative avenues of claim

5.35 Of course, and as some consultees pointed out, although ultimate investors will not be able to sue companies for breach of contract, they may be able to sue the company in tort.[39] Dr David Gibbs-Kneller considered several areas of law under which an ultimate investor may be able to bring a claim against a company or higher intermediary, and said:

> the investor is at the mercy of circumstance as to whether their losses will be legally protected. There appears to be a lack of coherent principles in the regulation and private law obligations and it is both parties suffering from the uncertainty: The investor, who is shouldering the risk of loss; and the issuer and intermediary who are unsure of their liability … [A]s the market has developed, the ultimate investor is forced to rely on disparate areas of law that are dependent on circumstances in the absence of specific legal provisions. Even when there is regulation some of the protection is still heavily dictated to by contract.

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[38] UKSA and ShareSoc pointed to the examples of SVS Securities and Beaufort Securities. These were intermediaries with retail clients. In the case of Beaufort Securities, it was placed into insolvency in March 2018. Client assets were held in omnibus accounts. The administrators informed the firm's clients that the costs of the administration would be taken out of the client assets, significantly reducing the amount in the omnibus accounts and meaning that some clients would suffer a loss. For the vast majority of clients, the FSCS was able to cover shortfalls of client money or custody assets. There were a small number of retail investors for whom the costs of distribution and any shortfalls would be over the (then) FSCS compensation limit of £50,000, so that they would not be fully compensated. We discuss the FSCS from para 6.45 below. In the case of SVS Securities, the FCA placed regulatory requirements on SVS, preventing it from conducting regulated activities and disposing assets. The SVS directors decided to place the firm into Special Administration. Ultimate investors were not able to participate in corporate actions that took place whilst their assets were under the control of administrators because of their position in the intermediated securities chain.

[39] We refer to the possibility of a tort claim, and consultees' views, at para 5.7 above.

5.36 The CLLS said that parties who wish to provide third parties such as ultimate investors with rights may provide for this either through a deed poll[40] or through the Contracts (Rights of Third Parties) Act 1999. However, Dr David Gibbs-Kneller pointed out that it may be difficult for ultimate investors to demonstrate that they satisfy the relevant criteria under the Contracts (Rights of Third Parties) Act 1999. The standard terms and conditions of investment funds also often exclude third party reliance on the contractual terms.

5.37 The CLLS also referred to existing 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.[41]

Do ultimate investors want to bring a claim?

5.38 Some consultees suggested that the principle does not cause a problem in practice because ultimate investors rarely want to pursue a claim against a company. For example, Chancery Advisors Limited said:

> 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.

5.39 However, several consultees said that actions brought by a group of shareholders may become more prevalent. The AMNT said:

> 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.

The benefits of the no look through principle

Legal certainty and privity of contract

5.40 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.[42]

5.41 Several consultees, including Professor Louise Gullifer QC and Professor Jennifer Payne, linked the no look through principle to the "basic" rule of privity of contract. Similarly, the CLLS said the principle provides autonomy to all the parties involved and the freedom for them to choose their preferred contractual structure.

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40 See the approach in *Re Public Joint-Stock Company Commercial Bank "Privatbank"* [2015] EWHC 3299 (Ch), discussed from para 5.19 above.

41 FCA Handbook COBS 2.1.1R.

42 The CLLS, Shepherd and Wedderburn LLP and the Law Society of Scotland.

5.42 The CLLS further noted that the characterisation of intermediated securities as a "series of trusts and sub-trusts"[43] 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.

5.43 Several consultees 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. This risk has to be put into context by recognising that the UK is currently a location of choice for securities-related services. Professor Louise Gullifer QC and Professor Jennifer Payne agreed that "the combination of the no look through principle and the PRIMA rule also means that one law will apply to the ultimate account holder's property rights … thus increasing certainty and decreasing costs."[44]

Market efficiency

5.44 Some consultees said that the no look through principle contributes to the efficient operation of the market. For example, the CLLS said that the principle allows for the effective settlement of securities transactions in CREST:[45]

> The no look through principle allows the issuing company to act efficiently, safely and effectively with respect to any instructions received from the holder of the securities in exercise of the contractual rights attached to the securities.

Benefits to the company

5.45 A retail investor, 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.

5.46 Three consultees said that one benefit of the no look through principle is that it protects companies from litigation. For example, AMNT said that the principle reduces the cost of doing business for financial institutions by allowing them to discount

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43 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [163].

44 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 362. "PRIMA" refers to the "Place of the Relevant Intermediary Approach". Pursuant to this approach, the rights of an ultimate investor in relation to intermediated securities will be governed by the law of the place of their immediate intermediary. The no look through principle focuses on the relationship between the ultimate investor and their immediate intermediary. If the no look through principle were to be changed, the legal certainty provided by PRIMA would be decreased because an ultimate investor would be able to bring a claim in contract or trusts law against any of the intermediaries above it, as well as the issuing company. There would need to be an analysis of which law applied at each tier of the chain. Each intermediary would have to do the same analysis, which may lead them to restrict investment from certain jurisdictions.

45 The CLLS said that the effect of the no look through principle is that neither the issuing company, nor the intermediary nor EUI itself are under an obligation to investigate whether instructions (such as to transfer an interest) on CREST have been given with authority. Any claim in contract or trusts law can only be brought by the ultimate investor against their immediate intermediary. They said that "[t]his allows for the swift and smooth settlement of securities transactions in the financial markets".

litigation. However, AMNT also said that this benefit for companies does not justify the principle.

5.47 UKSA and ShareSoc said that the benefits enjoyed by companies because of the no look through principle could affect corporate governance because of "the reduced accountability of directors who know they are less likely to be sued".

> 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.

Benefits to the ultimate investor

5.48 The CLLS said that ultimate investors also benefit from the no look through principle. They said the principle protects ultimate investors from the direct exercise of rights, or direct imposition of costs or administrative procedures, by the company.

5.49 Professor Louise Gullifer QC and Professor Jennifer Payne said that the no look through principle reduces costs for the ultimate investor by reducing the risk of claims being brought by other parties in the chain:

> The costs of mitigating against this risk, particularly in systems where there is no information about parties in the chain other than immediate parties, would be great and would, inevitably, be passed onto the ultimate account holder.

5.50 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 ... . 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.

Is reform desirable?

5.51 Some consultees said that reform in this area may be desirable because it would enhance corporate governance and the rights of ultimate investors. Other consultees warned that any reform of the no look through principle could cause far-reaching and unintended consequences. For example, the CLLS said that the no look through principle is "extremely valuable both legally and economically" and that change would "require a major legislative programme" giving rise to uncertainty and additional competing claims which "would be damaging to the operation of the financial markets and the wider UK economy". Dorothy Livingston has argued that there should be no reform affecting the no look through principle, saying that it "creates a high level of

certainty which is important to the smooth operation of financial markets and enables the swift execution of instructions".[46]

5.52 The Law Society of Scotland and Shepherd and Wedderburn LLP suggested that other types of actions, including derivative and ancillary rights of action, may be more appropriate than the "radical reappraisal" needed to introduce a look through principle.

POSSIBLE SOLUTIONS

5.53 Some consultees strongly opposed any interference with the no look through principle. They said that the principle is an inherent part of the UK trusts and contract law system and provides certainty for parties. We do not suggest any changes to the general principle.

5.54 However, we think that there are some discrete changes that could be made to improve the position for ultimate investors. These include:

(1) amending section 98 of the CA 2006; and

(2) clarifying the FSMA; and

(3) exploring the potential for creating a new statutory cause of action.

Amending section 98 of the CA 2006

5.55 Section 98 of the CA 2006 allows "holders" of shares to apply to the court to set aside a special resolution of a public company to be re-registered as a private limited company. Section 98(1) provides:

> (1) Where a special resolution by a public company to be re-registered as a private limited company has been passed, an application to the court for the cancellation of the resolution may be made—
>
> (a) by the holders of not less in the aggregate than 5% in nominal value of the company's issued share capital or any class of the company's issued share capital (disregarding any shares held by the company as treasury shares);
>
> (b) if the company is not limited by shares, by not less than 5% of its members; or
>
> (c) by not less than 50 of the company's members;
>
> but not by a person who has consented to or voted in favour of the resolution.

5.56 A special resolution of a public company to be re-registered as a private limited company is likely to affect the value of a company's shares, and an ultimate investor's ability to sell their shares. In *Eckerle v Wickeder Westfalenstahl GmbH*, the board of directors announced its intention to propose at the next company AGM the

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46 D Livingston, "Intermediated Securities: the "no look through" principle will work alongside necessary changes" (2020) 3 *Butterworths Journal of International Banking and Financial Law* 152 at 153.

cancellation of the listing of the claimants' shares on all domestic exchanges and the company's re-registration as a private limited company. This announcement had a negative impact on the marketability of the claimants' shares, as the value of the shares dropped by nearly 15%.[47]

5.57 However, section 98 limits the ability of ultimate investors to bring an application in two ways. The first way is by limiting standing to "holders" of shares, whose names are on the company register of members. The emphasis in this provision is on the relationship between the issuing company and the member on the register.[48] An application can only be brought by the legal owner of the securities, and not by the ultimate investor.

5.58 The second barrier for ultimate investors is that an application may not be made by a person "who has consented to or voted in favour of the resolution". This means that intermediaries who vote both in favour of and against the resolution (for example, because they represent opposing views of different clients or allow an ultimate investor to be appointed as a proxy to vote) are unable to challenge the resolution. Even when an ultimate investor convinces an intermediary to bring an application under section 98, they may be barred from doing so.

5.59 These barriers were highlighted in *Eckerle v Wickeder Westfalenstahl GmbH*,[49] in which the claimants were ultimate investors. Their intermediary, BNYM, had voted both for and against the resolution, and was therefore barred from bringing an application on their behalf.[50]

5.60 Following consultation with stakeholders, we think that there are two ways in which section 98 could be reformed to enhance the rights of ultimate investors:

(1) removing the bar on applications from "a person who has consented to or voted in favour of the resolution"; and/or

(2) enabling ultimate investors to bring an application themselves.

Removing the bar on applications from "a person who has consented to or voted in favour of the resolution"

5.61 One obvious change which should be considered is amending section 98(1) to remove the words "but not by a person who has consented to or voted in favour of the resolution." This amendment would ensure that an ultimate investor's intermediary could bring an application against a company on their behalf.

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47 [2013] EWHC 68 (Ch), [2014] Ch 196 at [5].

48 See from para 2.92 above.

49 [2013] EWHC 68 (Ch), [2014] Ch 196.

50 See from para 5.12 above.

5.62 This is not the first time that such an amendment has been suggested. In 1962, the Company Law Committee said in relation to a similarly-worded provision:[51]

> Under section 72 a shareholder who has assented to a variation of the special rights attached to his shares cannot apply to the Court for a variation to be cancelled. This can cause difficulty to a nominee who holds shares on behalf of a number of persons, for the fact that he has assented to a variation as the nominee of one of those persons deprives him on the right to apply, as the nominee of the other, for the variation to be cancelled. While we recognise that the condition is reasonable where a member holds all his shares beneficially or on behalf of one other person we do not think that there is a substantial likelihood of such persons applying to the Court, and we think that the difficulty of the nominee holding for different interests could be best met by repealing the condition.

5.63 Academic commentators broadly agree with this amendment.[52] For example, Professor Louise Gullifer QC and Professor Jennifer Payne have said that the case of *Eckerle* demonstrates that section 98 "is clearly aimed at a situation in which only direct holdings of shares are envisaged".[53] They argue that a "simple legal solution" to the problem faced by the claimants in *Eckerle* would be to remove the condition that the person applying to the court under section 98 cannot have voted in favour of the resolution.[54] We are not aware of any stakeholders who oppose this solution.

5.64 Amending section 98 as described would only remove one barrier for an ultimate investor wishing to bring an application under this section. They would still have to persuade their intermediary to bring an application on their behalf. We think that it is likely that most intermediaries would exclude this possibility in their agreements with investors. If the Government were to consider that this would be undesirable, regulatory measures could be introduced to require an intermediary to bring an application at the request of an ultimate investor who otherwise satisfies the requirements under section 98.

Allowing the ultimate investor to bring an application

5.65 An alternative solution to the problem faced by the claimants in *Eckerle* would be an amendment to section 98 to allow an ultimate investor to bring an application. The CLLS agreed that there is "no reason in principle" why section 98 should not be amended in this way.

5.66 From a practical perspective, some stakeholders including the Registrars' Group have said that if an ultimate investor is able to bring a direct action against a company, the company needs to be able to confirm that the ultimate investor is in fact entitled to bring a claim. This would require transparency as to who owns a beneficial interest in

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51 Jenkins Committee Report (1962) Cmnd 1749, para 193. The Jenkins Committee was created to review certain provisions in company legislation and recommend law reform.

52 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 378; and E Micheler, *Intermediation and Beyond* (2019) pp 253 and 254.

53 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 378.

54 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 379.

securities. We think that this would be possible by using the mechanism in section 793 of the CA 2006.

5.67 Under this provision, which we discuss above, a company may request the identification of an ultimate investor from an intermediary.[55] Both sections 98 and 793 include time constraints by which the relevant application must be made. An application under section 98 must be made within 28 days after the passing of the resolution.[56] A response to a section 793 request must be provided "within such reasonable time as may be specified in the notice".[57] This means that a company can include an appropriate time limit in its section 793 request. If all the parties act promptly, the time limits under the various legislative provisions should not unreasonably bar an ultimate investor's application.

Clarifying the FSMA

5.68 Section 90A of the FSMA provides a statutory exception to the no look through principle, allowing an ultimate investor to bring a direct action against an issuing company, as we discuss above.[58]

5.69 *SL Claimants v Tesco plc*[59] is clear authority that ultimate investors with a beneficial interest in securities have standing to bring a claim under section 90A of the FSMA. Any other interpretation would have left the legislation "unfit for purpose".[60] However, Mr Justice Hildyard pointed out that the lack of clarity in the legislation is out of step with market practice. He commented that it was "unsettling" that an important part of the legislation was "open to such legitimate disputation and doubt".[61] Academic commentators have since agreed with this.[62] Stakeholders, including AFME and the AGC, told us that they share this concern.

5.70 We have considered whether "any interest in securities" could be defined or explained in the FSMA in a useful way. In *SL Claimants v Tesco plc*, Mr Justice Hildyard said:[63]

> It is quite plain that intermediated securities held through CREST, as most are and all shortly will be in the UK market, are not the same as securities held directly in certificated form, even though economically they are the same. It is in some way surprising that this was not expressly recognised and provided for in FSMA.

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55 We discuss section 793 from para 3.127 above.

56 CA 2006, s 98(2).

57 CA 2006, s 793(7).

58 See para 5.8 above.

59 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250.

60 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [10], [88].

61 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [73].

62 L Gullifer and J Payne, "Intermediated Securities and Investor Protection" (2020) 136 *Law Quarterly Review* 204.

63 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [73].

5.71 Mr Justice Hildyard referred to a 2004 paper by the FMLC, which recommended that:[64]

> It would be helpful to embody a specific rule in the statute that unless otherwise agreed an investor enjoys a bundle of co-proprietary and personal rights in and to securities held by his intermediary, including income and other benefits associated with the securities.

5.72 Although Mr Justice Hildyard's decision in *SL Claimants v Tesco plc* is clear that ultimate investors in an intermediated securities chain have standing to bring a claim under section 90A of the FSMA, it is arguable that it would be valuable to clarify this point through a legislative amendment.[65] Such an amendment could place the matter beyond doubt. However, the main purpose of legislation is to change, rather than to clarify, the law. There is also a risk that an amendment to clarify the law in one context may unintentionally cause problems if a similar form of words used elsewhere in legislation is left unamended.

5.73 It is possible that other provisions in legislation may limit the rights of ultimate investors, either inadvertently or as a result of previous policy decisions which should now be reviewed.[66] Section 98 of the CA 2006, which we discuss above, is one example. Other examples include the following.

(1) Section 633 of the CA 2006, which provides for objections to the variation of rights attached to a class of shares and has similar wording to section 98 of the CA 2006, discussed above.[67]

(2) Section 338 of the CA 2006, which empowers members to require circulation of resolutions for AGMs. Section 153 of the CA 2006 provides a procedure by which ultimate investors can make such a request. However, stakeholders including the Share Centre have mentioned that this process does not facilitate the exercise of these rights by ultimate investors.[68]

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64 FMLC, *Issue 3 – Property interests in investment securities* (July 2004), at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf. We note that reg 3(1) of the USRs, SI 2001 No 3755 takes such an approach.

65 We note that s 90B of the FSMA provides a power to make provision by regulations about the liability of issuers of securities traded on a regulated market.

66 Section 90 of the FSMA has similar wording to s 90A. Section 90 provides for compensation where a claimant acquires securities (or "any interest" in securities) and suffers loss as a result of untrue or misleading statements or omissions in the listing particulars or prospectus. It is arguable that a court would interpret it in the same way as s 90A.

67 See from para 5.55 above.

68 For example, section 338 requires a request to be made by (1) members representing at least 5% of the total voting rights of all the members who have a right to vote on the resolution; or (2) at least 100 members who have a right to vote on the resolution and hold shares in the company on which there has been paid up an average sum of at least £100 for each member. The Share Centre pointed out that £100 refers to the value of the shares at the time when they were authorised or issued, not the current market value. The Share Centre said that this limits the ability of retail investors to meet the criteria. In 2014, for certain companies in the FTSE350, an investor would need to hold an average of £138,075 market value to be above the £100 nominal value threshold.

(3) Sections 570 and 571 of the CA 2006, which provide for the disapplication of existing members' rights of pre-emption.[69] When a company issues new shares, the company must first offer them to each person who already holds shares in the company according to the existing proportion of shares held, on the same or more favourable terms than offerings to third parties. This right of first refusal (referred to as a "right of pre-emption") is intended to prevent shareholdings from being diluted without knowledge or consent.[70] However, a special resolution may be passed either giving the directors a general power to allot shares or waiving pre-emption rights for a specific issuance.[71] In addition to the fact that ultimate investors may not be able to vote on these special resolutions,[72] consultees have told us that a lack of transparency between investor and company also creates problems. The company may wish to issue new shares quickly, in order to raise money. To reach ultimate investors, offers need to be passed down intermediated securities chains and responses passed back up. This process is "logistically very challenging" for companies.[73] As a result, retail investors holding through intermediaries may be excluded from the discounted share offerings from which institutional investors benefit.

5.74 We have considered whether a general legislative provision could "sweep up" all of these provisions. We are not currently convinced that such an approach would be appropriate. A general legislative provision would be unlikely to catch every instance, and it could be argued that the general statement did not apply to a specific provision.

5.75 We think that an appropriate approach would be for the Law Commission to review legislation such as the CA 2006 and the FSMA. The purpose of such a review would be two-fold. First, to identify provisions where, as Mr Justice Hildyard said, "the draftsman and legislature did understand the market in intermediated securities [and] did not intend to strip away the rights of investors who chose that mode of holding their investment".[74] Secondly, to identify provisions which restrict the rights of ultimate investors and might therefore require reconsideration. Amendments could be suggested once such provisions had been identified.

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69 Rights of pre-emption are set out in s 561 of the CA 2006. When a company issues new shares, the company must first offer them to existing shareholders according to the existing proportion of shares held, on the same or more favourable terms than offerings to third parties. This right of first refusal is intended to prevent shareholdings from being diluted without a shareholder's knowledge or consent.

70 CA 2006, s 561.

71 CA 2006, ss 570 and 571. The Pre-Emption Group, which offers best practice guidelines, has recommended that during the COVID-19 pandemic, investors support companies issuing shares of up to 20% of issued share capital over 12 months. Normally, best practice guidelines recommend that shares issued without pre-emption rights do not exceed 5% of issued share capital for general corporate purposes, with an additional 5% for specified acquisitions or investments: see Pre-Emption Group expectations for issuances in the current circumstances, at https://www.frc.org.uk/getattachment/9d158c89-f0d3-4afe-b360-8fafa22d2b6a/200401-PEG-STATEMENT.pdf.

72 We discuss voting by ultimate investors in ch 3 above.

73 EIU/Primary Bid, *Untapped capital: understanding the retail investor pool* (2020) p 4, at https://primarybid.com/whitepaper/understanding-retail-investor-pool.

74 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [88].

5.76 As we note above, ultimate investors in Scots law do not hold any kind of "legal or equitable interest" in the securities. This would need to be taken into account when considering any potential amendment, as a different formation is likely to be required to extend protection to them.

A new statutory cause of action?

5.77 In response to the call for evidence, some consultees said that it would be preferable to create a new statutory cause of action than to reform the no look through principle generally. For example, Dr David Gibbs-Kneller suggested the creation of a specific statutory remedy for retail investors to pursue loss or wrongdoing by intermediaries and/or the company and its directors.

5.78 However, consultees did not point to a specific problem currently faced by ultimate investors which could be solved by a general statutory cause of action. There also already exist statutory provisions which target particular issues, such as section 90A of the FSMA. Without evidence of specific problems, we do not consider that it is necessary to consider legislative reform at this stage.

5.79 As well as existing statutory and regulatory provisions, parties may also take practical steps to ensure that ultimate investors have rights directly against an issuer.[75] However, this approach relies on the parties being motivated to empower ultimate investors. Where parties are not so motivated, which is likely when smaller institutional investors or retail investors are involved, the ultimate investors will remain excluded.

[75] See, eg, *Re Public Joint-Stock Company Commercial Bank "Privatbank"* [2015] EWHC 3299 (Ch) and para 5.23 above. Richard Salter QC has explained that ultimate investors may be able to use deed polls in other circumstances: R Salter, *Intermediation and Beyond* (2019) pp 144 and 145.

Chapter 6: Insolvency of an intermediary

6.1 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.

6.2 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. In this chapter, we explore how the law operates in this area and how the interests of an ultimate investor may be affected by an intermediary's insolvency. We set out the rules relating to the safekeeping of intermediated securities by intermediaries, and the ways in which an ultimate investor may be compensated for any loss sustained.

6.3 We then outline consultees' views and consider possible solutions to some of the issues raised by consultees, including the liability of intermediaries, the distribution of assets from omnibus accounts upon the intermediary's insolvency and compensation limits under the Financial Services Compensation Scheme ("FSCS").

THE INSOLVENCY OF AN INTERMEDIARY

6.4 Insolvency occurs when a company, such as an intermediary holding intermediated securities for ultimate investors, is unable to pay its debts.[1]

6.5 The legal framework for insolvency in the context of intermediated securities in England and Wales is complex.[2] It includes the Insolvency Act 1986 and the Insolvency (England and Wales) Rules 2016,[3] the Investment Bank Special Administration Regulations 2011 (the "2011 Regulations"),[4] as well as regulation through the FCA Handbook Client Assets Sourcebook ("CASS").[5]

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1 Insolvency Act 1986, s 123.

2 Corporate insolvency in Scotland is separately regulated by the Insolvency (Scotland) (Receivership and Winding Up) Rules 2018, SSI 2018 No 347 and the Insolvency (Scotland) (Company Voluntary Arrangements and Administration) Rules 2018, SI 2018 No 1082. In addition, insolvency of non-limited liability partnerships and individuals is governed by the Bankruptcy (Scotland) Act 2016. These pieces of legislation have implications for the effects of insolvency on ultimate investors described in the remainder of this chapter. We discuss devolution and Scots law from para 1.44 above.

3 SI 2016 No 1024.

4 SI 2011 No 245.

5 The FCA regulates the financial markets sector and establishes and enforces rules designed to protect client assets if a business, such as an intermediary, fails. These rules are set out in the FCA Handbook CASS. Part 6 of the CASS deals with custody of client assets, including investment securities. All businesses regulated by the FCA are subject to the CASS.

The general position: an ultimate investor's assets are protected

6.6 A key objective of insolvency law is to ensure that the company's assets are distributed fairly among its creditors.[6] By creditors, we mean people who are owed money or the equivalent, and who may include the company's employees and its lenders. The company's assets may include cash, tangible property such as land, plant and machinery, or intangible property such as book debts.

6.7 When an intermediary becomes insolvent, it may be holding intermediated securities on behalf of ultimate investors. However, those intermediated securities are not included in the intermediary's assets for the purposes of distribution. We explain above that an intermediated securities chain has been considered by the High Court to be "a series of trusts and sub-trusts", with the ultimate investor having a beneficial interest in the securities.[7] In general, assets held on trust are effectively "ringfenced" and not available to general creditors upon the trustee's insolvency.[8] Trusts law provides that intermediated securities held on trust must be held for the beneficial owner and not made available to the general pool of creditors.[9] Therefore, the general position is that the ultimate investor's assets will be protected when an intermediary becomes insolvent.

The position in Scots law

6.8 We explain above that trusts in Scotland will not arise under any doctrine of equity.[10] Accordingly, it cannot be said as a generality that, under Scots law, interests of ultimate investors will not be included in the intermediary's assets for the purpose of distribution to the intermediary's creditors. Whether the ultimate investor's interest will be included in the general pool of assets for distribution will depend on whether, in the individual case, the intermediary holds the security (or the beneficiary's right under a trust which holds the security) under a trust created expressly in favour of the ultimate investor.

6.9 For the remainder of this chapter, we focus on the position in English and Welsh law.

Shortfalls may affect the ultimate investor's position

6.10 Although the general position is that an ultimate investor's assets will be protected on the intermediary's insolvency, there is a risk that the intermediary may not have

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6 R Goode and K van Zwieten (eds), *Goode on Principles of Corporate Insolvency Law* (5th ed 2018) para 2-00.

7 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [163]. We discuss the legal relationships in an intermediated securities chain from para 2.63 above.

8 See Insolvency Act 1986, s 283(3) in relation to individual trustees. In relation to corporate trustees, *Lewin on Trusts* says that despite the absence of an express statutory provision, it has always been accepted that property held on trust by the company at the commencement of the winding-up falls outside the insolvency regime: L Tucker, N Le Poidevin, J Brightwell, *Lewin on Trusts* (20th ed 2020) para 27-029. See also R Goode and K van Zwieten (eds), *Goode on Principles of Corporate Insolvency Law* (5th ed 2018) para 3-03.

9 This depends on the trust assets being properly segregated: see V Dixon, *Intermediation and Beyond* (2019) p 77 and *MacJordan Construction Ltd v Brookmount Erostin Ltd* [1994] CLC 581; *Re Global Trader Europe Ltd* [2009] EWHC 602 (Ch), [2009] 2 BCLC 18.

10 See from para 2.72 above.

sufficient assets in a pooled or omnibus account to satisfy claims by its account holders. This is called a "shortfall".[11]

6.11 A shortfall may arise through the legitimate use of the assets, such as under a securities lending transaction to which the ultimate investor has consented. In a securities lending transaction, the holder of securities transfers them to a third party ("the counterparty"), who undertakes to return securities of the same kind at a later point. The counterparty will provide collateral, usually cash but sometimes other securities.[12]

6.12 Although the securities lending transaction will result in a temporary shortfall, the impact on the ultimate investor "may not be quite as dramatic as envisaged".[13] This is because the counterparty will be under a contractual obligation to return the securities to the intermediary (or their insolvency office holder), at which point the shortfall will be reduced or extinguished. Should the securities not be returned (or not returned in full), a shortfall may arise, although it should be covered by collateral taken by the intermediary in return for lending the securities. In practice there may be a mismatch between the value of the collateral and the value of the security due to market movements.[14] However, we have been told that any net shortfall should not ordinarily represent a significant amount.

6.13 A shortfall may also arise because an intermediary has acted negligently or fraudulently, or both. For example, assets may be removed from the account through breach of trust, administrative error or poor record keeping.[15] We turn now to consider the regulatory obligations imposed on intermediaries in relation to record keeping and the involvement of other intermediaries in custody services.

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11 See V Dixon, *Intermediation and Beyond* (2019) p 80; L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 372.

12 T Keijser and C W Mooney Jr, *Intermediation and Beyond* (2019) p 319; J Benjamin and L Gullifer, *Intermediation and Beyond* (2019) p 218. See also R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22, which provides a useful summary of the possible contexts in which shortfalls may arise.

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

14 The primary purposes of a securities lending transaction are: (1) to enable the stock lender to put securities it owns to use and generate some revenue from them by charging a stock borrowing fee to the borrower; and (2) to enable the stock borrower to complete the settlement of a transaction under which it has sold securities it does not own (and under which the stock borrower may make a profit by virtue of movements in the market price under the sale and buyback transaction). An intermediary will lend the securities to a borrower, although legally, ownership of the securities transfers to the borrower. Securities loans are usually secured by the borrower providing cash collateral to the lender or its intermediary. This means that on termination of the loan, the borrower is contractually obliged to deliver to the lender securities "equivalent" to the loaned securities. "Equivalent" securities are securities of an identical type, value, description and amount to the loaned securities. The lender is contractually obliged at the same time to repay the cash collateral.

15 T Keijser and C W Mooney Jr, *Intermediation and Beyond* (2019) p 319; and V Dixon, *Intermediation and Beyond* (2019) p 80.

Reconciliation and record keeping: regulatory requirements

6.14 Pursuant to the CASS, intermediaries must ensure that assets are in the correct place and that records are kept up to date.[16]

6.15 One way in which this is checked is through reconciliation. Reconciliation is a process whereby the intermediary closest to the ultimate investor, assuming that intermediary is subject to the CASS, checks that its records match statements provided by the next intermediary in the chain. The next intermediary would be required to do the same if it were also subject to the CASS. This is intended to ensure they are in agreement with each other and thereby reduce mistakes and protect assets.[17]

6.16 Reconciliation must be undertaken:[18]

(1) internally, within each intermediary; and

(2) by each intermediary against statements (or accessible online records) maintained by the next intermediary in the chain.

6.17 This means that reconciliation will occur between each set of neighbouring parties in the intermediated securities chain.[19] However, there will not be a general reconciliation which spans the entirety of the chain. Each intermediary in the chain may choose to conduct their reconciliation at a different point in time, which can result in discrepancies and shortfalls being overlooked.[20] In addition, only FCA-authorised intermediaries are required to undertake reconciliation. If there is only one FCA-authorised intermediary in a long intermediated securities chain, there is an increased risk that reconciliation will not be carried out by most of the parties in the chain.

6.18 The FCA Handbook Conduct of Business Sourcebook ("COBS") also imposes rules on intermediaries regarding record keeping.[21] These rules provide, for example, that records of transactions and order processing must be kept for five years.[22]

Depositing client assets with third parties: regulatory requirements

6.19 Terms and conditions in contracts between intermediaries and ultimate investors generally provide that intermediaries are entitled to appoint a third party to hold client assets. This third party is the next intermediary in the chain, and the agreement may

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16 FCA Handbook CASS 6 sets out requirements for the custody of assets.

17 E Micheler, *Intermediation and Beyond* (2019) p 256.

18 Internal reconciliation is mandated by FCA Handbook CASS 6.6.19R, and reconciliation with immediate third parties such as third parties with which the firm has deposited clients' safe custody assets is mandated by FCA Handbook CASS 6.6.34R. An intermediary must also undertake a reconciliation in the event of its failure: FCA Handbook CASS 6.6.46A R.

19 If one of the intermediaries is located abroad, there would need to be similar reconciliation requirements in the other jurisdiction.

20 E Micheler, *Intermediation and Beyond* (2019) p 256.

21 A comprehensive table of these rules is in sch 1 of FCA Handbook COBS. The intermediary must be a "firm" under COBS 1.1.1R in order to be subject to FCA Handbook COBS.

22 FCA Handbook COBS 11.5A.5EU.

also permit the "delegation" of other services such as the execution or settlement of transactions to the intermediary or intermediaries further up the chain. The third party to whom custody of the ultimate investor's assets is delegated may then delegate to a further fourth party, and so on.

6.20 All of these parties become intermediaries in the chain. They are sometimes referred to as "sub-custodians", whereas the intermediary with the direct relationship with the ultimate investor is the "custodian". These labels derive from the "old world of paper securities" and now seem counter-intuitive,[23] particularly given that a "custodian bank" is often the CREST member at the top of the chain. Although in the following paragraphs we reference texts which use "custodian" and "sub-custodian", we prefer to use the term "intermediary" for all of these parties.[24] In this chapter, the "custodian" is referred to as the ultimate investor's "immediate intermediary".

6.21 For example, an ultimate investor may agree:[25]

> Where instructed to do so, or where the Custodian considers it is in the best interest of the Customer to do so, the Custodian may arrange for a third party to provide custody and/or settlement services in relation to certain Client Assets.

6.22 Such arrangements are subject to regulatory requirements. For example, when an intermediary decides to deposit custody assets with a third party, the intermediary must exercise all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements in place.[26]

6.23 The CASS also states that an intermediary should consider carefully the terms of the agreement under which it deposits custody assets, and provides a list of examples of issues that should be covered.[27] For example, the agreement should address:

(1) that the third party will hold the assets separately from assets belonging to the intermediary or to the third party;

(2) restrictions as to the circumstances in which the third party may withdraw the assets; and

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23 The term sub-custodian was "apt in the context of paper securities, where the sub-custodian's possession derived from that of the primary custodian, but in the modern structure the position is reversed: the interests of the lower tier intermediaries and of the [ultimate investor] are derived from those of parties above them in the chain, as the use of the term 'sub-trust' illustrates." L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 7 and 8; and see E Micheler, *Intermediation and Beyond* (2019) pp 239 to 242.

24 We define "intermediary" at para 2.79 above.

25 SEI Investments (Europe) Ltd, Terms and conditions for custody services, para 5.3. SEI Investments (Europe) Ltd is an asset management firm.

26 FCA Handbook CASS 6.3.1(1)R. FCA Handbook CASS 6.3.2G sets out a list of matters which the intermediary should consider in order to discharge its obligation under this rule, including market practice and the credit-worthiness of the third party.

27 FCA Handbook CASS 6.3.4B G. In addition, the contract must be in writing and must clearly set out the custody service which the third party is to provide: FCA Handbook CASS 6.3.4A R.

(3) the extent of the third party's liability in case the asset is lost, where there has been fraud, wilful default or negligence on the part of the third party or its agent.

6.24 It is possible that an intermediary with whom custody assets have been deposited will enter into securities lending transactions, as a way of generating a profit from the securities they hold. As discussed above, when securities from an omnibus account are loaned, there is a risk of shortfall.

6.25 The FCA Handbook provides that an intermediary subject to the CASS must have the express prior consent, in writing and signed, of its client to undertake securities lending transactions.[28] This also applies to securities held in omnibus accounts.[29]

6.26 This means that the ultimate investor's immediate intermediary needs the ultimate investor's consent to enter into securities lending transactions. If the intermediary above the immediate intermediary is subject to the CASS, it will need the consent of the ultimate investor's immediate intermediary, and so on up the chain. It is common practice for an ultimate investor's immediate intermediary contractually to prohibit the intermediary from lending securities unless the immediate intermediary has the ultimate investor's consent. It is possible that the immediate intermediary may fail to obtain consent, or other intermediaries may fail to comply, although the CASS requirements on ongoing monitoring and reconciliations are designed to identify such failures. Therefore, it is possible that a shortfall may be created further up the chain by a securities lending transaction to which an ultimate investor has not expressly agreed.[30]

6.27 None of the FCA's requirements prohibits intermediaries from agreeing with ultimate investors, often through their standard terms and conditions, that the intermediary will determine the content of the agreements further up the chain. Intermediaries usually exclude liability for certain losses that may arise as a result of appointing other intermediaries.[31] Although intermediaries subject to the CASS are required to accept the same level of responsibility for nominee companies controlled by themselves (or by affiliated companies),[32] they are not required to accept liability for the actions of other intermediaries in the chain.

6.28 The ultimate investor will also be prevented from bringing a direct action against any intermediary in the chain which is not their immediate intermediary (usually their

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28 FCA Handbook CASS 6.4.1R(1), (3).

29 FCA Handbook CASS 6.4.1R(2).

30 E Micheler, *Intermediation and Beyond* (2019) p 241. Although an ultimate investor may not have expressly agreed to a securities lending transaction undertaken by an intermediary higher up the chain, they will have agreed to the (usually standard) terms and conditions of their immediate intermediary, which allow for the deposit of securities with a third party. We discuss terms and conditions from para 9.22 below.

31 The extent to which this is permissible is restricted by certain rules in the FCA Handbook COBS including COBS 2.1.1R, which requires that a firm must act honestly, fairly and professionally in accordance with the best interests of its client and COBS 2.1.2R, which prohibits a firm from seeking to exclude or restrict any duty or liability it may have to the client under the regulatory system.

32 FCA Handbook CASS 6.2.4R.

broker or bank), because of the operation of the no look through principle.[33] The effect of this is that an ultimate investor may be left out of pocket and without any legal recourse where an intermediary further up the intermediated securities chain has lost or disposed of their assets.[34]

What happens to an ultimate investor if there is a shortfall?

6.29 In general, an ultimate investor's assets will be protected from the general pool of creditors upon an intermediary's insolvency. However, if there is a shortfall as we have described, what are the options for an ultimate investor?

How will the assets be distributed?

6.30 If there is a shortfall, the first question is: how would the remaining assets in an omnibus account be distributed?[35]

6.31 It is likely that these assets would be distributed on a proportionate basis. This may be because the insolvency is subject to the Special Administration Regime ("SAR"). Even where an intermediary's insolvency is not subject to the SAR, it is likely that assets will be distributed on a proportionate basis.

The SAR and the distribution of assets

6.32 Following the failure of Lehman Brothers International (Europe) in 2008, HM Treasury created the SAR, an insolvency regime for investment firms. The legal framework for the SAR is set out in the 2011 Regulations.[36] The SAR works with the CASS to provide a mechanism under which client assets can be returned to clients in the event of an investment firm failure.[37]

6.33 It should be noted that there is a substantive difference between the FCA's statutory powers in respect of money compared to assets such as intermediated securities. There are detailed rules on the distribution of client money, which is underpinned by a trust set out in the FSMA.[38] There is no equivalent statutory trust or distribution rules for intermediated securities.

6.34 Under the 2011 Regulations, shortfalls in intermediated securities omnibus accounts are borne on a proportionate basis by ultimate investors, as unsecured claims against

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33 For a description of the no look through principle, see from para 5.3 above.

34 Although they may be eligible for compensation from the Financial Services Compensation Scheme ("FSCS"), discussed from para 6.45 below. The ultimate investor may also, in theory, be able to claim against their immediate intermediary, encouraging them to claim against the next intermediary, and so on up the chain. For a discussion of the no look through principle see ch 5 above.

35 If the intermediary is holding client assets in a single client account, and those assets are lost, then the starting point is that the client sustains the entirety of the loss. However, they may have other avenues of recourse as we discuss below.

36 Investment Bank Special Administration Regulations 2011, SI 2011 No 245, reg 12(2) and (7).

37 The detailed workings of the SAR are set out in the Investment Bank Special Administration Regulations 2011, SI 2011 No 245 and the Investment Bank Special Administration (England and Wales) Rules 2011, SI 2011 No 1301.

38 FSMA, s 137B.

the investment bank.[39] These regulations apply to "investment banks", which are institutions authorised to safeguard and administer investments or deal in investments, as principal or agent, and which hold client money or other client assets.[40] In practice, many intermediaries will be considered investment banks although they are not obliged to use the SAR and can instead follow an "ordinary" administration process. We discuss the 2011 Regulations further below.[41]

6.35 A significant amount of work has been done to build on and improve this regime. HM Treasury commissioned Peter Bloxham to conduct a review of the SAR within two years of it coming into force. The Bloxham Final Report was published in January 2014 and contained recommendations relating to the SAR regulations, the CASS and the procedures administrators follow in the event of an investment firm failure.[42] In January 2017 the FCA published a consultation paper[43] and subsequent policy statement[44] which proposed changes to the CASS in relation to an investment firm failure and its interaction with the SAR.

6.36 Collectively, these proposals aimed to speed up the distribution of client assets, improve results for consumers and reduce the market impact of an investment firm failure. They were implemented through additional regulations in 2017.[45] The new regulations aim to speed up the administration process by providing, for example, that special administrators may under certain circumstances return assets to ultimate investors without court approval.[46]

Insolvency not falling under the Special Administration Regime

6.37 Whilst there is no rule for intermediated securities falling outside the scope of the 2011 Regulations, academic commentators generally appear to agree that assets will be distributed between ultimate investors on a proportionate basis and that they should share the losses equally.[47]

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39 SI 2011 No 245, reg 12(2) and (7).

40 Banking Act 2009, s 232.

41 See from para 6.106 below.

42 *Final review of the Investment Bank Special Administration Regulations 2011: by Peter Bloxham* (2014), at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/271040/PU1560_SAR.pdf.

43 FCA, *CASS 7A & the Special Administration Regime Review* (2017) CP 17/2, at https://www.fca.org.uk/publication/consultation/cp17-02.pdf.

44 FCA, *CASS 7A & the Special Administration Regime Review: Feedback to CP17/2 and final rules* (2017) PS17/18, at https://www.fca.org.uk/publication/policy/ps17-18.pdf.

45 The Investment Bank (Amendment of Definition) and Special Administration (Amendment) Regulations 2017, SI 2017 No 443.

46 SI 2017 No 443, reg 10(a).

47 This is known as the pari passu principle. See A Keay, *McPherson's Law of Company Liquidation* (4th ed 2017) para 13-001. See also V Dixon, *Intermediation and Beyond* (2019) pp 82 and 83; R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22; L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 372.

6.38 However, a court may take a different approach. Professor Louise Gullifer QC has said that it is "reasonably clear" that a loss which has been caused by a shortfall would be borne proportionately. However, she has also noted that this is "by no means the only possible solution under English law", and that it would probably be necessary to imply a term into the contract between the ultimate investor and the intermediary outlining this.[48] In practice, an intermediary's standard terms and conditions will usually provide that any shortfall in intermediated securities held in an omnibus account is to be suffered proportionately by ultimate investors.

6.39 Irrespective of how the remaining assets are distributed, it is likely that an ultimate investor will stand to lose money if there is a shortfall in the account when the intermediary enters insolvency. We now consider ways in which the ultimate investor might recover their investment.

Reconstituting the trust property

6.40 Where the actions of an intermediary cause a shortfall, that intermediary has a legal obligation to reconstitute the trust property.[49] However, in general there is no obligation on an intermediary to reconstitute trust property that is lost by another intermediary in the chain.[50]

6.41 This is also the position in the FCA Handbook, which provides that an intermediary must make good a shortfall it has created by appropriating its own assets or money to cover the value of the shortfall.[51] However, this rule is not primarily intended for insolvency scenarios and, in fact, a firm that has failed is relieved from having to take such action in so far as the legal procedure for the firm's failure prevents the firm from taking such steps. If an intermediary concludes that a shortfall has been created by another party, they have an obligation to take all reasonable steps to resolve the situation with that party, but they do not have to reconstitute the trust property themselves.[52] Therefore, where an intermediary further up the chain creates a shortfall and then becomes insolvent, no other intermediary in the chain is liable to compensate the ultimate investor for losses suffered because of the insolvency.

Recovering the assets

6.42 Where there is a shortfall in the property held by an intermediary (and so, potentially, a breach of trust), an ultimate investor may wish to bring a personal or proprietary claim against their intermediary, or a proprietary claim against a third party. In order to locate the property in the latter case, an ultimate investor may "follow" or "trace" the

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48 R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22.

49 R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22.

50 *Low v Bouverie* [1891] 3 Ch 82 at 99; B McFarlane and C Mitchell, *Hayton and Mitchell on the Law of Trusts & Equitable Remedies* (14th ed 2015) para 10-020; R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22.

51 FCA Handbook CASS 6.6.54R(2).

52 In addition, under FCA Handbook CASS 6.6.54R(3), until the discrepancy is resolved the intermediary must consider whether it would be appropriate to notify the ultimate investor of the situation.

assets concerned.[53] Following allows a claimant to follow property into the hands of another, whereas tracing identifies a new asset as being the substitute for the old asset in which the claimant originally had a proprietary interest. Tracing enables the claimant to substitute the new asset as the subject matter of their claim.

6.43 For example, if an intermediary ("Money Bank") wrongly transfers an ultimate investor's ("Alice") assets to a person ("Roxanne"), Alice may attempt to follow the assets and make a claim against Roxanne for the securities. [54] By contrast, where Money Bank sells the assets and uses the money to purchase real estate, Alice may be able to trace her interest in the assets into the real estate and make a claim against Money Bank for a proportion of the real estate that represents the value of her interest in the assets.[55] The process of tracing becomes more complicated if Money Bank transfers intermediated securities into an omnibus account and then uses some of the intermediated securities from the omnibus account to purchase real estate. Under these circumstances, Alice must show by tracing that the value in the real estate is attributable to her misappropriated intermediated securities.[56] The law has developed a complex set of rules to deal with this.[57]

6.44 In practice, the complexity of an intermediated securities system and the processes involved mean that it may be difficult to follow or trace intermediated securities.[58] An ultimate investor may have to trace their interest in the securities through multiple transfers between different people. Those people may be using omnibus accounts which are subject to frequent inward and outward transfers of intermediated securities. It is also likely, particularly where an intermediary has been fraudulent or negligent, that accurate records have not been kept of every transfer. All of this will make it

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53 See *Foskett v McKeown* [2001] 1 AC 102 at 127; *Boscawen v Bajwa* [1996] 1 WLR 328 at 334; L Tucker, N Le Poidevin, J Brightwell, *Lewin on Trusts* (20th ed 2020) ch 44; and B McFarlane and C Mitchell, *Hayton and Mitchell on the Law of Trusts & Equitable Remedies* (14th ed 2015) ch 12. We think that, in the context of intermediated securities, tracing is more likely to be used than following because the asset will not keep its original form. However for completeness we deal with both tracing and following.

54 Tracing of property might not be possible in the same way under Scots law. If the intermediary has been acting as a trustee or agent when transferring the assets, then tracing might be possible by virtue of the assets being held by the transferee in constructive trust for the ultimate investor, provided that is in bad faith as to the wrongful transfer. If the intermediary has not acted in either of those capacities or the transferee is not acting in bad faith, tracing will not be possible. We discuss devolution and Scots law from para 1.44 above.

55 We refer here to tracing in equity rather than at common law. This is because under common law tracing the claimant must have legal title to the asset, and the common law cannot trace through a mixed fund. In the context of intermediated securities, claimants are likely to have beneficial title to their securities only, and are likely to need to trace through mixed funds, such as omnibus accounts.

56 *Foskett v McKeown* [2001] 1 AC 102 at 137.

57 See *Re Hallett's Estate* (1880) 13 Ch D 696 and *Re Oatway* [1903] 2 Ch 356 for the rules applicable where the misappropriated property is mixed with property belonging to the wrongdoer. See *Re Diplock* [1948] Ch 465 for the rules where the misappropriated property is mixed with the property of an innocent third party.

58 R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22; and V Dixon, *Intermediation and Beyond* (2019) p 82. See also FMLC, *Issue 3 – Property interests in investment securities* (July 2004) para 5.2, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf.

difficult for an ultimate investor to follow the trail of their securities and makes it unlikely that this is a practical approach for an ultimate investor.

The FSCS

6.45 Where there is a shortfall that affects ultimate investors, they may have recourse to the FSCS, which provides compensation to customers of financial services firms that have failed.[59]

6.46 The provisions dealing with FSCS claims are set out in the FCA Handbook Compensation Sourcebook ("COMP"). COMP 3.2 sets out the qualifying conditions for paying compensation. In summary, the FSCS may pay compensation to an "eligible claimant" for a "protected claim" against a "relevant person" "in default".

(1) "eligible claimant": the ultimate investor must be a person, charity or small business. Large companies and partnerships are excluded, as is any corporate body if the claim relates to a protected debt management business.[60]

(2) "protected claim": the claim must fall within certain prescribed categories, which include "protected investment business".[61]

(3) "relevant person": the claim must be against a participant firm (or its representative).[62] This could be an intermediary, such as an authorised bank or broker.[63]

(4) "in default": a participant firm may be in default when it is unable, or likely to be unable, to satisfy protected claims against it.[64]

6.47 The FSCS will assess whether an act or omission of the participant firm has caused the loss suffered by the ultimate investor, thereby giving rise to a valid claim of civil liability against the participant firm. If, for example, the loss is caused by a change in

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

60 The claimant must satisfy the criteria under FCA COMP 4.2. It should be noted that under FCA COMP 4.2.2R(4) the trustee of a personal pension scheme or an occupational pension scheme is eligible to claim compensation. See also: https://www.fscs.org.uk/how-we-work/small-business-charity/.

61 See FCA COMP 5.2. FCA COMP 5.5.1R(1) defines "protected investment business" to include "designated investment business", which is defined in the FCA Handbook Glossary as including dealing in investments as principal, or as agent, managing investments and safeguarding and administering investments. See also the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2000 No 544, Part II. The category for claims made for investments is relatively broad and includes managing investments in shares and pensions schemes. There are some conditions on different investment products. For example, collective investment schemes must be authorised by the FCA, or registered or domiciled in the UK: FCA COMP 5.5.3R.

62 FCA COMP 3.2.1R; and FCA COMP 6.

63 The general position is that all authorised persons under s 31 of the FSMA must contribute to the costs of the FSCS and are participant firms.

64 FCA COMP 6.3.2R.

the value of the investment, rather than by any wrongdoing by the firm, the firm will not owe the ultimate investor any civil liability. In that case, the ultimate investor will not be able to claim compensation.

6.48 Where an ultimate investor does satisfy the above requirements, the amount of compensation they can claim has a limit of £85,000.[65] The limit applies to each eligible claimant, for each claim category, for each intermediary. Where individuals have invested their entire life savings in investments through one intermediary, this capped compensation may not be sufficient to cover their losses. If they have spread their investments between intermediaries, then they may receive up to £85,000 for each claim.[66]

6.49 The FSCS limit applies to each financial institution with an FCA authorisation. If multiple intermediaries, such as investment banks, are owned by the same institution with a single authorisation, this forms one "participant firm" for the purposes of the FSCS.[67] For example, if an ultimate investor invests £85,000 with each of three banks which form part of the same participant firm, and they each fail, the ultimate investor will only be able to claim a total of £85,000 from the FSCS, rather than the £255,000 they have invested. Whilst this could look in principle like a significant issue, we understand that it is a scenario that rarely arises in practice.

6.50 The FCA has recently increased the FSCS compensation limit for certain claims, including investment intermediation and investment provision, from £50,000 to £85,000.[68] The FCA explained that the percentage of claimants who missed out because the value of their claim was over £50,000 had risen from 5% to 13% between 2010 and 2014. The FSCS compensation limit was therefore increased to ensure that the limit was in line with the market.[69] In its consultation paper, the FCA said that FSCS data showed that if the compensation limit had been £85,000, 94.4% of

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65 FSCS, "Compensation limits". Available at: https://www.fscs.org.uk/what-we-cover/. See also: FCA, *Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP17/36, final rules and new proposals for consultation* (May 2018) CP 18/11, at https://www.fca.org.uk/publications/consultation-papers/cp18-11-reviewing-funding-financial-services-compensation-scheme.

66 This is provided the firm is "in default" under FCA COMP 3.2.1R. In practice, it is unlikely that several firms in which one ultimate investor invests would become insolvent, and be in default, at the same time as each other.

67 For example, the Bank of Scotland, Aviva and Halifax are all part of the same group, meaning they count as one "participant firm". There does not appear to be a simple way for consumers to check whether firms are part of the same group.

68 FCA, *Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP17/36, final rules and new proposals for consultation* (May 2018) CP 18/11, at https://www.fca.org.uk/publications/consultation-papers/cp18-11-reviewing-funding-financial-services-compensation-scheme.

69 FCA, *Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP16/42, final rules, and new proposals for consultation* (October 2017) CP 17/36 para 5.10, at https://www.fca.org.uk/publication/consultation/cp17-36.pdf.

consumer losses would have been fully compensated in the period between 2015 to 2017.[70] We discuss this further below.[71]

FSCS claim categories

6.51 As we pointed out in the call for evidence, insurance policies fall under a different category of claim which is not subject to the £85,000 compensation limit applicable to claims relating to designated investment business.[72] This is because insurance policies are not usually treated as investment products. For long-term insurance policies, there is no upper limit.

6.52 It is possible for an ultimate investor to purchase a long-term insurance contract which is linked to pooled funds containing securities issued by a particular company, rather than investing in the company through an intermediated securities chain. While the goal of the ultimate investor in each case is the same (investment), and the losses may be similar where the intermediary or pooled fund provider fails, an ultimate investor who has invested through an insurance product is not subject to the £85,000 limit. The fact that the amount of compensation available depends on the nature of the product can therefore lead to what looks like strange inconsistencies.

CONSULTEES' VIEWS

6.53 In the call for evidence, we asked consultees whether the current regulatory regime is sufficient to deal with potential issues arising from the insolvency of an intermediary in an intermediated securities chain or whether there should be legislative reform.[73]

6.54 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. 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.

6.55 About half of consultees said that the insolvency regime as a whole is not sufficient to deal with the problems arising from intermediary insolvency. Consultees highlighted specific parts of insolvency regulation which could be considered by the FCA, either individually or as part of any broader review in the future, including:

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70 FCA, *Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP17/36, final rules and new proposals for consultation* (May 2018) CP 18/11 paras 3.11 to 3.13, at https://www.fca.org.uk/publications/consultation-papers/cp18-11-reviewing-funding-financial-services-compensation-scheme. For investment intermediary claims, the number of less-than-fully-compensated claims would have decreased to only 2.6% of the total number of claims: para 3.13.

71 See from para 6.99 below.

72 Call for evidence (2019) para 2.57. See Financial Services Compensation Scheme, "Compensation limits", at https://www.fscs.org.uk/what-we-cover/.

73 Of the 21 consultees who answered question 10, three consultees said that the current regulatory regime alone is sufficient.

(1) the liability of intermediaries;[74]

(2) the distribution of ultimate investors' assets from omnibus accounts following an intermediary's insolvency;

(3) the FSCS compensation limit; and

(4) the SAR, which provides for the administration of most insolvent intermediaries.

6.56 AFME and UK Finance said that it is the machinery of insolvency, rather than insolvency law, which is defective. This means that it takes insolvency practitioners a significant amount of time to distribute assets. Although law reform is not necessary, it would be desirable for the law to set out the principles that are meant to be applied.

Effect of an intermediary's insolvency

6.57 We also asked consultees about the effect of an intermediary's insolvency on ultimate investors.[75] Most consultees agreed that an intermediary's insolvency could cause problems in the context of an intermediated securities chain, with some pointing to the collapse of Lehman Brothers as an example. Consultees also agreed that there is uncertainty about how assets would be distributed in the event of an intermediary's insolvency. They said 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 FSCS.

Delays in return of assets

6.58 Some consultees complained that there is a significant delay for ultimate investors having their assets returned when their intermediary becomes insolvent. For example, the AGC said that the time taken to gain enforcement rights, either through the courts or through an administrator, is too long:

> This was particularly highlighted in the case of the failure of Lehman Brothers International (Europe) … who dealt with thousands of counterparties, with the result that a very significant passage of time was required to adequately identify and return assets belonging to those counterparties, even if under English law those assets would have been considered "held in custody" by Lehman International.

6.59 The FCA noted that the "costs of the exercise to return the assets" have been the subject of many letters from Members of Parliament to the FCA.

The FSCS limit

6.60 Several consultees questioned the adequacy of the FSCS limit of £85,000. For example, the CLLS said that the current limit is:

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[74] For example, the CLLS said that a major flaw in the regulatory regime is that an intermediary's claims and liabilities cannot be easily transferred to a solvent party in the intermediated securities chain. Dr Eva Micheler said that liability for "outsourcing" of custody activities is a problem. We consider each of these issues at para 6.70 and para 6.79 below.

[75] Call for evidence (2019) paras 2.61 to 2.64.

> a wholly inadequate figure and needs to be increased significantly. It is of little comfort that the FCA claim that in Beaufort the existing FSCS limit would have covered 94.4% of investors.[76]

6.61 The CLLS submitted that the FSCS gives a "contradictory message" by encouraging ultimate investors to use a single investment platform for cost and convenience reasons, whilst limiting the compensation limit. This particularly affects ultimate investors with high-value portfolios. The CLLS advocated for "an unlimited compensation protection regime primarily funded by the industry".

6.62 Similarly, UKSA and ShareSoc agreed that the compensation limit should be "dramatically increased". However, Roger Lawson, a retail investor, observed that such an increase could be difficult to maintain in practice:

> the limit of £85,000 does not cover most pension assets for an individual. The limit would need to be many millions of pounds to provide adequate coverage which would put a significant burden on the Scheme and be difficult to fund.

6.63 Other consultees highlighted the need to ensure that ultimate investors are aware of the FSCS limit. The CLLS said that it would be better for ultimate investors if it were clearer and simpler to assess whether protection under the FSCS would be available in a particular scenario.

Distribution of assets

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

Education

6.65 We also asked consultees whether some form of education for consumers about the consequences of an intermediary insolvency could be beneficial. Almost all consultees who answered this question agreed, although some pointed out that education would not be helpful, as ultimate investors have limited bargaining power and therefore have no choice but to agree to standard terms and conditions.[77]

Insolvency of a company

6.66 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.[78] By "set off" we mean that where there have been mutual dealings between A and B, A has a right to rely on debts due to B as a form of security

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76 We discuss Beaufort Securities in a footnote to para 5.34 above.

77 See from para 9.26 below.

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

covering B's debts to A. For example, if A has a money claim against the company, and the company has a money claim against A, one claim can be set off against the other.[79] We suggested that where the ultimate investor has a debt security, and the company that issued the debt security has a claim against the ultimate investor (for example, because the company has lent the ultimate investor money to purchase the debt security), those claims may be set off against each other.

6.67 We asked consultees whether the application of a right to set off has the potential to cause problems in the context of intermediated securities.[80] Only a few consultees responded to this question. Some consultees, including the CLLS, Shepherd and Wedderburn LLP and Sir John Dermot Turing, told us that set off is unlikely to apply to debt securities as between an ultimate investor and an issuer in an intermediated securities chain. The same consultees told us that they were unaware of the right of set off causing problems in practice. For example, 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.

6.68 In these circumstances, we do not propose to deal with set off any further in this paper.

POSSIBLE SOLUTIONS TO INSOLVENCY ISSUES

6.69 We consider below possible solutions, in particular relating to:

(1) the liability of intermediaries;

(2) the distribution of ultimate investors' assets from omnibus accounts following an intermediary's insolvency;

(3) the FSCS compensation limit; and

(4) the SAR, which provides for the administration of most insolvent intermediaries.

Liability of intermediaries

Transfer of claims

6.70 In response to the call for evidence, the CLLS suggested that the claims and liabilities of an insolvent intermediary should be capable of being transferred automatically to a solvent party (the "successor intermediary"). They said that the current regulatory regime does not allow for such a transfer.

6.71 The CLLS further said that the current regime allows for the possibility that "a creditor in the chain of ownership can seek to exercise a lien or other remedy against

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79 I Fletcher, *The Law of Insolvency* (5th ed 2017) para 23-021.

80 Call for evidence (2019) para 2.70. See L Gullifer, "Insolvency set-off in the context of intermediated debt securities" (2019) 5 *Journal of International Banking and Finance Law* 287 and L Gullifer, *Intermediation and Beyond* (2019) pp 167 to 174.

securities in the name of a failed intermediary held on behalf of third parties". For example, a custodian bank may have a lien over intermediated securities held by an intermediary on behalf of the ultimate investor.[81] If the intermediary defaults on its obligations to the custodian, the custodian bank may be able to enforce the lien, potentially exercising a power of sale over the intermediated securities. This may mean that the ultimate investor may not be able to recover their assets on the intermediary's insolvency.[82]

6.72 The CLLS suggested a new mechanism, through which an intermediary's claims and liabilities in respect of securities held on behalf of others could be "automatically transferred to a successor free and clear of any set off, lien or withholding without the need for third party consent." The effect of this mechanism would be to protect the ultimate investor's interest. The CLLS noted that although such a transfer would require court supervision, it would "facilitate the immediate substitution of a solvent party in the chain of ownership and minimise disruption and delay."

6.73 No other consultee raised this issue or possible solution. We consider that in any future review of insolvency and intermediaries, the Insolvency Service and the FCA should analyse whether this could be a useful approach which could enhance the protection of ultimate investors' assets. Although we have not investigated this option in detail, it is clear that this solution could interfere with the current balance of rights under insolvency law. As such, it would require careful consideration and balancing of the interests of ultimate investors against those of other creditors, and especially secured creditors. In particular, the following questions would require analysis.

(1) Who would be the "successor"? Would one successor replace the intermediary for each intermediated securities chain or would one successor hold all interests held by the insolvency intermediary?

(2) How would the "successor" be chosen? Would the next intermediary in the chain take over the insolvent intermediary's interest? Or would there be some other mechanism for identifying the successor?

(3) What would be the impact on the insolvent intermediary's estate?

(4) At what stage of insolvency would the mechanism be triggered?

(5) Who would be responsible for implementing the mechanism?

(6) How would the transfer mechanism be funded?

(7) Whether there should be law reform to avoid this problem arising in the first place, rather than dealing with the consequences through the law of insolvency.

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81 We discuss custodian liens from para 7.82 below.

82 However, the ultimate investor may be able to claim compensation from the FSCS. We discuss the FSCS from para 6.45 above.

Shortfalls

6.74 Where the actions of an intermediary cause a shortfall, that intermediary has an obligation under trusts law to reconstitute the trust property.[83] However, in general there is no obligation on an intermediary to reconstitute trust property that is lost by another intermediary in the chain.[84] Therefore, where an intermediary creates a shortfall and becomes insolvent, no other intermediary in the chain will be obliged to make up the shortfall (by, for example, purchasing intermediated securities) or liable to compensate the ultimate investor for any losses suffered.

6.75 We have not received evidence from consultees as to how often, and the extent to which, ultimate investors suffer loss because of the shortfall in trust property upon an intermediary's insolvency. We consider that this is a question on which more information would be required before further work is taken forward. However, we have identified two potential approaches for dealing with the situation in which an ultimate investor suffers such a loss, both of which may warrant further investigation.

6.76 First, the assets available to ultimate investors upon the intermediary's insolvency could be expanded to meet any shortfall. For example, we explain above that ultimate investors' assets are held on trust and are therefore effectively "ringfenced". They are not available to the general creditors upon the trustee's insolvency.[85] This protection could be extended so that there would be a larger pool of assets from which to make up the shortfall. For example, intermediated securities owned by the insolvent intermediary and held in its own account, rather than on trust for third parties, could be included in the pool.[86] Alternatively, the ranking of creditors could be changed, so that ultimate investors rank ahead of general creditors.[87] The disadvantage of either of these approaches is that they would reduce the assets available to creditors of the insolvent intermediary. It would be an unusual step to prioritise a particular type of unsecured creditor, and the justification may not be as strong as where preferential status exists elsewhere,[88] particularly given the protection afforded by the FSCS.

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83 *Low v Bouverie* [1891] 3 Ch 82 at 99; B McFarlane and C Mitchell, *Hayton and Mitchell on the Law of Trusts & Equitable Remedies* (14th ed 2015) para 10-020; R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22.

84 *Low v Bouverie* [1891] 3 Ch 82 at 99; and B McFarlane and C Mitchell, *Hayton and Mitchell on the Law of Trusts & Equitable Remedies* (14th ed 2015) para 10-020.

85 See from para 6.6 above.

86 See, eg, the position in Luxembourg where, if there is a shortfall in securities held for investors, securities owned by the depository are included in the pooled assets: Loi du 1er août 2001 concernant la circulation de titres et d'autres instruments fongibles, art 7; and P R Wood, *Set-Off and Netting, Derivatives and Clearing Systems* (3rd ed 2019) para 23-074.

87 See, eg, the position in the United States: Uniform Commercial Code art 8-511. The Law Commission has previously said that it is "entirely appropriate" that ultimate investors should not rank ahead of other creditors in relation to securities that belong to the intermediary: "if account holders were automatically able to take priority over segregated house securities of the same description as those missing in a customer account, the intermediary's other creditors would have no way of assessing the credit risk of the intermediary": Further Updated Advice on Intermediated Securities (2008) at para 4.171, fn 138.

88 For example, in the case of employees on a company's insolvency: see Insolvency Act 1986, ss 175, 386 and sch 6.

6.77 Second, the suggested transfer of claims process discussed above could be expanded. Where there is a shortfall in the trust property (that is, the interests in securities held by the insolvent intermediary), the successor intermediary could be deemed to be liable to reconstitute that trust property. The benefit of such an approach would be that the ultimate investor would not suffer loss caused by a shortfall in the accounts of an insolvent intermediary. It is also arguable that if the successor intermediary obtains the benefit of their position (for example, in the payment of fees and charges by the ultimate investor which are passed up through the chain), they should also share the risk. However, depending on the extent of the shortfall, those costs could be disproportionate.

6.78 Either of the above approaches would involve a significant change to the law and would need to be carefully considered. As we say above, we think that evidence is required as to whether ultimate investors suffer loss in practice because of an intermediary's insolvency before work is taken forward on this issue.

Liability for depositing assets with third parties

6.79 We explain above that the terms and conditions in the contracts between intermediaries and ultimate investors generally provide that an intermediary is entitled to deposit assets with a third party. The third party may then deposit those assets with a further fourth party, and so on. All of these parties become intermediaries further up the chain.[89]

6.80 The general position in law is that an intermediary will not be liable to the ultimate investor for the actions of any other intermediaries in the chain. In practice, an ultimate investor's agreement with their immediate intermediary may provide for some level of liability for the actions of the next intermediary with whom the intermediated securities are deposited.[90] This is mandated where the ultimate investor's immediate intermediary is in control of the intermediary with whom it deposits intermediated securities,[91] for example where it is a parent company and uses a subsidiary company. However, the immediate intermediary will not usually provide for contractual liability for the actions of any further intermediaries in the chain.

6.81 The ultimate investor will also be prevented from bringing a direct contractual action against any intermediary in the chain which is not their immediate intermediary (usually their broker or bank), because they do not have a contract or direct relationship with intermediaries higher up the chain.[92]

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89 See para 6.20 above for our explanation of terminology.

90 See for example: BestInvest terms of business para 30.1, at https://www.bestinvest.co.uk/media/1604/ois-terms-of-business.pdf: "We may delegate any of our functions to a third party and may provide information about you and your investments to any such third party. We will remain liable for the acts and omissions of our delegates as if we had committed or omitted to commit them ourselves."

91 FCA Handbook CASS 6.2.4R.

92 We discuss the no look through principle in ch 5 above.

6.82 In a recent chapter in *Intermediation and Beyond*, Dr Eva Micheler explained the problem in practice:[93]

> The ultimate account holder's main custodian, having authority to delegate and on the terms they think fit, only needs to adequately oversee the one custodian they appoint as a sub-custodian. There is no requirement for the ultimate account holder's custodian to oversee that any arrangements that operate below their immediate sub-custodian are in compliance with legal requirements.

6.83 Dr Micheler has suggested that the liability regime for intermediaries acting for retail investors should be "tightened" so that they are "responsible for the full risk arising from any of their sub-custodians".[94] This would involve either a statutory or a regulatory provision imposing liability on intermediaries for the negligent or fraudulent actions of other intermediaries in the chain.[95]

6.84 Such a provision could include measures to balance the interests of intermediaries and ultimate investors. For example, the burden of proof could be reversed so that an intermediary could defeat a claim by demonstrating that they had adequate procedures for preventing the type of behaviour of the intermediary higher up the chain which had caused the loss. An intermediary would also be able to defeat an ultimate investor's claim by showing that the higher intermediary had not been negligent or fraudulent.

6.85 This approach would allow an ultimate investor to bring a claim against their immediate intermediary for the negligent or fraudulent actions of other intermediaries in the chain. Therefore, it would target a broad range of potential issues. For example, ultimate investors would be able to claim against their immediate intermediary if another intermediary in the chain fraudulently sold their intermediated securities, or was negligent in record keeping, resulting in lost assets. The rights of an ultimate investor would not be diluted through the recurrent delegation of services up the intermediated securities chain.

6.86 However, as with the proposed transfer of claims discussed above, this solution would significantly affect the rights and obligations of intermediaries in the chain. As above, we think that evidence of the current problems and potential consequences would be required before further work on this issue should be considered to be a priority.

Reconciliation

6.87 We explain above that this is a process whereby the intermediary closest to the ultimate investor, assuming that intermediary is FCA-regulated and subject to the CASS requirements, checks that its records match statements provided by the next intermediary in the chain. The next intermediary would be required to do the same if it

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93 E Micheler, *Intermediation and Beyond* (2019) p 248.

94 E Micheler, *Intermediation and Beyond* (2019) p 255.

95 See, eg, §3 of the German Safe Custody Act (Gesetz über die Verwahrung und Anschaffung von Wertpapieren (Depotgesetz - DepotG)). We are grateful to Dr Eva Micheler for bringing this to our attention and for the translation.

were also subject to the CASS. This process is intended to ensure they are in agreement with each other and thereby reduce mistakes and protect assets.

6.88 Reconciliation occurs between each set of neighbouring parties in the intermediated securities chain.[96] However, there is no general reconciliation which spans the entirety of the chain. Each intermediary in the chain may choose to conduct their reconciliation at a different point in time, which can result in discrepancies and shortfalls being overlooked.[97]

6.89 A new regulatory provision could require intermediaries to conduct reconciliation which spans the entirety of the intermediated securities chain, ensuring that discrepancies and shortfalls are caught and remedied more quickly than is currently the case.

6.90 However, this requirement may be practically difficult for intermediaries to fulfil. Intermediated securities chains can be long and cross several borders. Any regulatory requirement imposed by the FCA in the UK would have no effect in other jurisdictions. There may also be technology barriers to reconciliation. Each intermediary will likely use a different computer system, making communication which spans the chain difficult. These operational barriers would need to be carefully examined before any such regulatory requirement were imposed.

Distribution of assets from omnibus accounts

6.91 Academic commentators generally agree that, where there is a shortfall on insolvency, assets in an omnibus account would be distributed between ultimate investors on a proportionate basis and that they should share the losses equally.[98] However, it is possible that a court would take a different approach. In the call for evidence, we sought clarification from consultees on the methods by which assets are distributed in the event of a shortfall.

6.92 Consultees generally agreed that assets would be distributed on a proportionate basis. However, the CLLS suggested that the position is not certain where there is a shortfall:

> English law requires a line by line analysis of securities held by the intermediary, to determine its availability for distribution. If the quantum of a line of stock held is sufficient to meet the entitlements of all clients, it can be distributed. However, if there is some of a particular line of securities that is held but this is not sufficient to meet all client entitlements, the regulatory regime for the custody of securities does not prescribe how this is to be addressed.

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96 Internal reconciliation is mandated by FCA Handbook CASS 6.6.19R, and reconciliation with immediate third parties such as third parties with which the firm has deposited clients' safe custody assets is mandated by FCA Handbook CASS 6.6.34R. An intermediary must also undertake reconciliation in the event of its failure: FCA Handbook CASS 6.6.46A R.

97 E Micheler, *Intermediation and Beyond* (2019) p 256.

98 See from para 6.37 above.

6.93 Under the 2011 Regulations, shortfalls in omnibus accounts held by "investment banks" are borne on a proportionate basis by ultimate investors, as unsecured claims against the investment bank.[99] In practice, many intermediaries will be considered "investment banks".[100] Sir John Dermot Turing said in his response to the call for evidence that he was not aware of any significant class of intermediaries which would not constitute "investment banks".

6.94 Whilst there is no rule for intermediaries falling outside the scope of the regulations, Professor Louise Gullifer QC has said that it is "reasonably clear" that a loss which has been caused by a shortfall would be borne proportionately. However, she has also noted that this is "by no means the only possible solution under English law", and that it would probably be necessary to imply a term to this effect into the contract between the ultimate investor and the intermediary.[101]

6.95 One way to clarify the position would be to create a new regulatory requirement that on the insolvency of an intermediary, assets must be distributed on a proportionate basis. This provision could mirror the FCA's extensive regime on the distribution of client money (rather than client assets like intermediated securities) which has been pooled by firms, meaning that the money is no longer identifiable as belonging to any specific client.[102] Where a firm holding pooled client money becomes insolvent, any shortfall is suffered by the clients rateably and in accordance with specific rules.[103]

6.96 This change to the regulatory regime would benefit ultimate investors by providing legal certainty in the event that assets need to be distributed from omnibus accounts. Legal certainty is desirable in principle, but is also beneficial in practice. It could help lawyers and financial advisers to advise clients precisely and removes the potential for litigation on the issue of the basis of distribution.

6.97 On the other hand, a regulatory provision outlining how intermediated securities should be distributed may not be necessary. In 2016 the FCA published a discussion paper in which consultees were asked whether a custody distribution regime should be included in the CASS.[104] This regime would sit alongside the regime applicable to cases falling under the 2011 Regulations. The FCA noted that most respondents either did not think that such a regime should be introduced, or questioned whether it

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99 SI 2011 No 245, regs 12(2) and (7). We discuss these regulations from para 6.32 above.

100 "Investment banks" are defined as in s 232 of the Banking Act 2009, and include institutions dealing in investments as principal or agent.

101 R Goode and L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 6-22.

102 FCA Handbook CASS 7A.

103 FCA Handbook CASS 7A.2.4R(2)(a).

104 FCA, *CASS 7A and the Special Administration Regime Review* (March 2016) DP 16/2 Question 31, p 31, at https://www.fca.org.uk/publication/discussion/dp16-02.pdf.

would lead to unintended costs and legal uncertainty in light of existing court judgments.[105] Therefore, the FCA did not take the proposal any further.[106]

6.98 Although we think that regulatory clarification of the position is desirable, we note that there may not be sufficient demand from the market to justify the creation of it. This part of the regulatory regime has been recently reviewed by the FCA, and the costs and benefits of potential reform have already been considered. In those circumstances, we do not think that further work on this issue should be an immediate priority.

Increasing the FSCS compensation limit

6.99 As we discuss above, an ultimate investor may be able to claim compensation of up to £85,000 under the FSCS if an intermediary becomes insolvent. The limit applies to each ultimate investor, for each claim category, for each intermediary.[107] Where individuals have invested their entire life savings through one intermediary or "participant firm", this compensation limit may not be sufficient to cover all their losses, although they may be able to receive compensation up to that limit.

6.100 Several consultees, such as the CLLS and UKSA and ShareSoc, suggested that the FSCS compensation limit should be increased.

6.101 The FCA is responsible for making the rules surrounding the scheme for compensation.[108] The current limit of £85,000 is set out in the FCA Handbook, and was increased from £50,000 from 2019.[109]

6.102 We explain above that, if the compensation limit had been £85,000 from 2015 to 2017, 94.4% of consumer losses would have been fully covered in that period.[110] However, this means that 5.6% of ultimate investors (more than one in every twenty) would not have been able to make a claim for compensation covering the total sum of their losses, although they would have received compensation of £85,000. The CLLS said that in this respect the figure of 94.4% is "of little comfort". We do not know the extent to which 5.6% of ultimate investors suffered loss over £85,000.

6.103 Increasing the limit on compensation will allow more ultimate investors with protected claims to be compensated fully by the FSCS protection in the event of intermediary insolvency. However, we do not currently have sufficient evidence to suggest that this presents a material issue. We also note that the FSCS is paid for by a levy on the

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105 FCA, *CASS 7A & the Special Administration Regime Review* (January 2017) CP 17/2 paras 2.18 to 2.20, at https://www.fca.org.uk/publication/consultation/cp17-02.pdf.

106 FCA, *CASS 7A & the Special Administration Regime Review: Feedback to CP17/2 and final rules* (July 2017) PS 17/18 para 2.8, at https://www.fca.org.uk/publication/policy/ps17-18.pdf.

107 See para 6.48 above.

108 FSMA, s 213(1); The Financial Services and Markets Act 2000 (Financial Services Compensation Scheme) Order 2013, SI 2013 No 598, art 3.

109 FCA Handbook COMP 10.2.

110 FCA, *Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP17/36, final rules and new proposals for consultation* (May 2018) CP 18/11 paras 3.11 to 3.13, at https://www.fca.org.uk/publication/consultation/cp18-11.pdf.

firms protected by it.[111] This means that any further increase of the compensation limit may be unsustainable or result in costs to the industry which are eventually passed on to the ultimate investor through fees imposed on them by intermediaries.

6.104 The FSCS compensation limit has been recently reviewed by the FCA. In those circumstances, we do not think that further work on this issue should be a priority.

6.105 We understand that part of the reason for increasing the limit to £85,000 was to bring it in line with the limit under the depositor protection scheme.[112] It is helpful for the purposes of consumer education to have the same compensation limits regardless of whether they are saving money in a bank account or investing it. Along these lines, an alternative practical solution may be for ultimate investors with investment portfolios worth more than £85,000 to be encouraged to spread their investment across several intermediaries. However, ultimate investors would need to be carefully advised of which intermediaries form part of the same "participant firm" for the purposes of the FSCS. This change in the behaviour of ultimate investors could be facilitated by better education on the limits of FSCS protection.

The Special Administration Regime

6.106 As we discuss above, HM Treasury created the SAR following the failure of Lehman Brothers International (Europe) in 2008.[113] The SAR works with the CASS to provide a mechanism under which client assets can be returned to clients in the event of an investment firm failure.[114]

6.107 Some consultees, such as PIMFA, UKSA and ShareSoc, and the Share Centre, have highlighted the following problems with the SAR.

(1) Costs can be imposed on ultimate investors.[115]

(2) There can be a considerable delay in returning assets to ultimate investors. This may cause loss to the ultimate investor as they miss out on dividends and interest payments. Ultimate investors are also not able to engage in corporate actions whilst their assets are frozen.

(3) Special administrators do not have sufficient experience of administering regulated firms, and are not familiar with the client asset rules and the

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111 FSCS, "How we are funded", at https://www.fscs.org.uk/about-us/funding/.

112 For details on compensation under the depositor protection scheme, see Prudential Regulation Authority Rulebook, Depositor Protection, Chs 3 and 4.

113 See para 6.32 above.

114 See para 6.32 above. The detailed workings of the SAR are set out in the Investment Bank Special Administration Regulations 2011, SI 2011 No 245 and the Investment Bank Special Administration (England and Wales) Rules 2011, SI 2011 No 1301.

115 Under rule 135(1) of The Investment Bank Special Administration (England and Wales) Rules 2011, SI 2011 No 1301 expenses incurred by special administrators in pursuit of "objective 1" may be taken out of client assets. "Objective 1" is outlined in Part 5 of the rules and includes costs associated with, for example, the drawing up of a distribution plan.

settlement of trades. This contributes to delay in returning assets to ultimate investors.

6.108 The CLLS also suggested that the UK's system for dealing with insolvency should be compared to the USA's system. The USA system is governed by the Securities Investor Protection Act of 1970 ("SIPA").[116] The SIPA created the Securities Investor Protection Corporation ("SIPC"), a non-profit, private membership corporation to which most registered brokers and dealers are required to belong.[117] The SIPC fund is designed to protect the customers of brokers or dealers subject to the SIPA from loss in case of financial failure of the member.

6.109 SIPA provides priority to the claims of ultimate investors in the event of intermediary insolvency.[118] There is a statutory grant of authority to a SIPC trustee to purchase securities to satisfy customer net equity claims to specified securities.[119] The trustee is required to return customer name securities to customers of the intermediary,[120] distribute the fund of "customer property" rateably to customers,[121] and pay, with money from the SIPC fund, remaining customer net equity claims, to the extent provided by the SIPA.[122] This means that ultimate investors are less likely to lose out in the event of a shortfall. Consultees including the CLLS and Professor Joanna Benjamin referred to the perceived superiority of the SIPA scheme.

6.110 A review of the SAR is not within the terms of reference for this scoping study. However, we think that there may be merit in considering these aspects of the SIPA in any future review of the SAR and the insolvency of investment firms. We note that the fundamental differences between the USA and the UK models of holding securities would require particular analysis and may affect whether elements of the USA regime could be duplicated in the UK.

Improved information and financial education for retail investors

6.111 Although most consultees agreed that better financial education or additional information for ultimate investors (particularly retail investors) could be beneficial, some consultees doubted its effectiveness. We discuss these issues in Chapter 9.[123]

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116 The SIPA is codified in Title 15 of the United States Code, ss 78aaa to 78lll.

117 United States Code, Title 15, s 78ccc.

118 We are grateful to Professor Joanna Benjamin for bringing this to our attention.

119 United States Code, Title 15, ss 78fff-2(d).

120 United States Code, Title 15, s 78fff-2(c)(2).

121 United States Code, Title 15, s 78fff-2(c)(1).

122 United States Code, Title 15, s 78fff-3(a).

123 See from para 9.34 below.

Chapter 7: The good faith purchaser principle, formalities and other issues raised by consultees

7.1 This chapter covers several issues relating to transactions involving intermediated securities. First, we set out the protection available to a person who acquires intermediated securities in good faith, where those assets are affected by a claim of a third party. Whether the "good faith purchaser" is protected depends on the type of transaction, whether the transferred interest is legal or beneficial, and whether the transaction is effected through CREST. We discuss this complexity in the law and refer to the Law Commission's previous work on this issue. We suggest that the Government should consider further work to make the law more certain, clear and fair for purchasers of intermediated securities in this jurisdiction.

7.2 Secondly, we consider whether intermediated securities transactions must be "signed" and "in writing" in accordance with section 53(1)(c) of the Law of Property Act 1925. Consultees have told us that the issue does not arise in practice, but commentators suggest that the law is unclear. We consider two options for legislative reform suggested by consultees and suggest that both may be worth further examination.

7.3 Finally, we discuss three issues which consultees brought to our attention during consultation, and which affect intermediaries rather than ultimate investors. Two of these issues relate to the ability of an intermediary to take effective security over intermediated securities. Parties may wish to take security over intermediated securities as a way of securing the payment of fees and charges. The third issue relates to the definition of "control" under the Insolvency Act 1986, and how this may adversely affect intermediaries holding interests in securities.

GOOD FAITH PURCHASER PRINCIPLE

7.4 In the modern financial world, fast-paced securities transactions make it difficult (if not impossible) for a would-be investor to investigate title to assets before deciding to acquire them, in order to ensure that the party offering the assets has title to them or the authority to transfer them.[1] It is an underlying principle of the common law of England and Wales that no one can give what they do not have.[2] However, there are two relevant exceptions to this rule.

(1) Where an instrument is "negotiable",[3] the person who acquires the instrument may do so free of any defects of title of previous holders, legal or equitable,

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1 FMLC, *Issue 3 – Property interests in investment securities* (July 2004) para 6.8, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf.

2 *Snell's Equity* (34th ed 2019) para 4-002. This principle is commonly expressed in Latin as "nemo dat quod non habet".

3 Negotiability converts the instrument from mere evidence of ownership into an instrument that is legally deemed to constitute the securities. Ownership of the negotiable instrument is transferred by physical delivery (or, in some cases, by endorsement and delivery) of the paper certificate or document of title,

provided that person meets certain requirements.[4] Certificated bearer securities, such as bearer bonds, are a form of negotiable instrument.

(2) A person who acquires securities which are not negotiable may do so free of any equitable, but not legal, claim, right or interest of a third party if they are a good faith purchaser of the legal title to the securities without notice.[5]

7.5 Therefore, the holder in due course of a negotiable instrument takes title free of any defects in the title of prior parties (assuming that the transferee meets the other requirements including that they acquire title for value and in good faith). However, the receipt of an instrument or interest which is not negotiable will give the transferee priority over equitable title only (and then only if legal title is transferred).

7.6 This paper deals with registered rather than bearer securities.[6] Registered securities are not negotiable.[7] Therefore, we are concerned with the second of the two exceptions above: the good faith purchaser principle. Whether this principle applies to a transfer of registered securities depends on whether legal title or equitable title to these securities is transferred.[8]

The good faith purchaser rule

7.7 The CLLS provided us with the following expression of the good faith purchaser rule, which we adopt.

> A transferee[9] who acquires legal title to securities shall acquire that title free and clear from any equitable or other right,[10] interest or claim of any third party in or in relation to the securities (an "adverse claimant") if each of the following conditions is satisfied:

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provided that the transferor has the necessary intention to transfer. See the discussion in Further Updated Advice on Intermediated Securities (2008) para 5.18 onwards.

4 The acquirer must have acquired the instrument in good faith, for value and without notice of any defect: Bills of Exchange Act 1882, s 29.

5 See for example *Macmillan Inc v Bishopsgate Investment Trust plc (No 3)* [1995] 1 WLR 978 at 1000; L Tucker, N Le Poidevin, J Brightwell, *Lewin on Trusts* (20th ed 2020) para 44-119; and *Snell's Equity* (34th ed 2019) para 4-017 onwards.

6 See the distinction between bearer securities and registered securities at para 2.9 above.

7 We discuss the application and effect of reg 35 of the USRs from para 7.21 below. Reg 35 of the USRs, SI 2001 No 3755, ensure that transfers through CREST have the effect of being negotiable. A purchaser who acquires securities through CREST therefore takes legal title free from any prior legal or equitable interest in securities: L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 380.

8 L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 379 and 380; L Gullifer, *Intermediated Securities* (2010) pp 26 to 28. The Law Society of Scotland and Shepherd and Wedderburn LLP pointed out that the potential disparity does not have the same significance under Scots law, which does not have the concept of equitable ownership.

9 Whom we refer to as "purchaser".

10 "Other rights, interests or claims" may include rights of set-off, counterclaim, possession and rights that constitute an "equity" without amounting to an equitable right, interest or claim: *National Provincial Bank Ltd v Ainsworth* [1965] AC 1175 at 1253 and 1254.

(1) the transferee gives value directly or indirectly[11] for such transfer of title; and

(2) at the time such value is given, the transferee:

(a) was acting in good faith;[12] and

(b) either:

(i) did not have notice (actual or constructive) of the right, interest or claim of the adverse claimant; or

(ii) if it did have such notice of the right, interest or claim of the adverse claimant, did not have notice (actual or constructive) that any transfer or purported transfer to it of the legal title to the relevant securities free and clear from such right, interest or claim would be effected without the consent or authority of the adverse claimant.

Where an investor holds legal title

7.8 Where securities are held directly and the investor's name is on the register, the investor holds the legal title to those securities.[13] When the investor transfers those securities for value, the legal title is transferred to the purchaser.[14]

7.9 As set out above, there is a general common law rule that no one can give what they do not have. The application of this rule would mean that a person whose securities are transferred could recover them from a purchaser if the person purporting to transfer them did not have authority or legal title to do so.[15]

7.10 However, a purchaser who acquires such securities may be protected from an equitable claim if they have acquired the securities for value and in good faith, without notice of that equitable claim.[16] Since securities are not negotiable, the purchaser

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11 An example of a transferee providing value "indirectly" could be where the transferee acts as an agent for a principal in receiving the legal title to securities in performance of the contractual obligation of the principal's counterparty to deliver the securities.

12 Where the transferee acts honestly, whether the act is done negligently or not: see eg Bills of Exchange Act 1882, s 90.

13 See para 2.15 above.

14 By "purchaser", we mean the person who has acquired title to the securities for value. They may acquire title to securities under a broad range of arrangements under which value (not necessarily money) has been provided.

15 Further Updated Advice on Intermediated Securities (2008), para 5.20.

16 *Snell's Equity* (34th ed 2019) para 4-018 onwards. Further Updated Advice on Intermediated Securities (2008) para 5.22 onwards; FMLC, *Issue 3 – Property interests in investment securities* (July 2004) para 6.8, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf; L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 371, 379 and 380. A purchaser who acquires securities through a transfer in CREST will also take the securities free from prior legal and equitable interests: USRs, SI 2001 No 3755, reg 35. See from para 7.21 below.

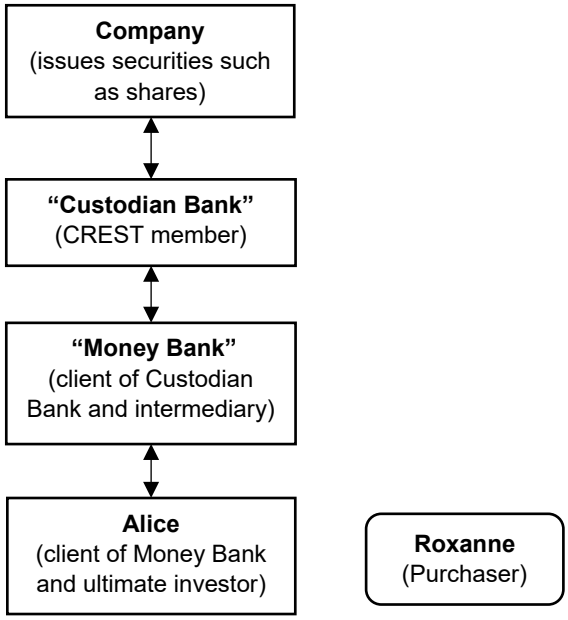
does not take free of legal title under common law. They may, however, take advantage of legislative protection, as we discuss below.[17]

Where the ultimate investor holds beneficial or equitable interests in the securities

7.11 Under the law of England and Wales, the protection enjoyed by a good faith purchaser applies only to the transfer of the legal interest in the property. It does not apply when only an equitable (beneficial) interest is transferred.

7.12 Therefore, where only a beneficial interest in securities is transferred, the person who acquires them takes them subject to any equitable claim, right or interest of a third party. This is the case even when the person who acquires them does so for value and has no notice (actual or constructive) of any such claim, right or interest.[18]

7.13 Consider the following example. Custodian Bank is an intermediary, holding registered securities in its own name on trust for a pool of clients, one of whom is Money Bank. Custodian Bank credits Money Bank's account to indicate the number of securities that it holds on Money Bank's behalf. Money Bank is also an intermediary and holds these intermediated securities for its client, Alice. Money Bank transfers the intermediated securities for value to a purchaser, Roxanne, without Alice's consent. Roxanne acts in good faith with no actual or constructive notice that the intermediated securities have been acquired in breach of Alice's rights in relation to the securities.



7.14 There are four methods by which this transfer could take place.

(1) Money Bank could instruct Custodian Bank to transfer the underlying securities to Roxanne's intermediary, Cash Bank, by having Cash Bank's name entered

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17 See our discussion of reg 35 from para 7.21 below.

18 *Snell's Equity* (34th ed 2019) para 4-023; L Gullifer and J Payne, *Intermediation and Beyond* (2019) pp 371 and 380; FMLC, *Issue 3 – Property interests in investment securities* (July 2004) para 6.8, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf; Further Updated Advice on Intermediated Securities (2008) paras 5.40 to 5.43.

onto the company register. As Cash Bank has acquired legal title to the securities, under the good faith purchaser principle it takes the securities free from Alice's equitable interest.[19] Cash Bank holds the securities on trust for Roxanne, who has an equitable interest in the securities. Alice is left with a personal claim against Money Bank for breach of trust. Therefore, Roxanne indirectly benefits from the good faith purchaser rule. However, if Cash Bank in fact has notice of Alice's prior equitable interest, prior to payment of the purchase price, then Roxanne will not benefit from the application of the rule. Roxanne's knowledge is not relevant in this scenario.

(2) Money Bank could instruct Custodian Bank to transfer the underlying securities directly to Roxanne by having Roxanne's name entered onto the company register. This would result in legal title passing to Roxanne herself. Roxanne is therefore able to rely upon the good faith purchaser principle against a claim by Alice, provided she did not have notice of Alice's interest. Alice is left with a personal claim against Money Bank for breach of trust.

(3) Money Bank could instruct Custodian Bank to debit the account it holds for Money Bank and credit an account opened by Money Bank for Roxanne. This is a transfer of an equitable interest only across the books of Money Bank, and therefore the good faith purchaser principle is not available to Roxanne. If Alice is able to follow or trace the transfer of intermediated securities to Roxanne, Alice could bring a claim[20] to recover the securities on the grounds of having an earlier equitable interest. Roxanne is left with a contractual claim against Money Bank for breach of the agreement to transfer the securities.

(4) Money Bank could effect the transfer on its own books by debiting Alice's account and crediting an account that Money Bank will open for Roxanne. Again, this is a transfer of an equitable interest only and so the good faith purchaser principle does not apply to protect Roxanne.

7.15 In summary, Roxanne would not be protected where the transfer occurs across the books of an intermediary (as in the third and fourth examples above). However, she would be protected if the transfer is of legal title, as long as the transfer was made without notice.

7.16 Most securities are held in electronic (dematerialised) form in CREST. Where transfers take place in CREST, these transactions will be protected by the USRs, as we explain below.[21] However, it will often be more efficient for the transactions to be conducted at a lower level in the intermediated securities chain, across the books of intermediaries. This results in only equitable title being transferred.

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19 If the underlying securities are held in CREST, Cash Bank can rely upon Regulation 35(2) to (6) of the USRs, SI 2001 No 3755, as a defence against adverse claims other than in circumstances where it has actual notice that the transfer was made without the authority of Alice. We discuss reg 35 from para 7.21 below.

20 For example, a claim for breach of trust or a claim of conversion.

21 SI 2001 No 3755. See from para 7.21 below.

7.17 The imbalance in protection between different modes of transfer has been considered previously by both the Law Commission and the FMLC.[22] In the 2008 Further Updated Advice to HM Treasury, the Law Commission considered the arguments for and against the extension of the good faith purchaser principle to cover transfers of equitable title.[23]

7.18 On the one hand, the Law Commission noted that some commentators felt that extending the good faith purchaser principle was unnecessary, as the issue had only arisen in a very small number of cases. They argued that ultimate investors had not been discouraged from holding their investments through an intermediated securities chains by the disparity in protection, and that typically, ultimate investors placed more emphasis on the perceived trustworthiness of their intermediaries than on their legal protection. They also noted that extending the good faith purchaser principle would reallocate rather than reduce risk. While the purchaser would benefit from increased certainty, the original investor's protection would be diminished.

7.19 On the other hand, the Law Commission also identified several arguments for extending the good faith purchaser principle.

(1) The current situation does not reflect market expectation and practice and "is not a rational development of the law".[24] In general, it makes sense that legal title affords greater rights than equitable title, as legal title can be investigated while equitable rights may be invisible. However, in the context of intermediated securities, a purchaser may have no knowledge or control over whether the securities credited to its account have been acquired as a result of a transfer of legal title or a transfer or equitable title. The current situation creates anomalous gaps in the protection afforded to purchasers. Market prices do not recognise this anomaly: the price an investor pays for intermediated securities is the same as it would pay to purchase the underlying securities. There is no reduction in price to reflect the absence of a defence against third party claims.

(2) A system that fully protects purchasers enhances the transferability of securities. The ease with which investment securities can be bought and sold "is one of their most valuable attributes".[25]

(3) Legal assurance matters to sophisticated participants in settlement systems. While it is true that issues in this area are rare, the value of the market means that even a small number of problems may cause concern.

7.20 The Law Commission concluded that the imbalance in protection between different modes of transfer could not be justified on either legal or commercial grounds,

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22 Further Updated Advice on Intermediated Securities (2008) Pt 5; and FMLC, *Issue 3 – Property interests in investment securities* (July 2004) para 6.8, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf.

23 Further Updated Advice on Intermediated Securities (2008) paras 5.63 to 5.85.

24 Further Updated Advice on Intermediated Securities (2008) para 5.68.

25 Further Updated Advice on Intermediated Securities (2008) para 5.75.

"potentially gives rise to arbitrary and anomalous results", and "does not reflect market expectations".[26]

Protection under the Uncertificated Securities Regulations

7.21 The USRs provide the legal framework for securities held and transferred in electronic "book entry" form.[27] Such securities may be evidenced and transferred under a "relevant system" under the USRs.[28] Currently the only system approved under the USRs is the CREST system operated by the UK CSD, which is EUI.

7.22 Regulation 35 of the USRs operates to protect the integrity and finality of transfers to title in the CREST system. Parties effecting transfers in the CREST system are protected, provided that the instructions for transfer are "properly authenticated dematerialised instructions". A "properly authenticated dematerialised instruction" means an instruction, election, acceptance or other message which is sent or received by a computer-based system and which meets prescribed authentication requirements.[29]

7.23 Regulation 35 provides four elements of protection.

(1) Where a properly authenticated dematerialised instruction sent by means of the CREST relevant system is expressed to have been sent by a "CREST sponsor"[30] on behalf of the transferor, a "statutory estoppel" arises under which:

(a) the transferor is unable to deny to the transferee (as an "addressee" of the instruction) that the instruction was sent with their authority or that the information contained in the instruction is correct; and

(b) the CREST sponsor is unable to deny to the transferee (as an addressee of the instruction) that they have authority to send the instruction or that they actually sent the instruction.

(2) Where a properly authenticated dematerialised instruction sent by means of the CREST relevant system is expressed to have been sent by the transferor itself, a statutory estoppel arises under which the transferor is unable to deny to the transferee (as an addressee of the instruction) that the information contained in the instruction is correct or that they actually sent the instruction.

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26 Further Updated Advice on Intermediated Securities (2008) para 5.1.

27 In relation to shares, see USRs, SI 2001 No 3755, regs 14 to 16. Regulation 3 on interpretation states that a "company" is to be given the definition in section 1(1) of the CA 2006, which states that companies must be registered in the UK. Regulation 19 deals with participation in relation to securities other than shares. For securities other than shares, an issuer may be incorporated or formed under the laws of any country, provided that certain requirements are met: regs 19(2) and 46.

28 USRs, SI 2001 No 3755, reg 2.

29 USRs, SI 2001 No 3755, regs 2 and 3; Sch 1, para 5(3). The authentication requirements are designed to minimise fraud and forgery.

30 We discuss CREST sponsors and members from para 2.56 above.

(3) A transferee (as an addressee of a properly authenticated dematerialised instruction) who receives that instruction (whether itself or through its CREST sponsor) "may accept" at all relevant times that:

(a) the information contained in the instruction was correct;

(b) the system-participant (that is, the CREST sponsor or other user) identified in the instruction as having sent it did indeed send it; and

(c) the instruction, where expressed to be sent by a CREST sponsor, was sent with the authority of the transferor on whose behalf it is expressed to have been sent.

The effect of this protection is that the transferee is able to maintain the integrity and finality of its title to the uncertificated units of a security transferred to it in settlement of the instruction against all third parties. It is subject to a requirement that the transferee does not have "actual notice" of certain defects.

(4) Even if a transferee has actual notice, they may still assume the matters we have outlined in point (3), if at the time they received actual notice, it was not practicable "to halt the processing of the instruction". The CLLS explained that this protection "recognises the practical and operational reality of a computer-based system".

7.24 Provided that regulation 35 has been complied with, a purchaser of securities through a transfer effected in CREST takes the securities free from any equitable or legal interest in, or claim or right to, the securities. This means that a transfer in CREST has the same effect as a transfer of a negotiable instrument, as discussed above.[31]

7.25 Regulation 35 also has the effect of protecting parties which use CREST, such as the CSD and system participants, from liability in damages arising from a negligent or fraudulent transfer of securities.[32] Once an instruction input into the CREST system is in accordance with EUI's technical specifications, those using CREST may assume that everything else about the instruction is also legitimate, unless they have actual notice to the contrary.

7.26 The USRs do not provide a legal basis for the direct registration, transfer or settlement of foreign securities. As a consequence, non-UK issuers looking to access UK capital markets and wanting to settle in the UK CSD must do so through the creation of a Depository Interest ("DI") or a CREST Depository Interest ("CDI").[33] These interests are similar and create a legal structure that allows an interest in securities held on a principal register in the issuer's country of incorporation to be transferred and settled within the CREST system.

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31 See para 7.4 above; and see L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 380.

32 USRs, SI 2001 No 3755, reg 35, paras 7 to 8.

33 These are usually created through a deed poll governed by English law. CDIs are issued by an EUI subsidiary as part of the CREST International Settlement Links Service. DIs are bespoke arrangements and are usually issued by CREST registrars at the request of a foreign issuer.

7.27 For example, if a company incorporated in Spain wanted to trade its shares on the London Stock Exchange, a DI or CDI would need to be created in the CREST system to represent interests in the underlying security which could be held and transferred by means of the CREST system. The function of the DI or CDI would be to enable electronic transfers in the CREST system to fall within the scope of the USRs. The underlying Spanish security could then be listed, traded and settled in the UK.

7.28 We understand from stakeholders including the CLLS that sometimes, for commercial reasons, a trade in a security constituted under foreign law is unable or ineligible to be settled through CREST using a DI or CDI. In that case, settlement must take place outside of the USRs. Where that settlement takes place under an intermediated or immobilisation model governed by English law, this means that the transfer will not have the protection of either regulation 35 or the good faith purchaser principle. Stakeholders have suggested that this makes English law less attractive for these transactions.

Extending the good faith purchaser principle

7.29 As we explain above, a purchaser who acquires a legal interest in securities in circumstances where the person purporting to transfer them did not have authority or legal title to do so may be protected from an equitable claim from the rightful owners by the good faith purchaser principle. However, this protection is not available to a good faith purchaser of only a beneficial interest in securities.

7.30 Most consultees agreed that the disparity in protection cannot be justified, and that the protection afforded to purchasers of a legal interest should be afforded to purchasers of a beneficial interest as well.[34]

7.31 We consider that this change could be effected by the creation of a new statutory provision, which mirrors the common law good faith purchaser principle, set out above.[35] This provision could ensure that there is equal protection to purchasers of beneficial and legal title to securities. If the provision did not mirror that existing rule, there would be two similar but not quite identical protections for beneficial and legal purchasers. This inconsistency and potential uncertainty would not be desirable.

7.32 This suggestion previously formed part of the Law Commission's detailed proposals on extending the good faith purchaser principle in 2008.[36]

7.33 Professor Louise Gullifer QC and Professor Jennifer Payne have said, in reference to the 2008 paper, that the Law Commission's recommendations for statutory reform

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[34] Of the 14 consultees who responded to question 16 of the call for evidence, 12 said the disparity in the way purchasers are protected has the potential to cause problems.

[35] See para 7.7 above.

[36] Further Updated Advice on Intermediated Securities (2008) para 5.105. The FMLC has also previously recommended that "there should be a clear rule in favour of the bona fide purchaser for value without notice": FMLC, *Issue 3 – Property interests in investment securities* (July 2004) para 6.8, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/fmlc_report.pdf.

would address the issues raised by the unavailability of the good faith purchaser principle in the intermediated securities context.[37]

The advantages and disadvantages of this approach

7.34 As the Law Commission has previously said, "extending the good faith purchaser rule to purchasers of intermediated securities offers an attractive symmetry".[38] It could remove the disparity we discuss above and make the application of the rule consistent, certain and clear. This would benefit both purchasers of intermediated securities and the financial services market. The former would be able to rely on the existing body of case law that has developed in relation to the good faith purchaser test. The latter requires a high degree of legal certainty, particularly with regard to the integrity or finality of settlement of securities transactions.

7.35 This solution could also preserve market confidence. A loss of confidence could, for example, be triggered by litigation about this issue or by a re-evaluation of legal risk following a financial crisis. In a worst-case scenario, it could have a significant adverse effect on securities markets in the UK and on the choice of English law to govern property rights in intermediated securities.[39]

7.36 Finally, extending the good faith purchaser principle could also fill the gap in protection, highlighted by the CLLS, where settlement of foreign securities takes place outside of the USRs or otherwise than by means of the CREST system. Extending the good faith purchaser principle would cover these transfers where the transaction is governed by the law of England and Wales.

7.37 Although consultees did not raise any objections to this approach in response to the call for evidence, the Law Commission has previously considered the disadvantages of extending the good faith purchaser principle.[40] Specifically, extending this principle would reallocate, rather than reduce, risk. While the transferee would benefit from increased certainty, the original investor's protection would be diminished.

Next steps

7.38 There is a question as to whether such reform is currently necessary. Consultees told us that problems in practice are uncommon. It may be that in the majority of cases any loss suffered as a result of an improper transfer is dealt with operationally by the intermediaries involved, in order to maintain an intermediary's reputation and client relations.

7.39 Notwithstanding this, we think that the Government should consider taking forward further work with the Law Commission in relation to this issue to make the law more certain, clear and fair for purchasers of intermediated securities in this jurisdiction.

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37 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 380.

38 Further Updated Advice on Intermediated Securities (2008) para 5.105.

39 Further Updated Advice on Intermediated Securities (2008) para 5.4.

40 See para 7.18 above.

The position in Scots law

7.40 Although Scotland does have good faith purchaser rules, these are not the same as those described above. The objective sought by any extension to the good faith purchaser principle would need to be achieved by alternative means in Scots law.

FORMALITIES

7.41 Some investors regularly buy and sell their interests in securities. Some of these transactions will take place in CREST, but others will happen at a lower level in the intermediated securities chain.

> **Example**
>
> Alice and Roxanne are both customers of Money Bank. Alice owns the beneficial interest in intermediated securities which are held by Money Bank. If Alice sells her intermediated securities to Roxanne, that transaction can take place by transferring her intermediated securities from Alice to Roxanne in the internal systems of Money Bank. The interest held at CREST level does not need to change.

7.42 The question arises whether transactions which take place at a lower level on the intermediated securities chain are subject to certain statutory formality requirements. A "formality" is a procedure which a party must follow in order to give legal effect to a transaction. Formalities include requirements that certain transactions are made "in writing" or signed.[41]

Section 53(1)(c) of the Law of the Property Act 1925

7.43 Section 53(1)(c) provides that:

> a disposition of an equitable interest or trust subsisting at the time of the disposition, must be in writing signed by the person disposing of the same, or by his agent thereunto lawfully authorised in writing or by will.

7.44 The USRs disapply section 53(1)(c) for transfers effected in CREST.[42] This is because "the markets dependent on [frequent financial] trading would grind to a halt if signed writing were required for every disposition".[43]

7.45 However, there is no statutory disapplication of section 53(1)(c) for the transfers of interests in securities which are effected at a lower tier in the intermediated securities

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41 Electronic Execution (2019) Law Com No 386, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2019/09/Electronic-Execution-Report.pdf.

42 USRs, SI 2001 No 3755, reg 38(5).

43 B McFarlane and C Mitchell, *Hayton and Mitchell on the Law of Trusts & Equitable Remedies* (14th ed 2015) para 3-104.

chain. If section 53(1)(c) applies to transfers at a lower tier then those transfers would need to be in writing and signed.

7.46 It is not clear whether section 53(1)(c) would apply to transfers of beneficial interests in securities which occur lower down the chain, outside of the CREST system. Commentators have described the position in relation to such transfers as "extremely uncertain"[44] and the general case law in relation to section 53(1)(c) as "inconsistent and illogical".[45]

7.47 For example, the authors of *The Law of Personal Property* suggest that whether section 53(1)(c) applies will depend on how the transfer takes place.[46] "Disposition" is widely interpreted.[47] If, in the above example, Alice's interest disappears on transfer and a new interest is created for Roxanne, section 53(1)(c) would arguably not apply because there has not been a disposition. However, if Alice gives an instruction to Money Bank to deal with her interest in a particular way, and to hold the assets on trust for Roxanne, section 53(1)(c) would apply.

7.48 In *Vandervell v Inland Revenue Commissioners*,[48] the House of Lords, when considering the purpose of section 53(1)(c), said that it was created to prevent fraud and enhance the transparency of transactions:

> the object of the section, as was the object of the old Statute of Frauds, is to prevent hidden oral transactions in equitable interests in fraud of those truly entitled, and making it difficult, if not impossible, for the trustees to ascertain who are in truth his beneficiaries.

7.49 More recently, in *SL Claimants v Tesco plc*, Mr Justice Hildyard said, in non-binding comments, that section 53(1)(c) does not apply to transfers of intermediated securities.[49] Referring to *Vandervell*, he said:

> I do not see in that case any suggestion that where a person (X) enters into a transaction pursuant to which, at X's direction and for value, shares previously held on trust by a custodian and then through a series of sub-trusts ultimately for X become held by the custodian and then through a series of sub-trusts ultimately for

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44 M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 26-050.

45 M Haley and L McMurtry, *Equity and Trusts: Textbook Series* (5th ed 2017) para 4.10. For commentary on the case law, see also J Glister and J Lee, *Hanbury & Martin: Modern Equity* (21st ed 2018) para 6-011 onwards; B McFarlane and C Mitchell, *Hayton and Mitchell on the Law of Trusts & Equitable Remedies* (14th ed 2015) paras 3-051 to 3-104; C H Tham, "Exploding the Myth that Bare Sub-Trustees 'Drop Out'" (2017) 2 *Trust Law International* 76.

46 M Bridge, L Gullifer, K F K Low and G McMeel, *The Law of Personal Property* (2nd ed 2018) para 26-050; B McFarlane and C Mitchell, *Hayton and Mitchell on the Law of Trusts & Equitable Remedies* (14th ed 2015) paras 3-099 and 3-100.

47 *Grey v Inland Revenue Commissioners* [1960] AC 1 at 13; J Benjamin, *Interests in Securities* (2000) para 3.39.

48 *Vandervell v Inland Revenue Commissioners* [1967] 2 AC 291 at 311. Section 53(1)(c) of the Law of Property Act 1925 replaced section 9 of the Statute of Frauds 1677. See also the purpose of formalities in Electronic Execution (2019) para 2.11.

49 *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus LR 250 at [116].

Y, would not constitute a disposal by X and an acquisition by Y of an interest in the relevant shares. *Nor do I see in that case any basis for a suggestion that separate writing would be necessary for the transfer of the ultimate interest in equity thereby effected. There is no question of any untoward or secret dealing such as to trigger section 53(1)(c): no person in the chain would have any right to object or dispute the transaction, nor would any person be in doubt as to their beneficiary.* (Emphasis added.)

7.50 We discuss below whether the law should be clarified. However, even if a court were to decide that section 53(1)(c) applied to transfers of intermediated securities then, depending on the exact process by which the transfer was effected, the conditions of section 53(1)(c) could be satisfied.

7.51 In a recent Law Commission report, we said that digital information represented or displayed on a screen satisfies the definition of "in writing".[50] In relation to electronic signatures, we also concluded that the common law does not prescribe any particular form or type of signature.[51] The courts have held that a name typed at the bottom of an email, clicking "I accept" on a website and the header of a SWIFT message constitute valid signatures.[52]

7.52 We are not aware of the details of the technological systems by which transfers of intermediated securities are executed. It is likely that they will differ between intermediaries. However, the common law takes a pragmatic approach to electronic execution of transactions.

Consultees' views

7.53 Consultees including the CLLS and the AGC said that the current position may cause legal uncertainty. The CLLS and EUI said that there is a "material concern" that a court could decide that section 53(1)(c) does apply to these transfers. This could undermine market confidence in the effectiveness of book entry transfers of intermediated securities.

7.54 Some consultees, such as Sir John Dermot Turing, pointed out that the section "may be more of a bugbear than an actual problem". Consultees told us that they did not have specific examples or evidence of section 53(1)(c) causing any problems in practice.[53]

7.55 We have not been able to establish the number of transfers of intermediated securities which do not occur in CREST. However, at least in relation to the retail investor sector, we have been told that "the practical reality" is that most transactions are

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50 Electronic Execution (2019) paras 2.15 to 2.17; Electronic commerce: formal requirements in commercial transactions – Advice from the Law Commission (2001), paras 3.8, 3.14 and 3.17, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/09/electronic_commerce_advice.pdf.

51 Electronic Execution (2019) p 2.

52 Electronic Execution (2019) p 3.

53 Of the 12 consultees who responded to question 17, none identified an example or gave specific evidence of problems caused by the section.

settled through CREST and that very few firms have the resources to settle trades at a lower level of the intermediated securities chain.[54]

Possible solutions

7.56 Although consultees told us that they did not have specific examples or evidence of section 53(1)(c) causing problems in practice, some consultees said that legislative reform could enhance legal certainty and confidence in the UK securities market. We consider two potential approaches, both of which we think would work well and warrant further consideration by the Government:

(1) a statutory disapplication of section 53(1)(c) to intermediated securities; and

(2) the creation of a new statutory provision, modelled on article 11 of the Geneva Securities Convention.[55]

7.57 Additionally, if section 53(1)(c) was considered to apply to transfers of intermediated securities, we think that it could be demonstrated that the requirements the section were met, depending on the exact technological process by which the transaction was effected, as discussed above.[56]

A statutory disapplication of section 53(1)(c)

7.58 An amendment could be made to disapply section 53(1)(c) to transfers of intermediated securities. The CLLS stated that disapplying section 53(1)(c) would:

> clearly and finally remove any potential risk of impractical and unworkable formality requirements applying to the electronic holding and transfer of intermediated securities.

7.59 We think that this would be a simple and self-contained solution to the current potential uncertainty. It would also be consistent with the USRs, which already disapply section 53(1)(c) in relation to transfers of intermediated securities in CREST.

The Geneva Securities Convention

7.60 The 2009 Geneva Securities Convention ("the Convention") is an international instrument which provides a legal framework for holding and transferring intermediated securities. It aims to harmonise the operation and outcomes of national laws, and to enhance the stability and cross-border compatibility of national financial markets. However, the Convention is not currently in force.[57]

7.61 Article 11 of the Convention addresses the transfer of interests in an intermediated securities chain. It provides that the only formality requirement for an effective transfer of intermediated securities is that there must be a credit to the account holder's account.

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54 Correspondence with Chris Horner, General Counsel at Interactive Investor.

55 UNIDROIT Convention on Substantive Rules for Intermediated Securities (May 2009).

56 See from para 7.50 above.

57 https://www.unidroit.org/status.

7.62 A new statutory provision could be modelled on article 11 and provide that:

(1) intermediated securities (or an interest in such securities) are acquired when a credit is entered in the securities account of the transferee, and they are disposed of when a debit is made to the securities account of the transferor; and

(2) no other formalities are necessary.

7.63 A new statutory provision which sets out positive formality requirements for the effective transfer of intermediated securities may provide more clarity to parties than disapplying existing statutory provisions. The existence of only one formality, which can be easily complied with and evidenced, could enhance confidence in the effectiveness of transactions.

The position in Scots law

7.64 The Law of Property Act 1925 does not apply in Scotland and the formalities of transfer described above are not the same under Scots law. Again, an alternative solution would be needed for Scotland.

TAKING SECURITY OVER INTERMEDIATED SECURITIES

7.65 When an ultimate investor uses the services of an intermediary, they will typically incur charges and fees for these services. To ensure that an intermediary does not end up out of pocket because an ultimate investor fails to pay these charges and fees, intermediaries usually take security over the intermediated securities in their custody.

7.66 In practice, the security that intermediaries take is usually a charge or a lien. A charge is a type of security interest that can be taken over an asset. The owner of the asset creates a proprietary interest in relation to that asset in favour of the person who takes the benefit of the charge.[58] For example, if an ultimate investor fails to pay fees as agreed with the intermediary, the intermediary may have a right to the proceeds of sale of the intermediated securities to recover the amounts owed to it.

7.67 By contrast, a lien is a right to retain possession of a thing until a claim or debt has been satisfied. Liens may arise by operation of law, by statute, or under a contract between the parties.

7.68 Both charges and liens ensure that the intermediary has a specifically enforceable right in respect of intermediated securities and the proceeds of their sale to discharge any debt owed by the ultimate investor. This right takes priority over claims of unsecured creditors. However, a lien requires the creditor (in this case, the intermediary) to take possession of the asset. A charge may be taken over an asset without the creditor taking possession of it.[59]

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[58] L Gullifer and R Goode, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) para 1-55.

[59] L Gullifer and R Goode, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) paras 1-53 and 1-55.

7.69 Consultees raised two discrete issues arising from the availability of certain types of security in the context of intermediated securities. Below, we consider:

(1) the application of the Financial Collateral Arrangements (No 2) Regulations 2003[60] ("FCARs") to intermediated securities; and

(2) the availability of a custodian's lien over dematerialised securities.

The Financial Collateral Arrangements (No 2) Regulations 2003

7.70 The FCARs enable intermediaries to take security over assets free from a number of restrictions and formalities which would usually apply.[61] The purpose of these provisions is to make it quicker and easier to enforce security in the event that the ultimate investor defaults on their obligations or becomes insolvent.

The requirement for "possession" or "control" under the FCARs

7.71 For a security arrangement to qualify for the exemptions provided by the FCARs, it must be considered a "security financial collateral arrangement".[62] Regulation 3 provides that "security financial collateral arrangement" means:

> an agreement or arrangement, evidenced in writing, where—
>
> (a) the purpose of the agreement or arrangement is to secure the relevant financial obligations owed to the collateral-taker;
>
> (b) the collateral-provider creates or there arises a security interest in financial collateral to secure those obligations;
>
> (c) the financial collateral is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker or a person acting on its behalf; any right of the collateral-provider to substitute financial collateral of the same or greater value or withdraw excess financial collateral or to collect the proceeds of credit claims until further notice shall not prevent the financial collateral being in the possession or under the control of the collateral-taker; and
>
> (d) the collateral-provider and the collateral-taker are both non-natural persons.

7.72 In the context of intermediated securities, the collateral provider (who could be an ultimate investor, or an intermediary in the chain), grants a security interest (such as a

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60 Financial Collateral Arrangements (No 2) Regulations 2003 ("FCARs"), SI 2003 No 3226.

61 FCARs, SI 2003 No 3226, reg 4. For example, reg 4 disapplies s 4 of the Statute of Frauds 1677, s 53(1)(c) and s 136 of the Law of Property Act 1925 in relation to a requirement for a signature and "writing". Regulation 4 also disapplies s 859A of the CA 2006 and s 4 of the Industrial and Provident Societies Act 1967, dealing with the registration of charges.

62 Under reg 3 of the FCARs there are two types of financial collateral arrangements. The first is a "security financial collateral arrangement", and the second is a "title transfer financial collateral arrangement". The second concerns transfer of legal title and is therefore not applicable in the context of intermediaries taking security over an ultimate investor's securities.

charge)[63] over its beneficial interest in securities, to the collateral taker (such as another intermediary).

7.73 We are particularly concerned with sub-paragraph (c) of the definition above. Academic commentary and case law indicate that it is potentially unclear whether an intermediary in an intermediated securities chain has sufficient "possession" or "control" of an ultimate investor's intermediated securities to satisfy the definition of "security financial collateral arrangement" in the FCARs.

7.74 Before 2010, there was some uncertainty about whether it was possible to "possess" intangible collateral, such as intermediated securities, for the purposes of the FCARs, which are based on an EU Directive.[64] In 2010, regulation 3 was amended to clarify that intangible collateral could be "possessed".[65] The amendment included an important qualification:[66]

> For the purposes of these Regulations "possession" of financial collateral in the form of cash or financial instruments includes the case where financial collateral has been credited to an account in the name of the collateral-taker or a person acting on his behalf … *provided that any rights the collateral-provider may have in relation to that financial collateral are limited to the right to substitute financial collateral of the same or greater value or to withdraw excess financial collateral*. (Emphasis added.)

7.75 In other words, the amendment provides that intangible collateral is capable of possession, on the condition that the ultimate investor has limited rights in relation to it. Specifically, the ultimate investor may only:

(1) substitute collateral (such as other intermediated securities) of the same or greater value; or

(2) withdraw any excess collateral.

7.76 In *Re Lehman Brothers*,[67] Mr Justice Briggs considered whether intermediaries who were granted a charge over securities were in possession or control of those securities, for the purposes of the FCARs.[68] He observed that both "possession" and

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63 See the definition of "security interest": FCARs, SI 2003 No 3226, reg 3.

64 *Gray v G-T-P Group Ltd; Re F2G Realisations Ltd (In Liquidation)* [2010] EWHC 1772 (Ch), [2011] BCC 896. The FCARs implement the EU Financial Collateral Directive 2002/47/EC, Official Journal L 168 of 27.06.2002 p 43. In *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2014] 2 BCLC 295 at [76], Briggs J said that "[a]s national legislation implementing an EU directive, the FCARs are to be interpreted, so far as possible, in a manner consistent with the meaning and purpose of the directive".

65 Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010, SI 2010 No 2993.

66 FCARs, SI 2003 No 3226, reg 3(2).

67 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2014] 2 BCLC 295.

68 Mr Justice Briggs found that the security interest, which was referred to as a "general lien" was a floating charge. See our discussion on custodian liens from 7.82 below.

"control" meant "something more than mere custody of financial collateral by the collateral taker".[69] Mr Justice Briggs said:[70]

> what needs to be shown (in order to bring a particular collateral arrangement within the protection of the FCARs), is that the terms upon which it is "provided" … or "delivered, transferred, held, registered or otherwise designated" … are such that there is shown to be sufficient possession or control in the hands of the collateral taker for it to be proper to describe the collateral provider as having been "dispossessed" … . There will be cases in which the collateral is sufficiently clearly in the possession of the collateral taker that no further investigation of its rights of control is necessary. In other cases … it will be necessary to analyse the degree of control thereby conferred on the collateral taker. There may be some cases, in particular where there is no delivery, transfer or holding to or by the collateral taker, but merely some form of designation, where the collateral remains wholly in the possession of the collateral provider, but on terms which give a legal right to the taker to ensure that it is dealt with in accordance with its directions.

7.77 Mr Justice Briggs concluded that the intermediary in this case was not in possession or control of the collateral because, under the terms of the arrangement, the ultimate investor had the right to withdraw more than "excess" collateral and therefore, in effect, had the right to dispose of the collateral.[71]

7.78 Some commentators argue there is uncertainty about what rights the ultimate investor can exercise consistently with the intermediary's possession or control. Professor Sir Roy Goode QC and Professor Louise Gullifer QC argue that this uncertainty has "caused particular consternation in the markets, since certain market practices could involve the collateral provider having additional rights". Additional rights, such as the right to dividends and the right to vote, may affect the application of the FCARs. They say that "such a conclusion would cut across many arrangements used in practice, and would be very unfortunate".[72]

7.79 The AGC, in their response to the call for evidence, said that this uncertainty is undesirable for two reasons. First, it undermines confidence in security arrangements which are widely used in the financial markets. Secondly, it may cause intermediaries to take steps to prevent ultimate investors from exercising their rights, so that the intermediary retains sufficient possession or control of the assets for the purposes of the FCARs.

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69 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2014] 2 BCLC 295 at [131].

70 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2014] 2 BCLC 295 at [136].

71 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2014] 2 BCLC 295 at [141] to [147]. In *Private Equity Insurance Group SIA v Swedbank AS* (C-156/15) [2017] EU:C:2016:851, [2017] 1 WLR 1602, the CJEU subsequently held that a collateral taker of money in a bank account could be regarded as having "possession or control" of the money only if the collateral provider was prevented from disposing of it (at [51]).

72 L Gullifer and R Goode, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) at 6-44.

Options for reform

7.80 The AGC said in their response to the call for evidence that the law should be amended to clarify that the exercise of legal rights (such as voting rights) by the ultimate investor does not disqualify an arrangement from the FCARs. The FMLC has also previously said that the FCARs should be amended.[73]

7.81 We think that further work on this issue could provide legal certainty and clarify the position for the financial markets. This may be particularly relevant if ultimate investors' rights were to be enhanced through future reform, as this could cause further uncertainty about the application of the FCARs.

Custodian liens

7.82 Some intermediaries may prefer not to take a charge over intermediated securities and instead may prefer to take custodian liens as security. For example, AFME and UK Finance, in their joint response to the call for evidence, said:

> 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.

7.83 A custodian's lien is a lien over assets held in custody. In the case of certificated shares, intermediaries have a lien over those shares deposited with them by ultimate investors, which arises by operation of law without the need for agreement between the parties.[74]

7.84 In the case of dematerialised securities, no such lien arises by operation of law. Instead, the contract between the intermediary and the ultimate investor will typically provide the intermediary with a "lien" over the securities it holds. This contractual term usually confers additional rights upon the intermediary, such as a power to sell the securities or a right to set off securities against the ultimate investor's debts owed to the intermediary.[75]

7.85 However, the issue of "possession" of intangible property arises again. It is uncertain whether it is possible for an intermediary to hold a custodian's lien over dematerialised

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[73] FMLC, *Issue 1: Collateral Directive Analysis of uncertainty regarding the meaning of "possession or … control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003* (December 2012), at http://fmlc.org/wp-content/uploads/2018/03/Issue-1-Collateral-Directive-Report.pdf.

[74] *Re London and Globe Finance Corp* [1902] 2 Ch 416.

[75] M Yates and G Montagu, *The Law of Global Custody* (4th ed 2013) para 4.72.

securities. In *Your Response v Datateam*,[76] the Court of Appeal held that a lien could not exist over intangible property, because a person can only be in "possession" of tangible property.

7.86 In that case, the claimant argued that a person can have "constructive" or "practical" possession of intangible property and can be in "possession" even though they do not have physical control of the property. Rather, "what matters is whether the claimant is able to exercise *effective* control" over the property (emphasis added).[77] The claimant gave the example of a person who holds the only key to a warehouse containing goods. That person is constructively in possession of the goods, even though they do not have physical control of the goods, because they can exercise complete control over who has access to them. Likewise, if a person can control access to an intangible asset, such as a database, that person is in constructive possession of that property, even though they cannot exercise physical control over it.

7.87 The Court of Appeal dismissed this argument on the basis that possession requires "physical control of tangible objects".[78] Lord Justice Moore-Bick drew a distinction between the holder of a key to a warehouse (who has physical control over the physical objects inside), and someone asserting constructive control over a database of information, over which physical control is not possible.[79]

7.88 Depending on the terms of the agreement, the court may characterise a security expressed to be a lien as a charge.[80] This emphasises the need for certainty in relation to whether the FCARs apply to charges over intermediated securities, discussed above.[81]

Next steps

7.89 We consider above whether it is possible to take a lien over dematerialised securities in the context of intermediated securities.

7.90 This issue will be considered in detail in separate work by the Law Commission, which will analyse how and why the common law's definition of "possession" creates difficulties for the legal treatment of intangible assets more generally, with a view to legislative reform.[82]

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76 *Your Response Ltd v Datateam Business Media Ltd* [2014] EWCA Civ 281, [2015] QB 41. This is the position taken by academic commentators as well: see L Gullifer and R Goode, *Goode and Gullifer on Legal Problems of Credit and Security* (6th ed 2017) paras 1-08 and 1-53.

77 *Your Response Ltd v Datateam Business Media Ltd* [2014] EWCA Civ 281, [2015] QB 41 at [22].

78 *Your Response Ltd v Datateam Business Media Ltd* [2014] EWCA Civ 281, [2015] QB 41 at [23].

79 *Your Response Ltd v Datateam Business Media Ltd* [2014] EWCA Civ 281, [2015] QB 41 at [34] and [39]. See also M Yates and G Montagu, *The Law of Global Custody* (4th ed 2013) para 3.14.

80 As happened in *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2014] 2 BCLC 295.

81 See from para 7.70 above.

82 https://www.lawcom.gov.uk/project/digital-assets/.

The position in Scots law

7.91 The forms of security available in Scotland are not the same as those described above. Again, bespoke solution would be required for Scotland.

INSOLVENCY AND "CONTROL"

7.92 One consultee, David Pollard QC, brought to our attention an issue arising from the definition of "associate" and "control" under the Insolvency Act 1986, and how this may impact on intermediaries holding the legal interest in securities.

7.93 A person is an "associate" of a company if they have "control" of the company.[83] Under section 435(10)(b) of the Insolvency Act 1986, a person has "control" of a company if they are:

> entitled to exercise, or control the exercise of, one third or more of the voting power at any general meeting of the company or of another company which has control of it.

7.94 There are various consequences of being an associate under section 435. Under the Insolvency Act 1986, an associate of a company, who has entered into a transaction with that company, faces a greater risk of the transaction being unwound by a court in the event of the company's insolvency. This is because being an associate of the insolvent company triggers the extended time limits and presumptions of insolvency, making it easier for the insolvency practitioner to succeed in an application to the court to reverse the transaction.[84]

7.95 Being an associate also has consequences under the Pensions Act 2004. Pursuant to that Act, the Pensions Regulator has powers to issue contribution notices and financial support directions to a person who is an associate of an employer, under section 435 of the Insolvency Act 1986.[85]

7.96 The Court of Appeal held in *Granada UK Rental & Retail Ltd v The Pensions Regulator*[86] that a person has "control" of a company for the purposes of section 435(10)(b) if they are:[87]

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83 Insolvency Act 1986, s 435(7).

84 See, eg, Insolvency Act 1986, ss 238 to 245.

85 Pensions Act 2004, ss 38 to 51.

86 [2019] EWCA Civ 1032, [2020] ICR 747.

87 [2019] EWCA Civ 1032, [2020] ICR 747 at [129]. The Court of Appeal in *Granada UK Rental & Retail Ltd v The Pensions Regulator* said at [129]: "a person registered as the holder of shares carrying a third or more of the total votes attaching to the relevant company's issued shares, and so as between himself and the company "entitled to exercise … one third or more of the voting power", is also to be considered to be so entitled within the meaning of s 435(10)(b) IA 1986 and, hence, an associate of the company." This is a different view from that in *Re Kilnoore (in liquidation)* [2005] EWHC 1410 (Ch), [2006] Ch 489.Section 435(10)(b) refers to the "exercise" of voting power, or the "control of the exercise" of voting power. Therefore, a company which controls an intermediary which has one third of the voting power, may therefore also be considered an "associate" under the Insolvency Act 1986. See D Pollard, "Shareholders' Control under the Insolvency Act 1986: A change in position" (August 2019) *PLC Magazine* 2.

registered as the holder of shares carrying a third or more of the total votes attaching to the relevant company's issued shares, and so as between himself and the company "entitled to exercise … one third or more of the voting power".

7.97 David Pollard QC said that following this decision, "it now seems that the legal/registered holder will be treated as being able to control the exercise of the relevant voting power, even where such legal holder is a [mere] trustee or depositary." He said that this position may dissuade intermediaries from becoming the registered owner of shares.

Next steps

7.98 One way to deal with this issue would be to amend the Insolvency Act 1986 to clarify that a bare trustee is not to be treated as having "control" of the company, and is therefore not an "associate" of the company.

7.99 However, we think that this issue requires consideration in the broader context of the Insolvency Act 1986 and should be referred to the Insolvency Service. Any work on legislative change would need to consider the effectiveness of the existing system and whether such an amendment is necessary. For example, we have been told that the current legislation is effective in most scenarios and the court already has a discretion to depart from the presumptions triggered by "association" under the Insolvency Act 1986.[88] There may be other, more targeted ways to address this, if it was thought necessary.

[88] For example, the court has such a discretion in cases of transactions at undervalue (s 238) and in relation to preferences (s 239).

Chapter 8: Opportunities presented by dematerialisation

8.1 In previous chapters, we discuss issues arising in relation to intermediated securities, such as voting, schemes of arrangement and the application of the good faith purchaser principle, and we outline specific targeted solutions which could be applied to strengthen ultimate investors' rights. We now turn to consider possible changes to the holding system, which may provide overarching solutions to these issues.

8.2 The increasing involvement of intermediaries in securities ownership is often attributed to the trend of moving away from paper certificates. But does the increase in electronic holdings necessarily mean that investors can no longer hold the legal interest in their investments, and must accept a beneficial interest only? In this chapter, we look at how the potential move to an entirely electronic system of holding securities ("dematerialisation") may provide opportunities to enhance the rights of investors in an intermediated securities chain.

8.3 We describe the options available to the Government if it wished to take the opportunity of dematerialisation, if and when it happens, to make more extensive changes to the system of share ownership so that intermediation is no longer a necessary feature. Depending on the nature of such a change, it may negate the need for the more targeted solutions to particular issues which we discuss above.

8.4 We consider that there are two obvious approaches to dematerialisation which could enhance the rights of investors already holding shares electronically.

(1) First, we look at an approach which would remove intermediation altogether, and under which all securities would be held directly and all investors would be named on the register of members (a "name on register" structure).

(2) Second, we consider an approach which represents a less fundamental change, retaining the current intermediated arrangements but also introducing a genuine alternative in the form of an affordable avenue for investors to hold their shares directly if they so wish.

8.5 Drawing on consultees' responses to the call for evidence, we conclude that, whilst a "name on register" system would ensure all investors benefitted from being a "member" in terms of the CA 2006, the second approach may be more proportionate. Rather than requiring profound changes to the current system, it would retain the current system and benefits of intermediation, whilst offering a realistic option to those investors wishing to hold securities directly. However, in the future the Government may wish to consider the potential long-term systemic benefits of such a "name on register" system, particularly where it could be paired with new technology such as distributed ledger technology ("DLT").

THE MOVE TOWARDS DEMATERIALISATION

8.6 Traditionally, securities were issued with a paper certificate to evidence them.[89] Most securities are now issued electronically, without a paper certificate. However, the Registrars' Group told us there are in excess of 10 million investors who hold their shares in paper certificated form.

8.7 "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. The general trend towards holding shares electronically was formalised by EU legislation in the form of the Central Securities Depositories Regulation ("CSDR").[90]

8.8 The CSDR sets a deadline of 2023 for ceasing the issue in paper form of most new publicly traded securities and a deadline of 2025 for the dematerialisation of existing paper shares for publicly traded securities.[91] Therefore, the CSDR affects individual shareholders who hold their shares directly through paper share certificates. These certificates will need to be replaced with an electronic form of holding shares.

8.9 Now that the UK has exited the EU, the CSDR requirements no longer apply.[92] However, regardless of the status of the CSDR in this jurisdiction, stakeholders have told us that dematerialisation is generally considered to be a positive step towards greater efficiency.[93]

8.10 During 2016 and 2017, the Government engaged with industry participants on the process for dematerialising existing paper share certificates. Following consultation with stakeholders, the Dematerialisation Working Group proposed an "industry model" of dematerialisation (the proposed industry model). 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.

Our terms of reference and the call for evidence

8.11 As part of our terms of reference, BEIS asked us to consider whether dematerialisation, if implemented, offers opportunities to enhance the rights of investors already holding shares electronically.

8.12 In the call for evidence, we asked the following questions.

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

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89 We discuss the difference between bearer securities and registered securities at para 2.9 above.

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

91 CSDR, arts 3 and 76.

92 European Union (Withdrawal) Act 2018, s 3(1) and (3).

93 Call for evidence (2019) paras 2.91 to 2.101.

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

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

THE PROPOSED INDUSTRY MODEL OF DEMATERIALISATION

What has the industry proposed?

8.13 It was clear from consultees' responses to the call for evidence, which we discuss below, that there has already been significant industry preparation for dematerialisation. Holders of paper securities generally hold those securities directly (rather than through an intermediated securities chain) and are therefore named on the register and are the legal owners of the shares.[94] The proposed industry model was developed to enable those investors to continue to hold their securities directly, even when they are converted to electronic form, so they will remain the legal owners of the securities. It is based on the removal of certificates as evidence of title, with individuals' shareholdings represented solely through electronic book entry records. Members would be given a unique password or "key" for the purposes of carrying out transactions.[95]

8.14 In their response to the call for evidence, Link Asset Services said:

> 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.

8.15 As we explain in Chapter 2, companies must keep a register of members.[96] In practice, this is usually managed by a third-party registrar on the company's behalf as its agent. A register of members is typically comprised of two parts:

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94 Computershare told us that although the vast majority of certificated positions indicate direct ownership, intermediaries do offer arrangements under which the shareholding is recorded in their name, on behalf of ultimate investors, but held in certificated form. The most common instance where this occurs is where securities are not eligible to be held on CREST.

95 The Registrars' Group of the Institute of Chartered Secretaries and Administrators, *An industry proposed model for dematerialisation* (2014), at https://www.computershare.com/uk/Shared%20Documents/Industry%20Dematerialisation%20Model%20for%20UK%20and%20Irish%20markets.pdf.

96 CA 2006, s 113. We discuss the register of members at para 2.12 above, and how this affects ultimate investors who hold intermediated securities from para 2.92 above.

(1) the “issuer record” or “certificated register”, which comprises members who hold their securities in paper form; and

(2) the “operator record”, which comprises members who hold their securities through the CREST system. The CREST system updates in real time as parties buy and sell securities.[97] The registrars receive copies of all CREST settlement activity and are obliged to reconcile the operator record with the register of members on a frequent basis.

8.16 Under the proposed industry model, the composition of the register of members would change. It would comprise:

(1) a direct record, which would be the equivalent of the current “certificated register”, holding the names of investors who hold securities directly; and

(2) the “operator record” kept by CREST. This is unchanged from the current position.

8.17 Settlement would continue to take place in CREST. We understand that the proposed industry model sets out a process for moving shareholdings between the direct record and the operator record. This process would be necessary when, for example, an investor on the direct record wants to sell shares to, or buy shares from, an investor on the operator record. In that case, the investor would need to engage the services of an intermediary to effect the transactions. In this respect, there would be no change for a current holder of certificated shares.

Consultees’ views

8.18 Several consultees, including UKSA and ShareSoc, AMNT, the CLLS, the Registrars’ Group, Computershare, Equiniti and Link Asset Services, referred to the previous work of the Registrars’ Group in consulting with stakeholders and producing the proposed industry model.

8.19 The Registrars’ Group further said that:[98]

> 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.

8.20 UKSA and ShareSoc argued that dematerialisation should go ahead regardless of the UK leaving the EU. They said that they supported the model suggested by the

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97 The CREST system is updated post-trade rather than at the point of the buy-sell event.

98 Computershare and Equiniti both endorsed this statement.

Registrars' Group and that dematerialisation is "an opportunity" to treat all investors equally and provide the same benefits to all investors. 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, whilst noting that there are important legal concerns to be considered, which we list below.[99]

8.21 The Registrars' Group told us that implementing dematerialisation more generally could have the following benefits:

(1) improved efficiency, because securities will be held electronically;

(2) increased opportunity for standardisation;

(3) reduced risk in relation to potential fraud, using a paper certificate; and

(4) reduced costs in certain aspects for investors. For example, the cost of issuing a replacement certificate if the certificate is lost would be removed.[100]

8.22 The initial work on dematerialisation was undertaken several years ago, with the proposed industry model published in 2014. We think that if the Government were to take forward work on dematerialisation, it would be useful to consult with industry to see, in particular, whether there have been any technological or operational developments in the intervening period that would be useful to incorporate.

What about investors who are not confident users of technology?

8.23 In general, we think that any reform which leads to an entirely electronic system should consider accessibility and the needs of older people or people affected by digital poverty. In the call for evidence, we asked consultees whether there are concerns about imposing dematerialisation on long-time shareholders currently holding paper certificates, particularly when they may not be confident users of technology.[101]

8.24 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 and EUI 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.

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99 We discuss the legal considerations from para 8.29 below.

100 The Registrars' Group told us that currently if a paper certificate is lost there is potential for the missing certificate to be misused. The process for issuing a replacement certificate involves indemnifying the issuer, and possibly the issuer's agent. Under the industry model, indemnification will not be necessary and therefore, the ultimate investor will save money.

101 Call for evidence (2019) para 2.101. We received 17 responses to this question.

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.[102] Some consultees told us that this issue has previously been considered in the context of the proposed industry model.[103] Link Asset Services also pointed to recent figures from the Office for National Statistics which indicate increasing usage of and access to the internet.[104] 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".

8.26 The Registrars' Group, Equiniti and Computershare all agreed that the "use of technology is not a prerequisite" of the industry model. They warned against simply moving such shareholders into the current intermediated system. They said 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 the greater concern is that investors who currently hold their securities directly will be "pushed into holding indirectly without fully appreciating that holding indirectly can affect their rights".[105]

8.27 UKSA and ShareSoc drew a parallel between dematerialisation and contactless methods of payment, electronic TV licences and email for "routine communications". PIMFA agreed that this is not a "major issue", pointing out that many retail investors already hold their shareholding electronically.

8.28 We did not hear from shareholders holding paper certificated shares in response to our consultation. We think that this additional perspective should be taken into account if the Government were to implement dematerialisation.

Legal considerations

Potential legislative amendments

8.29 If dematerialisation, using the proposed industry model, were to be implemented, the Government would need to analyse the potential amendments which would be necessary under the CA 2006, the USRs[106] and the Stock Transfer Act 1963.

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102 Of the 17 consultees who responded to this question, ten said that there were no such concerns; four said that there were concerns (with the CLLS and EUI saying that there were concerns "to some extent") and three consultees answered "other".

103 These consultees included the Registrars' Group, Equiniti, Computershare and Link Asset Services.

104 In particular, Link Asset Services referred to figures showing: (1) recent internet use in the 65 to 74 years age group increased from 52% in 2011 to 83% in 2019; (2) in 2011, of all adults aged 75 years and over, 20% were recent internet users, rising to 47% in 2019; and (3) since 2011, the percentage of adults aged 65 years and over who had never used the internet has declined by 29 percentage points to 29%: Office for National Statistics, *Internet users, UK: 2019* (May 2019), at https://www.ons.gov.uk/businessindustryandtrade/itandinternetindustry/bulletins/internetusers/2019.

105 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.

106 Uncertificated Securities Regulations 2001, SI 2001 No 3755.

8.30 Part 21 of the CA 2006 provides a broad power to make regulations dealing with dematerialisation of paper certificates. Sections 784 to 788 provide detailed regulation-making powers,[107] which could be used to implement the proposed industry model. For example, such regulations may:[108]

(1) enable title to securities to be evidenced and transferred without a written instrument;

(2) require companies to adopt arrangements under which title to securities is evidenced or transferred without a written instrument;

(3) prohibit the issue of certificates for the issue or transfer of shares.

8.31 The powers in these sections allow regulations to:[109]

(1) modify or exclude any Act, statutory instrument or "any rule of law";

(2) apply, with appropriate modifications, the provisions of any Act or statutory instrument (including those creating criminal offences);

(3) require the payment of fees.

8.32 The powers in Part 21 are broad and could be used to introduce regulations which amend the CA 2006, the USRs and the Stock Transfer Act 1963, as necessary, to implement a dematerialisation model.

Other legal considerations

8.33 There are additional legal issues which would require consideration before dematerialisation could be implemented. For example, although supportive of the proposed industry model, the CLLS said that there are:

> Important concerns from a legal perspective … 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.

8.34 In particular, the CLLS pointed out that 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 USRs (which were designed to mirror the law for certificated securities). They also said that 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:

(1) the consequences if a holder key is improperly used by a third party;

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107 Regulations under Chapter 2 are subject to an affirmative resolution procedure: s 784(3). Section 789 imposes a duty to consult on any regulations made under Chapter 2.

108 CA 2006, ss 785(1), 786(1), (4).

109 CA 2006, s 788.

(2) how a holder key may be recovered if it is lost or forgotten;

(3) the circumstances in which participants will be liable for losses caused by negligence or fraud; and

(4) the stamp duty and stamp duty reserve tax implications of dematerialisation.

8.35 There are, therefore, several legal and legislative issues which would need to be considered if the Government were to proceed with dematerialisation.

DEMATERIALISATION AND A "NAME ON REGISTER" SYSTEM

8.36 Some consultees have suggested that, assuming the proposed industry model is implemented, the opportunity should be taken to place ultimate investors on the register, and not simply those who currently hold their securities in certificated form. The effect of such a change would be that the investor would be the legal owner of the shares and the "member" for the purposes of the CA 2006.

8.37 Several consultees suggested this particular solution, including UKSA and ShareSoc, AMNT, the ABI and individuals such as Eric Chalker, Roger Lawson and Ali Haouas. Additionally, in his review of the UK equity markets, Professor John Kay recommended that:[110]

> The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

8.38 Under this solution, all investors would be "members" on the company's register.

Enhanced rights and protections for investors

8.39 As the legal owner of the securities, and as the "member" of the company, an investor's rights and protections would be significantly increased compared to the position of an ultimate investor holding their investments through an intermediated securities chain.

8.40 For example, an investor whose name is recorded on the register would be entitled to all the rights under the CA 2006 which are afforded to members. These rights include the right to receive notice of meetings, the right to vote at meetings and on written resolutions and to receive copies of documents such as annual reports.[111] Members also have the right to bring actions such as a challenge to a special resolution to re-register a public company as a private company and a derivative action on behalf of the company.[112] In accordance with the new Companies (Shareholders' Rights to

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110 *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012), p 13.

111 CA 2006, ss 307, 310 (notice of meetings); s 284 (voting); s 423 (receive documents). See G Morse (general ed), *Palmer's Company Law* (2018) paras 6.007 to 6.012 for a general summary of members' rights.

112 CA 2006, s 98 (challenging a special resolution), s 261 (derivative actions).

Voting Confirmations) Regulations 2020,[113] they would also be entitled to receive confirmation of their vote.

8.41 A "name on register" system would increase both certainty and clarity for an investor, who would have the legal, and not simply the beneficial, interest in their securities. An investor, as a member, would have statutory rights under the CA 2006, rather than contractual rights under the terms and conditions of their service agreement with an intermediary.

8.42 Implementing a "name on register" system could provide concrete protections to investors. For example, an investor could have a direct claim under contract law against an issuer.[114]

Enhanced corporate governance and transparency

8.43 UKSA and ShareSoc suggested that adding ultimate investors to the register would increase transparency, enhance engagement between an issuer and its investors, and ultimately improve corporate governance. Other consultees, including UKSA and ShareSoc, the CLLS and the QCA said that companies wish to engage with their investors, particularly before important votes.[115] This engagement is, obviously, only possible if a company knows who its investors are and how to contact them.

8.44 As we discuss above,[116] section 793 of the CA 2006 provides a process under which a public company can request information about its ultimate investors.[117] However, consultees have told us that in practice this process is not effective.

8.45 If all investors were recorded on the register, companies would be able to contact their investors directly through the information stored on the register. This would be an advantage for companies, which may wish to understand the voting intentions of their investors.[118] Increased transparency could also make it easier for investors to identify each other and to organise shareholder campaigns to engage with the company.[119] There would also be a clearer public record of the ultimate ownership of UK companies, which may be considered to be in the public interest.

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113 SI 2020 No 717, reg 4.

114 See our discussion of the no look through principle in ch 5 below.

115 See also Shareholder Voting Working Group, *Shareholder proxy voting: discussion paper on potential progress in transparency* (July 2015) pp 7 and 10 to 12, at https://www.investorforum.org.uk/wp-content/uploads/securepdfs/2020/06/SVWG-Shareholder-Proxy-Voting-DP-July-2015.pdf.

116 We discuss the s 793 procedure from para 3.127 above.

117 Under s 793, a public company can give a notice to any person who is "interested in the company's shares". That notice may require a person to confirm their interest and to provide certain additional information within a reasonable time, including the identity of the person interested in the shares.

118 See, for example, Shareholder Voting Working Group, *Shareholder proxy voting: discussion paper on potential progress in transparency* (July 2015) pp 7, 10 to 12, at https://www.investorforum.org.uk/wp-content/uploads/securepdfs/2020/06/SVWG-Shareholder-Proxy-Voting-DP-July-2015.pdf.

119 Note that some intermediaries expressly remove any responsibility on their part to notify ultimate investors of any shareholder lobbying or action: see, for example, the terms and conditions of Charles Stanley Direct at 1.13.11(xi).

Implementation and transitional costs compared with systemic benefits

8.46 In the call for evidence we asked about the costs of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain.[120] Some consultees said that the cost of providing rights and remedies to all ultimate investors would outweigh the benefits.

8.47 For example, 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. The Registrars' Group, Equiniti and Computershare said that the development of new systems would come with a "significant cost" and would not eliminate the need for intermediaries.

8.48 We agree that a move to a "name on register" system could involve substantial costs to the industry, some of which would inevitably be passed on to investors. We do not have information as to the number of ultimate investors who would need to be added to the new register. Information as to the scale of the exercise, simply from an administrative perspective, would be required were the Government to decide to conduct further work on this possible solution. We think that it is likely to be a significant number. For example, as of August 2020, there were over 6.5 trillion shares held in CREST for UK-registered companies, with a value of over £4.8 trillion.[121]

8.49 The Registrars' Group said that there are significant practical challenges in implementing the proposed industry model in relation to all securities, including:

(1) the need to identify ultimate investors with intermediaries who may be in another jurisdiction, and the potential costs of enforcing this requirement on a cross-border basis; and

(2) the need to ensure the integrity of information about who is the ultimate investor, which could lead to "potential legal challenges in relation to ownership rights".

8.50 As well as the costs of developing a new system, there would also be the costs of transitioning to that system. There would necessarily be a transition period, which would incur costs because participants would be required to operate two systems in tandem.

8.51 A change to a "name on register" system would affect the way in which many intermediaries operate their businesses. The nature of their relationship with investors would change because they would no longer automatically hold a proprietary interest in the securities. We think that it is likely that intermediaries would continue to offer services to investors. However, we recognise that there would be a change to their systems and operating models which would involve a substantial cost.

8.52 Wholesale reform could also lead to legal uncertainty, which could undermine the efficiency and convenience of modern securities trading. The CLLS raised this point in

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120 Call for evidence (2019) para 2.117.

121 EUI told us that as at 5 August 2020, there were 6,557,016,551,114 shares held in UK-registered companies, with a value of £4,867,804,643,840.

their response to the call for evidence and suggested this could harm the UK's reputation as a financial centre and reduce the attractiveness of the UK financial services market.

8.53 However, some consultees, including UKSA and ShareSoc and Susan Sternglass Noble, encouraged us to consider the long-term systemic benefits of a move to a model under which all ultimate investors are placed on the register and made the legal owners of securities. They said that implementation of this model might be a proportionate measure, when considered in the context of potential long-term systemic benefits.

8.54 The rise of distributed ledger technology, such as blockchain, could make the introduction of a "name on register" system available at lower cost. Although the use of DLT might not be a possibility now, it is something that the Government could consider in the future.[122] Susan Sternglass Noble said:

> an important advantage to considering the implementation of a distributed ledger or other technological solution over the medium- to long-term are the potential systemic benefits to the UK financial system. This could result in an enhanced competitiveness of the UK investment industry, more efficient markets and capital raising, lower levels of operational risk, and economic benefits associated with being global leaders in FinTech. The benefits would need to be carefully weighed against the costs and risks of any potential solution.

8.55 These consultees also pointed out that, even if the transitional and implementation costs of this change were significant, maintaining the current legacy systems could also entail significant costs.

Removing or reducing the current benefits of intermediation

8.56 Throughout the call for evidence, and in this document, we have highlighted how the intermediated securities system may negatively affect the rights of ultimate investors. However, there are also aspects of intermediation that are advantageous. One of the drawbacks of placing ultimate investors on a register would be that it would remove or weaken some of these advantages.

Increased efficiency

8.57 One crucial advantage of the intermediated securities system is its efficiency, particularly when it is combined with the use of omnibus accounts. Settlement of securities transactions can sometimes take place at the lowest point in the chain, and can take place on a net basis, so that the actual number of transfers is reduced.[123] This increases the speed of transfers.

8.58 Several consultees said that the current system of intermediation is convenient and efficient. For example, the QCA said the current system has made trading significantly quicker, lowered transaction costs, simplified voting processes and reduced the administrative burden for issuing companies. ShareSoc and UKSA identified the low

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122 We discuss DLT from para 9.57 below.

123 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 361.

cost of holding and transferring intermediated 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 "name on register" system.

8.59 At least some of the efficiency credited to the intermediated securities system may also be due to the use of technology, rather than the use of intermediaries.[124]

Reduced costs for ultimate investors

8.60 Increased efficiency, economies of scale and the opportunity for securities financing may all decrease costs for ultimate investors.[125]

Facilitation of diverse, cross-border investment portfolios

8.61 An intermediated securities system means that securities issued in a particular jurisdiction may be accessed by local specialists, who can then hold intermediated securities for other intermediaries or ultimate investors.[126] It also enables ultimate investors to hold an investment portfolio from multiple jurisdictions through one intermediary, which may increase efficiency and decrease costs. Professor Louise Gullifer QC and Professor Jennifer Payne say, in *Intermediation and Beyond*, that facilitating the flow of capital in this way is "probably the most significant advantage of the intermediated system, and the one most difficult to replicate in other ways".[127]

8.62 Similarly, intermediation can facilitate the holding of a diverse portfolio of shares. Ultimate investors can hold securities from a range of issuers, and deal with them through one intermediary, rather than dealing with each issuer individually.[128] However, we note that this way of holding securities is not precluded by a "name on register" system, where an ultimate investor could appoint an intermediary as an agent to manage securities on their behalf.

8.63 Intermediaries also offer a range of services to ultimate investors and fulfil a practical need for expertise for ultimate investors. As Christopher Twemlow explains:[129]

> With direct holding comes a number of practical consequences for the end investor to grapple with. By way of example, end investors would need individually to instigate all actions (such as each individual buy, sell and tax payment, as well as monitoring for and reacting to each corporate action process (such as selecting dividend currency or bonus issue uptake)). Access to trading venues (to obtain best price), clearing (to remove counterparty risk) and settlement venues (CSDs) would

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124 Eric Chalker, a retail investor, commented in his response to the call for evidence that the efficiency of the current system is primarily attributable to "computerisation, readily available software and the internet", not to intermediation itself.

125 See eg C Twemlow, *Intermediation and Beyond* (2019) p 98; L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 363.

126 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 361.

127 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 362.

128 L Gullifer and J Payne, *Intermediation and Beyond* (2019) p 366. We understand that registrars will also often provide investors with multiple holdings with the ability to administer them collectively and efficiently.

129 C Twemlow, *Intermediation and Beyond* (2019) p 94.

be significantly constrained due to the restrictions such infrastructure may have on access in order to meet financial stability and risk management considerations, in the interests of society.

8.64 More information is needed as to whether these functions could still be fulfilled by intermediaries simply as agents for investors, without them owning a proprietary interest in the securities.

Transparency

8.65 Finally, in response to the call for evidence, several consultees said that while the current system of intermediation lacks transparency, it protects the privacy of ultimate investors. For example, people 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. Although this protection would be removed if there were a move to a system of naming all ultimate investors on the register, we note that there is already a mechanism under section 793 of the CA 2006 which enables the discovery of ultimate investors in a company. In addition, investors who wished to remain anonymous could choose to hold their investments through a nominee name.

A potential interference with property

8.66 Article 1 of Protocol 1 ("A1P1") to the European Convention on Human Rights ("ECHR") protects property rights. It provides:

> 1. Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.
>
> 2. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.

8.67 A1P1 and most other rights under the ECHR have been incorporated into domestic law by the Human Rights Act 1998. These rights therefore form part of the current law, and any reform to the law relating to intermediated securities would need to be compliant with these rights.

8.68 It is likely that a solution which would make the ultimate investor the legal owner of securities by placing their name on the register would give rise to issues under A1P1 which would need careful consideration. Securities such as shares have been held to constitute "possessions" for the purposes of this provision.[130]

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130 *Bramelid & Malmström v Sweden* (1983) 5 EHRR 249 (App No 8588/79 and 8589/79) at 255; *Lithgow v UK* (1986) 8 EHRR 329 (App No 9006/80) at [107]; *Sovtransavto Holding v Ukraine* (2004) 38 EHRR 44 (App no 48553/99) at [91]. See also *Beyeler v Italy* (2001) 33 EHRR 52 (App No 33202/96) at [100] (article 1 is "not limited to ownership of physical goods … certain other rights and interests constituting assets can also be regarded as "property rights" and thus as "possessions").

8.69 Under A1P1, interference with possessions can fall into the categories of deprivation or control of use of property, or can be interpreted against the general principle of the peaceful enjoyment of property.[131] Examples of deprivation of possessions include where ownership rights are extinguished by operation of law and ownership is transferred,[132] and where there has been no formal transfer of ownership, but the impact on the owner's possession has been so severe as to render the owner's rights useless in practice.[133]

8.70 In the case of intermediated securities, moving to a new "name on register" system would provide the ultimate investor with the legal interest in the securities. This would involve removing the legal interest from the highest-ranked intermediary, and the beneficial interests from other intermediaries in the chain.[134] This would affect the ability of an intermediary to deal with these interests, for example, in securities financing transactions, and could constitute an interference with their right under A1P1.

8.71 However, A1P1 allows interference with possessions subject to certain conditions. Those conditions are the same for all categories of interference. It must be shown that the interference is in accordance with the law, pursues a legitimate aim in the public and general interest and is proportionate, striking a "fair balance" between the aim pursued by the State and any adverse impact on the property rights of persons affected.[135] Whether the interference is proportionate will require consideration of different factors depending on the circumstances of the case.[136]

8.72 An alternative option may be to apply the solution to the issuance of securities from a date in the future. This option would avoid the potential application of A1P1 because it would not transfer legal ownership from intermediaries to ultimate investors. However, this could introduce another level of complexity and uncertainty into the system as there would inevitably be a lengthy, or possibly indefinite, transition period where two systems operated in tandem.

Applying the proposed industry model to all securities

8.73 In their responses to the call for evidence, registrars involved in the development of the proposed industry model warned against applying that model as a general solution to problems caused by intermediation. For example, the Registrars' Group and Equiniti were both concerned about the effect this might have on timing for dematerialisation and said:

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131 *Sporrong and Lonnroth v Sweden* (1982) 5 EHRR 35 (A/52) at [61]; *James v UK* (1986) 8 EHRR 123 (App No 8793/79) at [37].

132 See *James v UK* (1986) 8 EHRR 123 (App No 8793/79); *Lithgow v UK* (1986) 8 EHRR 329 (App No 9006/80).

133 *Papamichalopoulos v Greece* (1993) 16 EHRR 440 (A/330-B) at [41], [42] and [45].

134 The A1P1 analysis would be different in Scots law as a result of the different interests held by parties in the intermediated chain under Scots law. We discuss the position at Scots law from para 2.72 above.

135 *Beyeler v Italy* (2001) 33 EHRR 52 (App No 33202/96) at [107] to [114].

136 The extent of any compensation paid is one such factor: *Lithgow v UK* (1986) 8 EHRR 329 (App No 9006/80) at [120] to [121].

> 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.

8.74 Computershare said that the issue of dematerialisation of certificated holders of securities and the issue of intermediated securities should not be conflated. Instead, 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.

8.75 The Registrars' Group told us that if the proposed industry model were to be applied to all existing securities, the effect on other financial services arrangements such as stock lending, collateralisation, ISAs, algorithmic and High Frequency Trading should be considered.

DEMATERIALISATION AND THE OPTION TO HOLD SECURITIES DIRECTLY

8.76 The proposed industry model for dematerialisation has been developed to enable holders of certificated securities to continue to hold them directly, even when they are converted to electronic form. We discuss above using dematerialisation to implement a "name on register" system. However, dematerialisation may also be used to provide an additional way for ultimate investors to hold securities directly where they wish to do so, without implementing industry-wide reform. An ultimate investor currently holding intermediated securities may choose to hold securities directly instead, through the proposed industry model.

8.77 As we discuss above, in order to hold dematerialised securities directly at the moment, an investor may have a personal CREST account, "sponsored" by an intermediary.[137] Where an investor has a personal CREST account, they retain legal rights in the shares. However, holding securities in a personal CREST account is not straightforward. We have been told that there are only four intermediaries who offer personal CREST accounts and the cost of such accounts has increased significantly in the last five years.[138]

8.78 In their response to the call for evidence, UKSA and ShareSoc said that "very few" intermediaries offer personal CREST accounts and those that do so impose "very

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137 We discuss holding securities as a sponsored CREST member from para 2.56 above.

138 See para 2.58 above. Intermediaries charge between £400 and £500 each year for a CREST personal account. In the 2016 BIS research paper, the authors noted that for a personal CREST account, an additional fee of around £50 to £100 each year was levied (in addition to portfolio management and/or transaction charges): Department for Business Innovation & Skills, *Exploring the intermediated shareholding model* (Research Paper No 216, 2016) p 73.

substantial charges". The Registrars' Group, Equiniti and Computershare also all pointed out that an investor is already able to have legal title on the register by having a CREST personal account. However, they all noted that "this is not widely used (most likely due to costs applied by intermediaries)".

A new avenue to hold investments directly

8.79 The implementation of the proposed industry model could create a new avenue, for those investors who so wish, to hold securities directly. This would enable such investors to obtain legal ownership of securities by being named on the register of members, and therefore exercise rights such as the right to receive information and to vote, without the need for a personal CREST account. It would also protect investors, who would not otherwise have a proprietary interest in the securities, in the case of the insolvency of their intermediary. Investors who did not choose to hold in this way could continue to hold through the intermediated securities chain, with the associated benefits and detriments.

8.80 One advantage of this solution would be that it could provide investors with a genuine ability to hold the legal interest in securities within the current system. Investors who do not wish to change their current arrangements would continue to hold through an intermediated system, with the benefits and disadvantages of that system. Link Asset Services, in their response to the call for evidence, pointed out that by leveraging current systems and structures, disruption to investors would be minimised.

Potential disadvantages

8.81 Using dematerialisation and the proposed industry model to provide another avenue for direct holding for investors would be a piecemeal approach. The success of this approach would rely on investors understanding the features of this way of holding and choosing to hold their securities accordingly. Investors who did not actively choose to hold securities through the proposed industry model would not enjoy the benefits of holding directly.

8.82 We think that holding securities through the proposed industry model should be a genuine choice for an investor and that any costs of holding investments directly should be proportionate. We asked the Registrars' Group about the cost of holding securities directly under the proposed industry model. They said that an investor would not be charged for holding their investments through this model.

8.83 However, intermediaries' fees for actions such as effecting transactions would remain. If an investor wished to buy or sell securities, they would need to engage the services of an intermediary. The success of offering another avenue to hold securities directly would rely, in part, on these services being offered to investors at a reasonable cost.

8.84 Therefore, if this solution were to be taken forward, there would need to be further work on whether steps should be taken to ensure competition and the provision of services to investors at a reasonable and proportionate cost.

8.85 There should also consideration as to how best to provide investors with consistent, useful information about the types of products available and how those products may affect their rights.[139]

8.86 Dematerialisation in general will carry a range of implementation, transition and ongoing costs. Using dematerialisation to implement a new way of holding securities directly for investors would have relatively few additional costs. These costs could include the costs of providing information to investors as to the new system of holding securities directly.

[139] See our discussion of disclosure to consumers from para 9.46 below.

Chapter 9: Non-legislative systemic approaches

9.1 In previous chapters, we discuss possible legislative and regulatory changes which could alleviate or solve some of the problems that arise in relation to intermediated securities for ultimate investors, particularly in relation to their ability to vote.

9.2 We think that legislation or regulation should generally only be considered as a solution where non-legislative options are unlikely to achieve the desired result. In this chapter, we consider the potential for an industry-led response, which would not involve legislative or regulatory reform. In particular, we consider three possible "soft law", or non-legislative, solutions:

(1) the creation of a non-binding set of principles of best practice or code of practice;

(2) consumer education; and

(3) the use of technology to enhance and facilitate the exercise of rights by ultimate investors.

THE POTENTIAL FOR AN INDUSTRY-LED RESPONSE

9.3 The notion of a voluntary solution led and developed by industry and backed by the Government is attractive, particularly in the context of the financial services market, which is already subject to a significant amount of regulation.

9.4 However, stakeholders, including intermediaries, have told us that the industry requires an incentive, such as a legislative or regulatory obligation, in order to change its current practices. They pointed to examples of initiatives started within the industry which subsequently failed because it was difficult to obtain "buy-in" from all the parties on the intermediated securities chain. During discussions with stakeholders, we were told that any deviation from the current system would be too complicated and costly to achieve.

9.5 We are also aware that the problems we describe in this scoping paper are not novel. In June 2001, the Company Law Review Steering Group ("the Steering Group") published its final report, *Modern Company Law for a Competitive Economy*.[1] This review sought to create a framework for company law which promoted enterprise and competition, represented a modern view of the balance of interests and aimed to be as simple and as accessible as possible. In its final report, the Steering Group made comments on the intermediated securities chain which are particularly relevant to this scoping paper.

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1 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy Final Report* (2001), at https://webarchive.nationalarchives.gov.uk/20060215135312/http://www.dti.gov.uk/cld/final_report/.

9.6 The Steering Group noted the development of specialists such as custodian banks, brokers, and holders of nominee accounts, acknowledging the role they played in "the efficient holding, transfer and recording of shares". It is notable that, almost 20 years ago, the Steering Group said:[2]

> [I]t was put to us that, at least in regard to the right to vote, practical advances in the use of electronic technology would very soon make it feasible, at low cost, for the intermediary who is the registered holder to collect diverse instructions from beneficial owners, reflect them accurately in proxy voting instructions passed to the company registrar, and obtain and pass back to the beneficial owners confirmation that the votes had been recorded.

9.7 In the same report, the Steering Group said:[3]

> A number of responses have stressed the complexity of this problem and the need to ensure the full involvement of the legal shareholders in the development of answers. We recognise this; but given the increasing use of nominee accounts and the desire of many of these beneficial shareholders – including foreign investors who find our existing arrangements obscure and unnecessarily complex – we also have great concern that solutions should be found. We hope that the market will produce them. We understand that some progress has been made on developing a technical solution to the problem of vote execution, in particular, in recent weeks.

9.8 When considering whether a voluntary, industry-led approach should be taken to solve the problems we describe in this paper, we encourage Government to bear in mind the lack of progress in relation to these issues in the years since the Steering Group's final report.

PRINCIPLES OF BEST PRACTICE

9.9 We have explored whether a set of non-binding best practice principles could provide an effective solution to some of the problems raised in previous chapters, particularly in relation to the exercise of voting rights. In general, stakeholders were not enthusiastic about this approach, for reasons we discuss below. However, in its response to the call for evidence, PIMFA pointed out that the focus of the Stewardship Code 2020 is primarily institutional investors and that some firms provide discretionary services only to retail investors. They suggested that consideration should be given to developing a Stewardship Code in respect of the retail sector. Similarly, the Share Centre said that their experience showed that it is possible to provide a "simple, online voting system". The Share Centre recommended a code of best practice to encourage uniformly higher standards within the industry.

9.10 We think that any principles of best practice should cover the relationships between intermediaries and both retail and institutional ultimate investors. There would need to

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2 The Company Law Review Steering Group, *Modern Company Law For a Competitive Economy Final Report* (2001) paras 7.1 and 7.3.

3 The Company Law Review Steering Group, *Modern Company Law For a Competitive Economy Final Report* (2001) para 3.51.

be consultation with market participants on the precise detail of the principles. However, examples of the type of matters which could be covered include:

(1) the provision of information to an ultimate investor about how the type of investment product may affect an ultimate investor's ability to exercise a right to vote and their rights upon the insolvency of an intermediary (including how the FSCS limit may apply to them)[4];

(2) the provision of information to an ultimate investor about how the terms of the agreements further up the chain may affect the ultimate investor's ability to exercise rights;

(3) a commitment from an intermediary to facilitate the provision of information from the company to the ultimate investor or to facilitate the exercise of voting rights by an ultimate investor;

(4) reporting requirements as to the number of requests received to pass back voting rights to ultimate investors and the percentage which were granted; and

(5) a commitment from an intermediary to facilitate the timely transmission of information from an issuer through the chain to the ultimate investor, including as to confirmation of votes.

A new set of principles

9.11 Consultees suggested that a set of best practice principles could be placed in an existing code, such as the new Stewardship Code 2020 ("the 2020 Code"), which is already well established within the industry.[5] In December 2010, the FCA introduced a rule in the COBS requiring certain financial services firms to disclose the nature of their commitment to the Stewardship Code or otherwise explain its alternative investment strategy.[6]

9.12 However, we think that there are compelling reasons why it may be preferable for any best practice principles for intermediated securities to be contained in a standalone code. First, whilst some of the issues we have discussed in this scoping paper are linked to stewardship principles, they are generally not stewardship principles in themselves. Secondly, although the 2020 Code applies to both institutional investment and retail investment, there is a focus on institutional investment. Any principles of best practice for intermediated securities should have an equally strong retail investor focus, particularly in relation to the information provided to retail investors.

9.13 We think that it would be preferable in the circumstances for there to be a separate code of practice, containing best practice principles. This could be led by the industry, with Government support. The benefit of this would be to facilitate "buy-in" from the industry.

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4 We discuss the FSCS limit from para 6.45 above.

5 In 2019, there were 280 organisations, including asset owners, asset managers and service providers who were signatories to the previous Stewardship Code.

6 FCA Handbook COBS 2.2.3R.

9.14 We envisage that, initially, following the best practice principles could be voluntary. Depending on the effect of the principles on the market, they could move to a system under which signatories would agree to abide by the principles. Over time, a similar approach to that for the 2020 Code could be adopted. That is, the FCA could introduce a rule requiring certain financial services firms to explain the nature of their commitment to the best practice principles.

The potential advantages and disadvantages of a new set of best practice principles

9.15 The development of a set of best practice principles could be taken forward by a group of stakeholders representing all parts of the intermediated securities chain. It could promote engagement between parties with different interests.

9.16 These principles could promote and encourage best practice within the industry, in a way that is more flexible than traditional legislation or regulation. In the financial services market, companies, intermediaries and ultimate investors come in all shapes and sizes. Compared to legislation or regulation, it may be simpler to amend the principles over time to adapt to new scenarios.

9.17 A set of best practice principles could also provide additional clarity to ultimate investors and assist in consumer education. In particular, retail investors may benefit from more information about the effect of different investment products on their legal rights.

9.18 The most obvious, and significant, disadvantage of implementing a code of practice is that there is a risk that it will either not be created in the first place or, if it is created, that it will have no effect on the behaviour of participants in the market. In our discussions, consultees have not strongly supported the introduction of a code of practice.

9.19 If the Government wished to take forward further work on this possible solution, it would be necessary to measure carefully the level of stakeholder support. This potential solution is entirely dependent on market participants collaborating to identify and abide by an agreed set of best practice principles. These principles should take into account the considerations listed above and recognise the genuine concerns of ultimate investors. Without such support, this solution would fail and more intrusive legal controls such as regulation or legislation may be required.

9.20 A code of practice, as "soft law", is also not enforceable. An ultimate investor would not be able to bring an action against an intermediary who has failed to abide by the principles.[7] Nor would they be able to report the intermediary to the FCA, unless they had also breached a regulatory requirement. The only recourse available to an ultimate investor would be to switch to another intermediary.

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7 See, eg, Carillion, Report of the Business, Energy and Industrial Strategy and Work and Pensions Committees (2017–19) HC 769 para 179, at https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf; and Sir John Kingman, *Independent Review of the Financial Reporting Council* (December 2018) paras 2.80 to 2.87, at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf.

9.21 Finally, best practice principles could be tailored to alleviate certain issues in relation to voting, such as the ability of an ultimate investor to exercise a right to vote. However, it would not solve "legal" issues such as those highlighted in relation to intermediary insolvency or good faith purchasers.

TERMS AND CONDITIONS

9.22 Legal agreements between the parties in an intermediated securities chain are one of the layers of law that apply to intermediated securities.[8] Parties in an intermediated securities chain will agree the terms and conditions which govern their relationship.

9.23 Terms and conditions can materially alter the rights of participants in an intermediated securities chain. The ultimate investor's position can be affected by:

(1) the terms of the agreement they enter into with their immediate intermediary; and

(2) the terms of agreements entered into between intermediaries higher up in the chain.

9.24 In the first case, the terms of the agreement between an ultimate investor and their immediate intermediary may create, limit or alter the rights of an ultimate investor. For example, the ability of an ultimate investor to receive information on, or vote in relation to, potential corporate events may be limited, or made subject to certain conditions, by the terms of their agreement with their immediate intermediary.[9] Likewise, terms and conditions may provide that an intermediary will not participate in litigation on the ultimate investor's behalf. Agreements usually also address an intermediary's liability if it causes loss to the ultimate investor, and whether an intermediary will take legal action against the company or a negligent or fraudulent intermediary higher up in the chain on the ultimate investor's behalf.[10]

9.25 In the second case, ultimate investors may also be affected by agreements entered into between intermediaries higher up in the chain. Dr Eva Micheler has explained that the different sets of terms and conditions used to regulate individual relationships along the chain can "accumulate", so that the ultimate investor receives the least favourable set of rights.[11]

What are the issues (or problems, from the perspective of ultimate investors)?

9.26 As we see above, the terms of agreements throughout the intermediated securities chain will affect the rights of an ultimate investor, for example, in relation to voting. In response to the call for evidence, consultees noted that contractual terms and

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8 See para 2.5 above.

9 We discuss voting in ch 3 above.

10 We discuss the ability of an ultimate investor to bring a trusts or contract claim against an intermediary or issuing company in ch 7 above.

11 E Micheler, "Custody chains and asset values: why crypto-securities are worth contemplating" 2015 74(3) *Cambridge Law Journal* 505 at 509 to 512.

conditions are often determinative of whether an ultimate investor may exercise voting rights.

9.27 For example, Dr David Gibbs-Kneller contrasted two sets of standard terms and conditions. In the first set, the ultimate investor:

(1) acknowledges and agrees that the intermediary does not have a duty to inform the ultimate investor of any corporate actions;

(2) waives their rights to exercise any corporate actions; and

(3) agrees that the intermediary may act on those corporate actions as it sees fit.

9.28 In the second set, the intermediary agrees to arrange for the ultimate investor to attend meetings, vote and receive information issued to shareholders, upon the "prior and timely receipt of an instruction by you".

9.29 Although these types of agreements are the foundation of the relationship between an ultimate investor and an intermediary, they may not be easily understood by investors. These are complex legal agreements dealing with financial services products. They use technical and often complicated language, which is not used consistently across the industry. Even experienced retail investors may find them difficult to decipher.[12]

9.30 UKSA and ShareSoc told us:

> There are, for example, approximately 14,000 words in the Hargreaves Lansdown terms and conditions. This is not untypical. Hence it is difficult for the individual investor to know precisely what his or her rights are.

9.31 Similarly, Dr Gibbs-Kneller said, in relation to the second set of terms and conditions considered above, that the right to vote was "buried" in the agreement and was not advertised to the ultimate investor before opening an account.

9.32 These concerns are compounded by the effect that agreements between intermediaries higher up in the chain can have on the rights of ultimate investors. Dr Eva Micheler refers to the arrangements with those intermediaries as "outsourcing". In her response to the call for evidence, Dr Micheler explained:

> 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.

9.33 Even if an ultimate investor understands the effect of an intermediary's terms and conditions, in practice they may not be able to change that effect. An ultimate investor, particularly a retail investor or small institutional investor, has no, or limited, bargaining power to negotiate a bespoke agreement. The use of standard terms and conditions by intermediaries is understandable, particularly in the regulated financial services

[12] We discuss the position of retail investors from para 9.34 below.

sector. An ultimate investor's only choice, if they do not agree with a standard agreement's terms, is to find another intermediary who offers a different service.

CONSIDERATIONS SPECIFIC TO RETAIL INVESTORS

9.34 In response to the call for evidence, some consultees told us that:[13]

(1) retail investors do not always understand how the intermediated securities system works, how it affects their legal rights to vote on shares and what steps they need to take if they want to vote; and

(2) there is a mismatch between the expectations of retail investors and the reality of their legal agreement with their intermediary.

9.35 Consultees raised similar issues in relation to insolvency. In particular, consultees suggested that retail investors could be better informed about:[14]

(1) the different risks attached to different methods of investing and how to "choose trusted intermediaries";[15]

(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.

9.36 These responses are consistent with the Government's previous work on intermediated securities in the 2016 BIS research paper. In particular, the authors of the research paper emphasised that retail investors are often unaware of the effect of the type of holding on shareholder rights, saying that the level of knowledge is "relatively poor".[16] For example, of 133 people that were holding shares in an omnibus account, 43% were unaware that they were not entitled to rights, such as the ability to vote and attend annual general meetings.

9.37 The 2016 BIS research paper also pointed out that interest in, and take up of, voting rights is low, even when shareholders were better informed. It is arguable that interest in voting rights among retail investors may have grown given the increased focus on environmental, social and governance factors.[17] Although we do not have formal

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13 In the context of institutional investment and pooled funds, AMNT noted that some pension fund trustees are "misled" into believing that there is no possibility of influencing how or whether votes are cast in relation to securities in which the trustees have a beneficial interest.

14 We discuss issues that arise in relation to an intermediary's insolvency in ch 6 above.

15 For example, the CLLS said that ultimate investors should at least consider a personal CREST membership.

16 Department for Business Innovation & Skills, *Exploring the intermediated shareholding model* (Research Paper No 216, 2016) pp 31, 41 to 43, 45, 56, 72, 80 to 82.

17 See para 2.41 above.

updated data on this point, anecdotal evidence suggests that there is increasing interest on the part of ultimate investors in exercising their voting rights.

Contributing factors

9.38 Our discussions with stakeholders have highlighted the following factors which might contribute to the low level of knowledge held by consumers about how they hold investments, and the consequences for ultimate investors of an intermediated holding system.

Information asymmetry

9.39 First, a retail investor purchasing an investment product will generally be much less well informed about that product than the intermediary selling it. This is known as "information asymmetry".[18] It has been suggested that this imbalance, which occurs in many markets, is "often intense" in relation to financial services.[19] The European Commission has said that information asymmetry is one of the reasons that consumers are unable to "benefit fully from this market".[20] In the case of intermediated securities, it is arguable that the mismatch in information continues even after the ultimate investor has purchased securities from an intermediary. From that time, the ultimate investor relies on the intermediary for any information about their investment, including information from the company, dates of corporate events, as well as permission to vote.

9.40 In recent years there has been an emphasis on informing consumers as to the risks of various financial products not performing as expected. However, there has not been a similar focus on the legal consequences of holding investments through an intermediated securities chain.

Accessibility of information

9.41 Secondly, and related to the first factor, information provided by intermediaries about the legal nature of holding shares in an intermediated securities chain is not generally accessible and easy to understand. We discuss above that the terms and conditions for investment products involving intermediated securities often use technical and complicated language, which even experienced retail investors may find difficult to decipher.[21] Examples of terms dealing with ownership of securities include:

> You agree that the Custodian may register or record legal title to any Investment Product in the name of its nominee company or a nominee company controlled by the Custodian's sub-custodian or agent. In such circumstances 'beneficial' title to the Investment Product will remain with you: this means that the nominee would be

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18 Information asymmetry is the subject of a body of academic literature. See, eg, G A Akerlof, "The Market for "Lemons": Quality Uncertainty and the Market Mechanism" (1970) *Quarterly Journal of Economics* 488.

19 J Armour, D Awrey, P Davies, L Enriques, J N Gordon, C Mayer and J Payne, *Principles of Financial Regulation* (2016) pp 55 and 56.

20 European Commission, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective* (November 2010) para 2, at https://ec.europa.eu/info/sites/info/files/retail_investment_services_2010_en.pdf.

21 See para 9.29 above.

> treated as the holder of the Investment Product by the product provider but the nominee will pass benefits on to you.[22]
>
> Investments which are capable of being registered, and which are purchased through or by us, will be registered or otherwise recorded in the name of our nominee … or of a nominee controlled by a recognised or designated investment exchange or by a Custodian (or its nominee), in accordance with the custody rules set out in chapter 6 of the Client Assets sourcebook of the rules of the FCA. In relation to those of your Investments registered in the nominee's name that nominee will hold the legal title to such Investments and you will at all times be the beneficial owner.[23]
>
> Investments either purchased by us, or transferred to us, on your behalf will be held in safe custody which means that they will be held separately from our own investments and will be registered in the name of our Nominee or another custodian on trust for you as beneficial owner …[24]
>
> We do not accept liability for any default or mistakes by any third party who is the nominal holder, or has some other form of custody, of your registered investments. Within an [account] you remain the beneficial owner of the investments (and cash) and agree you will not try to sell, mortgage, use as security for a loan or otherwise deal in or part with beneficial ownership of the investments and cash held in the Account, other than where you give and we accept your dealing instructions under these Terms.[25]

9.42 We acknowledge repeatedly throughout this paper that the law and practical operation of intermediated securities chains are complicated. It is not surprising that agreements dealing with intermediated securities are also complicated. However, the above sample of clauses are unlikely to be easily intelligible to a lay reader. In particular, only the first of the above clauses attempts to explain the consequences of the distinction between legal and beneficial ownership of securities.

9.43 Intermediaries are already subject to regulatory requirements in relation to the disclosure of information to consumers. For example, the COBS places obligations on investment firms, and provides guidance, in relation to the way in which they conduct business with their clients.[26] COBS 2.2.1R provides that an intermediary must provide "appropriate information in a comprehensible form" to clients about:

> (a) the firm and its services;

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22 Citi, "Terms of business for investment and insurance services" para 2.22.3.

23 Charles Stanley Direct, "Business Terms" para 1.13.1.

24 Interactive Investor, "Terms of Service" para 5.2.1.

25 Hargreaves Lansdown, "Terms and conditions of the HL Service" para A26.

26 The COBS applies to "designated investment business" which includes investment activities including managing, safeguarding and administering investments: COBS 1.1.1R; Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001 No 544.

(b) designated investments and proposed investment strategies; including appropriate guidance on and warnings of the risks associated with investments in those designated investments or in respect of particular investment strategies;

(c) execution venues; and

(d) costs and associated charges;

so that the client is reasonably able to understand the nature and risks of the service and of the specific type of designated investment that is being offered and, consequently, to take investment decisions on an informed basis.

9.44 COBS 4.2.1R provides that intermediaries must ensure that communications or financial promotions are fair, clear and not misleading.[27] COBS 4.2.4G provides guidance as to the type of information which should be included. For example, a financial promotion:

(1) for a product that involves risk to a consumer's capital must make that clear;

(2) that quotes a yield figure must give a balanced impression of both the short and long term prospects for the investment.

Consumer behaviour

9.45 A third factor which should be taken into account when considering the low level of consumer knowledge about the consequences of holding investments through an intermediated system is the effect of consumer behavioural biases. Consumer behavioural biases describe the way in which consumers may not behave rationally.[28] Examples of such biases include consumers finding it difficult to forecast future events and preferences or being overly confident. In the context of intermediated securities, they may not imagine wanting to vote on company resolutions or what might happen in the event that their intermediary becomes insolvent. Consumers may also make financial decisions based on what other investors are doing (that is, on the basis of "herd" mentality) rather than on a rational basis.

Additional disclosure as a possible solution

9.46 The most obvious solution to redress the concerns that we highlight would be to require intermediaries to provide clear and comprehensible information to consumers about whether their investments are being held through an intermediated securities chain, and the legal consequences of that system of holding.

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27 This rule applies in a way that is appropriate and proportionate, taking into account the means of communication, the information to be conveyed and the nature of the client and its business: FCA Handbook COBS 4.2.2G.

28 See Office of Fair Trading, *Consumer Behavioural Biases in Competition* (2011), at http://londoneconomics.co.uk/wp-content/uploads/2012/06/Consumer-behavioural-biases-in-competition-OFT1.pdf. There is a substantial body of literature on consumer biases and heuristics. See, eg, A Tversky and D Kahneman, "Judgement under Uncertainty: Heuristics and Bias" (1974) 185 (4157) *Science* 1124; R H Thaler and C R Sunstein, *Nudge* (2008).

9.47 If this suggestion were to be taken forward, we think that the Government could consider how this information could best be presented to retail investors. For example, intermediaries could be required to provide retail investors with a "key facts" document that follows a standard layout. Such a document would enable intermediaries' services to be compared side-by-side and allow an ultimate investor to see their rights, such as whether they will be entitled to vote, at a glance.

9.48 However, simply providing consumers with more information is not necessarily the answer. Professor John Armour and Professor Luca Enriques point out (in the context of crowdfunding):[29]

> Mandatory disclosure is a cornerstone regulatory strategy in both securities and consumer laws, where it is often justified as a means of overcoming information asymmetry. However, a body of recent behavioural research makes clear that the context of disclosure matters greatly for its efficacy in improving outcomes for the recipients of information. What matters is not so much whether disclosure is required, but rather what must be disclosed and how it must be conveyed. It is costly for most individuals to make sense of, and process, a large body of information: the simple fact of "disclosure" does not equate to comprehension by the recipient.

9.49 The views of consultees were consistent with this message. For example, the CLLS said that although there is a need for better education and information, this alone is "unlikely to add significant value". Ultimate investors are unlikely to consider the consequences of insolvency of an intermediary when balanced against the advantages immediately available from holding investments through an intermediated chain. 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".

9.50 Other consultees, including UKSA and ShareSoc and Dr Eva Micheler, pointed out that regardless of any requirement for additional information to be provided to consumers, ultimate investors have limited bargaining power and therefore have no choice but to agree to standard terms and conditions.

9.51 We think that if the Government were minded to take forward work in this area, it should be in combination with other possible solutions suggested in this paper, and in consultation with the FCA. For example, if dematerialisation were to be implemented to provide an additional avenue for holding securities directly,[30] it would be sensible to combine this with a regulatory requirement on intermediaries to provide information about different available methods of holding.

TECHNOLOGY

9.52 In our terms of reference, BEIS asked for "a summary of technological developments that might make it easier for underlying investors to exercise shareholder rights".

9.53 Our early research and discussions with stakeholders in the lead up to the publication of the call for evidence suggested that DLT in particular has potential application to

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29 J Armour and L Enriques, "The Promise and Perils of Crowdfunding: Between Corporate Finance and Consumer Contracts" (2018) 81(1) *Modern Law Review* 51 at 72.

30 We discuss this possible option from para 8.76 above.

intermediated securities. We therefore asked specifically about DLT in the call for evidence:

> Do you consider that distributed ledger technology has the potential to facilitate the exercise of shareholders' rights and, if so, in what way? What are the obstacles to adoption of this technology? Are there any other jurisdictions we should look to as examples?

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

9.55 PIMFA raised a general concern that questions of technology had 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.

9.56 As will be obvious from the below paragraphs, the Law Commission takes a "technology neutral" approach and does not favour a particular type of technology. We asked for consultees' views in order to provide Government with a summary of any technological developments which could be used to enhance the rights of ultimate investors. However, if the Law Commission were to take on further work with regards to these developments, then we would do so in consultation with the industry and technology experts.

Distributed ledger technology

9.57 DLT is a method of recording and sharing data across a network, characterised by the absence of reliance on any centralised hub, (the "distributed" element of the name refers to the fact that all data are always available to all participants).[31] A DLT system comprises a digital database (a "ledger") which is shared (that is, "distributed") among a network of computers (known as "nodes"). The ledger contains a record of data, such as a history of transactions, and each node holds a copy of the ledger on its system. When data is added to the ledger, every node's copy of the ledger is updated instantaneously. Therefore, at any point in time, every node holds an identical and up-to-date copy of the ledger. We provide a more detailed explanation of DLT and its potential benefits in the following paragraphs and in Appendix 4.

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[31] For overviews of DLT, see P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) chs 1 and 2; World Bank, *Distributed Ledger Technology and Blockchain* (2017) chs 1 and 3, at https://olc.worldbank.org/system/files/122140-WP-PUBLIC-Distributed-Ledger-Technology-and-Blockchain-Fintech-Notes.pdf.

9.58 The distinguishing feature of DLT compared to other shared databases is that the ledger is not maintained by a central administrator. Instead, the ledger is maintained collectively by the nodes on the network.[32]

9.59 There are two types of DLT systems.

(1) "Permissionless" systems. Anyone can join this system. Once they have joined, participants can view transactions and participate in the network by, for example, verifying transactions. The Bitcoin blockchain is an example of a permissionless DLT system.[33]

(2) "Permissioned" systems. Permission is required to join the network: participants must receive permission from a central administrator, who controls network access and enforces the rules of the ledger. Participants typically have to verify their identity before they will be admitted. Permissioned systems are considered to be more appropriate in certain industries, such as financial services, where the law requires the identities of transacting parties to be disclosed.[34]

Potential relevance of DLT in the intermediated securities context

9.60 Commentators have argued that DLT could remove the need for a CSD entirely: instead, legal title to securities could be transferred directly on the ledger.[35] It could also have a role in the current system, making the chain more transparent.

9.61 We said in the call for evidence that permissioned DLT systems are of increasing interest to the financial services market, in part because such systems may allay concerns about the privacy of the data of ultimate investors.[36] These systems often have a central authority. Where that is the case, commentators including Dr Eva Micheler and Luke von der Heyde have questioned whether there is a real benefit to using a DLT system over other forms of technology.[37]

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32 The process by which nodes agree that an entry should be recorded is known as the "consensus mechanism".

33 World Bank, *Distributed Ledger Technology and Blockchain* (2017) ch 4; P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) pp 31 to 32.

34 World Bank, *Distributed Ledger Technology and Blockchain* (2017) p 19 (referring to "Know-Your Customer" laws in Anti-Money Laundering/Combating the Financing of Terrorism regulations).

35 S Green and F Snagg, *Intermediation and Beyond* (2019) p 341.

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

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

9.62 We noted that Australia,[38] Estonia[39] and South Africa[40] had already announced work on including DLT in their voting or settlement systems.[41]

Consultees' responses

9.63 Approximately half of consultees agreed that DLT has the potential to facilitate the exercise of investor rights, with several consultees referring to its advantages. The main benefit of the use of DLT which was highlighted by consultees is the potential for a transparent system. For example, the AGC said:

> 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.

9.64 However, consultees also highlighted concerns in relation to the adoption of a DLT system. Consultees pointed out that DLT is still developing as a technology and that it is still 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.

9.65 The Registrars' Group, Equiniti and Computershare said that investment in technology would be a key barrier. The PLSA agreed 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".

9.66 Some consultees said that although there is "significant potential" for new technologies, technology by itself is not sufficient to resolve current underlying problems. For example, Computershare said that "relatively simple principles such as share reconciliation and vote confirmation will go a long way to improving the integrity and confidence in the system." The AGC also observed that there is an operational aspect to the question of DLT's suitability. Certain processes, such as the notary function and custody, will still need to be performed by intermediaries, even if DLT is

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38 ASX, "CHESS Replacement", at https://www.asx.com.au/services/chess-replacement.htm.

39 Nasdaq, "Is Blockchain the Answer to E-voting? Nasdaq Believes So" (2017), at https://www.nasdaq.com/articles/blockchain-answer-e-voting-nasdaq-believes-so-2017-01-23.

40 Strate, "Adoption of digital solutions for AGMs is long overdue" (2020), at https://strate.co.za/2020/07/03/adoption-of-digital-solutions-for-agms-is-long-overdue/; Strate, "Nasdaq tech community spotlight" (2020), at https://strate.co.za/2020/05/06/nasdaq-tech-community-spotlight/.

41 Call for evidence (2019) para 2.86.

used in the future. EUI and Dr David Gibbs-Kneller agreed that new technology may not remove the need for intermediaries.

Discussion and next steps

9.67 We think that the potential benefits of using DLT in the financial services markets are clear. Using DLT could enable the creation of a direct relationship between investors and companies,[42] which would solve or ameliorate most of the issues we discuss in this paper. For example, investors would have, in theory at least, the ability to bring a claim against an issuing company and would be able to exercise the rights attached to their securities, such as those in relation to voting.[43]

9.68 Using DLT may also mean that assets do not have to be pooled, reducing the risk that an investor's securities are used to settle another's transaction.[44] According to some commentators, the use of DLT may also reduce risk generally, including risks associated with settlement (that is, that the transaction may not happen because of a system error) and counterparties (that is, that a counterparty may default), as well as any overarching systemic risk.[45]

9.69 However, it is also clear that there would be significant challenges to the implementation of a DLT system in relation to the financial services market. The uncertainty of the legal aspects of DLT is but one of these challenges and presents an opportunity for the Law Commission to provide assistance to the Government and participants in the market. For example, some consultees suggested that there are legal and regulatory aspects of DLT that are uncertain, including the following.[46]

(1) The nature of DLT, spread across a number of "nodes" which may be anywhere in the world, means that there could be uncertainties in relation to conflict of laws issues.

(2) The "legal qualification" or legal nature of the issued instrument on the ledger is uncertain. Would it constitute, or merely evidence, a property right?

(3) Whether an issuer would be able to issue securities "under any legislation and independently of the [issuer's] location".

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42 S Green and F Snagg, *Intermediation and Beyond* (2019) pp 341 and 342.

43 S Green and F Snagg, *Intermediation and Beyond* (2019) p 343.

44 S Green and F Snagg, *Intermediation and Beyond* (2019) pp 341 and 342.

45 D Tapscott and A Tapscott, *The Blockchain Revolution: How the Technology Behind Bitcoin is Changing Money, Business and the World* (2016) pp 59 and 60; S Green and F Snagg, *Intermediation and Beyond* (2019) p 342.

46 These consultees included the AGC, the CLLS, Shepherd and Wedderburn LLP and the Law Society of Scotland. See also S Green and F Snagg, *Intermediation and Beyond* (2019) pp 337 to 358; L Gullifer and R Hay, "How final is final? Settlement finality, blockchains and DLT" (2020) 1 *Journal of International Banking and Financial Law* 8; J Benjamin, "The medium is the message: how can the development of DLT improve upon the workings of the indirect holding system for intermediated securities?" (2019) 10 *Journal of International Banking and Financial Law* 646.

(4) How to ensure that the obligations of system participants are clearly conceived and articulated.

(5) How actions taken on DLT would be evidenced and what their legal effect would be.

9.70 We will be considering some of these issues in an upcoming project on digital assets, which will analyse how and why the common law's definition of "possession" currently creates difficulties for the legal treatment of intangible assets, and how this may be changed through legislative reform. This project will take a general approach and will not focus on financial services specifically.[47]

9.71 However, we also consider that there would be merit in a separate project which provides advice to the Government on the legal issues which could arise in relation to the application of DLT to the financial services market. Such an advice could provide clarity on some of the issues which may be current barriers to development.[48]

Other forms of technology

9.72 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.

9.73 Some consultees, particularly retail investors, said that the advantages of technology are "inherently limited" without fundamental changes to the existing intermediated system. Although some consultees said that technology could increase transparency in the system, Computershare said that such an approach would be "likely very costly" and would require a "rigorous cost/benefit analysis".

9.74 Other consultees, including PIMFA, emphasised that intermediaries were already using technology to provide solutions for clients. One such example is the Share Centre. In a response to the call for evidence, Gavin Oldham described his experience of using technology to facilitate voting by ultimate investors and the provision of information to those investors under Part 9 of the CA 2006. He said that under the Share Centre 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.

9.75 During consultation discussion, some consultees referred to "Proxymity", a relatively new technology product which has been developed by market participants.[49] This product is marketed as a tool to enhance communication between ultimate investors and companies. We were told that through its use of an algorithm, Proxymity is able to

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47 https://www.lawcom.gov.uk/project/digital-assets/.

48 For example, 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.

49 www.proxymity.io.

bypass the section 793 procedure which we discuss above, to work out the identity of the ultimate investor and create a channel of communication between them and the company, which can be used for voting and confirmation of votes.

9.76 We can see the benefits of the use of technology to enable communication between ultimate investors and companies and to provide a mechanism for the exercise of certain shareholder rights, such as voting. However, this type of technology does not change the legal position of ultimate investors and will only enhance the rights of ultimate investors where intermediaries are motivated to invest in it and use it for this purpose. Otherwise ultimate investors will be excluded from its benefits. We are also reminded of the Company Law Review Steering Group comments, referred to above, in relation to emerging technology in 2001.[50]

[50] See from para 9.5 above.

Chapter 10: Summary of potential areas for further work

10.1 In the previous chapters, we analyse the law underlying intermediated securities, potential problems which arise, the views of stakeholders, and possible solutions. We note that although the intermediated holding system provides obvious benefits to ultimate investors, it can significantly affect their ability to exercise shareholder rights. There are also areas of legal uncertainty in relation to intermediated securities which would benefit from clarification.

10.2 In this concluding chapter, we draw together the possible solutions identified in the paper, listing areas for future work either by the Government or by the Law Commission. We then set out stakeholder views as to the potential costs and benefits of changes to the current system and highlight areas for further research and analysis.

LIST OF POSSIBLE SOLUTIONS FOR FURTHER WORK

10.3 The Government asked the Law Commission to provide a "range of possible solutions" to the problems which arise in relation to intermediated securities.

10.4 Our discussion in the previous chapters show that the Government could take one of two approaches. On the one hand, the Government could take an approach which alters the underlying intermediated holding system, either removing intermediation altogether, or creating a new avenue for investors to hold their investments directly.[1] On the other hand, the Government could take a targeted approach which applies relatively discrete solutions to specific problems.[2]

10.5 As we set out in Chapter 8, although we think that there would be certain benefits to a systemic approach, we do not think that removing intermediation altogether is a necessary step. However, we do consider that there should be further work into specific solutions which could alleviate some of the problems caused by intermediation, possibly supported by a genuine option for holding dematerialised securities directly for those investors who wish to do so. We think that this approach would be effective and proportionate. We also consider that there are several areas in which the law in relation to intermediated securities could be improved and clarified.

10.6 Throughout this paper we identify possible solutions which could be taken forward with additional work. For convenience we list these below in the following categories:

(1) possible targeted solutions to enhance ultimate investors' rights and improve corporate governance;

(2) possible targeted solutions to increase legal certainty and confidence; and

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1 We discuss these possible overarching solutions in ch 8 above.

2 We discuss this targeted approach in relation to specific issues in chs 3 to 7 above.

(3) opportunities provided by dematerialisation to provide overarching solutions.

Possible targeted solutions to enhance ultimate investors' rights and improve corporate governance

Any review of voting rights should consider:

- the creation of a new obligation on intermediaries to arrange for ultimate investors, upon request, to attend meetings, vote and receive information that the company sends to its members;
- the possible extension of the application of the Shareholder Rights Directive II to enhance the rights of ultimate investors;
- potential improvements to the procedure under section 793 of the Companies Act 2006, enabling companies to identify ultimate investors;
- potential amendments to facilitate the confirmation to ultimate investors that their votes have been received and counted by the company.

Any future review of schemes of arrangement should consider:

- removing the "headcount" test in section 899 of the Companies Act 2006;
- whether other measures should be put in place to protect minority shareholders.

Any future review of the "no look through" principle should consider:

- amending section 98 of the Companies Act 2006, which is not fit for purpose in the context of intermediated securities;
- whether a legislative amendment should be made to clarify the application of section 90A of the Financial Services and Markets Act 2000 to ultimate investors;
- whether the Law Commission should review the Companies Act 2006 and the Financial Services and Markets Act 2000 to identify provisions which inadvertently disadvantage holders of intermediated securities.

Possible targeted solutions to increase legal certainty and confidence

In order to increase legal certainty in relation to intermediated securities transactions, the Government should consider:

- whether a legislative or regulatory amendment is necessary to confirm that distribution of an insolvent intermediary's assets to ultimate investors should be effected on a proportionate basis;
- further work to implement the Law Commission's previous 2008 recommendations in relation to the purchase of intermediated securities by a purchaser in good faith and without notice;
- amending the law to clarify that the formalities requirements in section 53(1)(c) of the Law of Property Act 1925 do not apply to transfers of intermediated securities;
- amending the Financial Collateral Arrangements (No 2) Regulations 2003 to remove potential uncertainty in relation to whether an intermediary has sufficient "possession" or "control" of an ultimate investor's intermediated securities;
- how best to support the Law Commission's current work on digital assets, which considers whether intangible property (such as intermediated securities) can be "possessed".

Opportunities provided by dematerialisation to provide overarching solutions

Any future work on dematerialisation could consider:

- the long-term systemic advantages offered by an approach which would remove intermediation altogether, under which all securities would be held directly and all investors would be named on the register of members (a "name on register" structure);
- an approach which represents a less fundamental change, retaining the current intermediated arrangements but also introducing a genuine alternative in the form of an affordable avenue for investors to hold their shares directly if they so wish. This approach would require additional consideration of how to ensure that it remains an affordable option for both retail and institutional investors.

10.7 Further work on any of the above solutions should include:

(1) additional consultation with stakeholders on the detail of the proposals;

(2) a cost-benefit analysis, which we discuss below;[3]

(3) analysis of the effect that any possible legislative or regulatory measures would have on parties based outside of the UK;

(4) consideration of the potential for parties to contract out of legislative or regulatory obligations (especially given the potential power imbalance between intermediaries and ultimate investors);[4] and

(5) analysis of the Scots law position.[5]

10.8 The Government could also consider further work in relation to technological developments in this area. We explain above that the potential benefits of using DLT in the financial services markets are clear.[6] However, there would be significant challenges to the implementation of such a DLT system, including in relation to legal uncertainty.

Possible further work in relation to technological developments

Future work in relation to the use of DLT in the financial services market should include consideration of the following issues.

- The nature of DLT, spread across a number of "nodes" which may be anywhere in the world, means that there could be uncertainties in relation to conflict of laws issues.
- The "legal qualification" or legal nature of the issued instrument on the ledger is uncertain. Would it constitute, or merely evidence, a property right?
- Whether an issuer would be able to issue securities under the legislation of any jurisdiction, independently of their location.
- How to ensure that the obligations of system participants are clearly conceived and articulated.
- How actions taken on DLT would be evidenced and what their legal effect would be.

ASSESSING THE IMPACT OF POSSIBLE SOLUTIONS

10.9 As well as a range of possible solutions, our terms of reference ask for:

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3 We discuss assessing the impact of possible solutions from para 10.9 below.

4 We discuss the terms and conditions of legal agreements between the parties from para 9.22 above.

5 We discuss the position in Scots law from para 1.44 and from para 2.72 above.

6 We discuss DLT and next steps from para 9.67 above.

A summary of the costs and benefits of the potential solutions (in a form that will be useful to BEIS analysts), and suggestions about where further analytical work might be needed (eg interview, survey, and/or behavioural research with stakeholders);

10.10 There are over 4.2 million companies registered in the UK.[7] Most of these companies are private companies, which fall outside the scope of our work. There are approximately 6,500 public limited companies on the companies register. As to the number of securities in question, EUI provided us with the following figures, accurate as at 5 August 2020, which demonstrate the scale of the issues involved and which would need to be considered in further work.

(1) There are approximately 6.6 trillion shares held in CREST, 6.5 trillion of which are in UK companies.[8]

(2) Of the 38% shares held on CREST that have an "account type description", 18% are held in omnibus accounts[9] (accounting for 42% by value of all shares held on CREST).

(3) There are a total of 6,566 members in CREST, with 2,394 corporate members and 4,172 individual members.

10.11 In the call for evidence, we asked consultees the following questions about the potential impact of reform.[10]

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

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

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

10.12 In our subsequent discussions with industry stakeholders, we asked about the costs – financial or otherwise – of a legal requirement to allow investors to vote in relation to shares held through an intermediary when they request to do so.

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7 Most companies registered in the UK are private companies. Recent figures demonstrate there are only 6,529 public limited companies on the register of companies: Companies House, *Companies register activities: 2018 to 2019* (August 2019), at https://www.gov.uk/government/publications/companies-register-activities-statistical-release-2018-to-2019/companies-register-activities-2018-to-2019.

8 There were 6,619,274,929,068 on CREST, with 6,557,016,551,114 for UK companies.

9 The remaining 62% of shares are listed as "blank". This occurs where the CREST member has not populated this information on the account. See table at para 2.89 above.

10 Call for evidence (2019) paras 2.115 to 2.117.

10.13 When responding to our questions, consultees did not provide any figures, preferring to comment in a more general way on potential costs and benefits of changes to the current system. This approach is understandable – the scoping nature of our work means that we did not provide any specific options for detailed assessment by consultees. We discuss areas for further research and analysis below.[11]

Consultees' views as to the costs and benefits of the current system

The use of omnibus accounts prioritises the interests of intermediaries

10.14 Several consultees, including both investor and business interests, said that the use of nominee accounts prioritises the interests of intermediaries over the interests of ultimate investors. Some consultees said that the current system forces ultimate investors to use the services of intermediaries because there is not a practical alternative. 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.

10.15 Computershare said that intermediaries impose "unofficial deadlines" on ultimate investors, forcing them to make last-minute/snap decisions if they wish to vote.[12]

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

10.17 Dr Ewan McGaughey said that the current system delivers "very considerable benefits" for the intermediaries at "tremendous cost" to everyone else. These costs include 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.

10.18 Mohammed Amin, Ali Haouas and Eric Chalker, all retail investors, did not consider that the current system of intermediation delivers any benefits.

Lack of transparency around share ownership

10.19 Several 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.[13]

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11 See para 10.35 below.

12 Equiniti and the Registrars' Group made a similar point that intermediaries impose "false deadlines" for voting on corporate actions.

13 We discuss the potential problems in relation to s 793 of the CA 2006 from para 3.127 above.

Increased privacy for ultimate investors

10.20 However, registrars and the Registrars' Group said that while the current system of intermediation lacks transparency, it protects the privacy of ultimate investors. 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 in the register. Investors who invest in companies perceived as "controversial" may wish to avoid the potential harassment that could result if their names were recorded.

Efficiency and convenience

10.21 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. Thousands of investors use these services successfully every day - they are familiar and comfortable with the processes.

10.22 Andrew Turvey, a retail investor, said that the current system "provides considerable benefits regarding cost savings and convenience, facilitating small retail investors to make the investments they want". 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.

10.23 ShareSoc and UKSA identified the low cost of holding and transferring intermediated 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 securities. Eric Chalker, a retail investor, commented that the efficiency of the current system is primarily attributable to "computerisation, readily available software and the internet", not to intermediation.

The effect of voting and engagement

10.24 The IA said that the current intermediated system could be considered to have a positive effect on engagement with companies. In relation to pooled funds, they said:[14]

> If an investment manager has been engaging with an investee company on a particular issue, it is important that they are able to follow through on this engagement with their voting decisions. In some cases, if a company has responded to the investment manager's concerns, then they will often wish to support the company in view of changes made or forthcoming. Alternatively, if the investment manager has been engaging with the company on material risks and their response is considered insufficient then the manager will often signal their concern by voting against relevant resolutions, board members or requisitioning a resolution. Splitting the vote, by voting some shares for and others against at the request of one client in

[14] Following a discussion with the Law Commission, the Investment Association circulated a short set of questions to members in its Stewardship Committee and the Stewardship Reporting Working Group. The Investment Association received information in a conversation about the questions with the Stewardship Committee and direct feedback from a few members. The responses do not represent the views of the Investment Association membership as a whole.

the fund undermines the ability of the investment manager to use voting as a tool to the maximum effect, at the expense of other shareholders in the fund.

Consultees' views as to the costs and benefits of reform

Improved corporate governance

10.25 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. 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. Eric Chalker, a retail investor, 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".

10.26 AMNT said that increased engagement by ultimate investors would improve "the quality of investee companies' contributions to the economy and society of the UK". It referred to a study it conducted which found a misalignment between the voting policies of asset owners and asset managers.[15] 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.

10.27 UKSA and ShareSoc 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 tend to have a long-term focus. They said 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".

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

10.29 In contrast, the CLLS and EUI[16] said that the current system already enables investors to exercise rights and remedies, for example by holding a CREST membership. Rights and remedies could be made available to ultimate investors through "regulation and education" at a reasonable cost. In contrast, "wholesale reform" would come at a huge cost without providing commensurate benefits.

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15 AMNT, *AMNT review into fund managers' voting policies and practices* (May 2019), at https://amnt.org/wp-content/uploads/2019/05/AMNT-final-review-for-FCA-22-May-2019.pdf.

16 EUI agreed with the CLLS responses to questions 26 to 28.

Reduced cost of exercising rights

10.30 UKSA and ShareSoc said that providing rights and remedies to ultimate investors 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, and said this would lower the cost of capital for UK businesses and lead to increased investment in jobs and businesses in the UK.[17]

Implementation and ongoing costs

10.31 Some consultees said that the cost of providing rights and remedies to ultimate investors would outweigh the benefits. 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, potentially harming the UK's reputation as a financial centre and reducing GDP.

10.32 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, a retail investor, said that the administrative and regulatory costs of ensuring that rights and remedies were made available to ultimate investors would be "significant".

10.33 Dr David Gibbs-Kneller warned 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 (although he noted that competition between intermediaries may lower these costs).

10.34 In contrast, AMNT said that the costs arising from changes to the system of intermediated securities would be "very small relative to costs overall". John Hunter, a retail investor, made the same point.

Areas for further research and analysis

10.35 If the Government were to decide to take forward any of the possible solutions outlined above, there would need to be additional work done to support an impact assessment. We think that this should include interviews and potential surveys with industry stakeholders, to consider the potential costs and benefits in greater detail, and the extent to which, for example, the impact might vary between businesses of different sizes. We note that there has already been research and surveys by the then Department for Business Innovation & Skills on a range of issues including awareness of the impact of pooled accounts on shareholder rights.[18] This research could be used to help inform an impact assessment.

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17 Similarly, Andrew Turvey, a retail investor, said that "the costs and inconvenience" of exercising shareholder rights would be reduced if they were made available to the ultimate investor.

18 Department for Business Innovation & Skills, *Exploring the intermediated shareholding model* (Research Paper No 216, 2016).

Potential costs and benefits for further analysis

Additional work should consider analysis of the following potential costs.

- Implementation costs including, for example:
  - the cost to intermediaries of changing internal systems to enable ultimate investors to vote and receive information from companies upon request; and
  - costs of education and training for businesses, including their lawyers.
- Transitional costs, for example if there is a period during which two holdings systems (such as an intermediated system and a “name on register” system) are operating.
- Ongoing costs including, for example, the costs of any additional resource that may be required to accommodate the new procedures or systems on an ongoing basis.

Additional work should consider analysis of the following potential benefits.

- Increased certainty for both investors and intermediaries as to their legal rights.
- Increased clarity of the current law, for example in relation to:
  - the ability to bring an application under section 98 of the CA 2006;
  - the ability to bring an action under section 90A of the FSMA; and
  - the tests which must be satisfied for a scheme of arrangement under section 899 of the CA 2006.
- Increased efficiency in operations.
- Increased confidence in the financial markets holding system, for example in relation to:
  - the ability to exercise rights;
  - the availability of the good faith purchaser principle for acquirers of intermediated securities;
  - the ability to confirm that votes have been received and counted; and
  - the ability for an intermediary to take security such as a charge or lien over intermediated securities.

Appendix 1: Advisory panel

We are grateful for the feedback and comments from the following members of an advisory panel of experts, who have commented on draft proposals and shared their expertise and evidence with us:

Helen Boyd and Adam Wreglesworth (Financial Conduct Authority)

Leanne Clements (Association of Member Nominated Trustees)

Ian Cornwall (Personal Investment Management & Financial Advice Association)

Caroline Escott (formerly of the Pensions and Lifetime Savings Association)

Professor Louise Gullifer QC (Hon) (University of Cambridge)

Dorothy Livingston (City of London Law Society)

Peter Parry (UK Shareholders' Association)

Professor Jennifer Payne (University of Oxford)

Michael Sansom (The Chartered Governance Institute Registrars Group)

Susan Sternglass Noble

David Styles (Financial Reporting Council)

Peter Swabey (The Chartered Governance Institute)

Christopher Twemlow (formerly of Euroclear UK & Ireland)

Cliff Weight (ShareSoc)

Appendix 2: Acknowledgements

CALL FOR EVIDENCE

The following bodies and individuals responded to our call for evidence, which ran from 27 August to 5 November 2019.

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

ShareSoc – UK Individual Shareholders Society

Government and public bodies

Financial Conduct Authority

Law firms

Shepherd and Wedderburn LLP

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

Individuals

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

The Institute of Cancer Research Pension Scheme

Principles for Responsible Investment

ShareAction

David Pollard QC

MEETINGS

The Law Commission met or otherwise corresponded with members of the project's advisory panel as well as the following people and organisations in relation to this project.

Lawyers and Law Firms

Jonathan Baird (Hogan Lovells LLP)

Government and public bodies

Bank of England

Department for Business, Energy and Industrial Strategy

Department for Work and Pensions

Financial Conduct Authority

Financial Reporting Council

Financial Services Compensation Scheme

HM Treasury

National Employment Savings Trust

Individuals

Eric Chalker

Businesses

Ario Advisory

Aviva Investors

Baillie Gifford

Broadridge Financial Solutions

Computershare

Euroclear UK and Ireland Limited

Georgeson

Institutional Shareholder Services

Interactive Investor

London Stock Exchange Group

Minerva Analytics

Proxymity

The Share Centre

Tumelo

UBS

Professional membership organisations

Association for Financial Markets in Europe

Association of Global Custodians

Association of Member Nominated Trustees

Financial Markets Law Committee

Investor Forum

Pensions and Lifetime Savings Association – Stewardship Advisory Group

Personal Investment Management & Financial Advice Association

The Chartered Governance Institute (ICSA)

The Investment Association

The Law Society – Company Law Committee

The Quoted Companies Alliance

The Registrars' Group

Other organisations

UK Shareholders' Association

2 Degrees Investing Initiative

ShareSoc

Academics

Professor Joanna Benjamin, London School of Economics (emeritus professor)

Professor Iris Chiu, University College London

Professor Sir Roy Goode QC, University of Oxford

Dr Dionysia Katelouzou, King's College London

Dr Ewan McGaughey, King's College London

Professor Vincent Mak, Cambridge Judge Business School

Dr Eva Micheler, London School of Economics

Sir John Dermot Turing, University of Oxford

Appendix 3: Terms of reference

This project was included in the Law Commission's Thirteenth Programme of Law Reform.[1] It is sponsored by the Department for Business, Energy and Industrial Strategy (BEIS). It consists of a scoping study of investor rights in a system of intermediated securities.

The scoping study will provide:

(1) An accessible statement of the current law, including a clear explanation of how shares and bonds are "owned" and held;

(2) A description of the corporate governance and other legal issues associated with intermediated shareholdings and an assessment of whether the issues cause difficulties in practice;

(3) A range of possible solutions – both legislative and non-legislative – presented in sufficiently developed form to provide a basis for future focused policy development and consultation by BEIS;

(4) A summary of technological developments that might make it easier for underlying investors to exercise shareholder rights;

(5) A summary of the costs and benefits of the potential solutions (in a form that will be useful to BEIS analysts), and suggestions about where further analytical work might be needed (eg interview, survey, and/or behavioural research with stakeholders);

(6) A view on whether systems being put in place to remove paper certificates by 2025 (with the issue of new paper certificates phased out in 2023) offers opportunities to enhance the rights of investors already holding shares electronically as well as maintain in full the existing rights of holders of paper certificates;

(7) An account of the views of the main stakeholders.

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

[1] Thirteenth Programme of Law Reform (2017) Law Com No 377 p 16.

Appendix 4: A summary of distributed ledger technology

OVERVIEW

4.1 Distributed ledger technology (DLT) is a method of recording and sharing data across a network.[1] A DLT system comprises a digital database (a "ledger") which is shared (that is, "distributed") among a network of computers (known as "nodes"). The ledger contains a record of data, such as a history of transactions, and each node holds a copy of the ledger on its system. When data is added to the ledger, every node's copy of the ledger is updated instantaneously. Therefore, at any point in time, every node holds an identical and up to date copy of the ledger.

4.2 The distinguishing feature of DLT compared to other shared databases is that the ledger is not maintained by a central administrator. Instead, the ledger is maintained collectively by the nodes on the network. No single node has the power unilaterally to add data to the ledger. A node can propose a new data entry, but it will only be added to the ledger when the other nodes reach "consensus" that the entry should be recorded. The process by which this occurs is known as the "consensus mechanism".

4.3 The consensus mechanism is set by the software underlying a DLT system. In general, it requires some or all of the nodes to determine the validity of a proposed data entry. If the nodes determine that the proposed entry is valid, the entry is automatically added to each node's copy of the ledger. The consensus mechanism is typically designed so that, once data is added to the ledger, the data is very difficult to amend.[2]

4.4 For example, in the Bitcoin blockchain,[3] a "block" of bitcoin transactions can only be added to the ledger when the nodes reach consensus on the solution to a mathematical problem.[4] Broadly, this problem requires the nodes to generate a number (known as a "hash") for the proposed block based on the hash of the preceding block. Finding a solution requires significant computational resources.[5]

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1 For overviews of DLT, see P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) chs 1 and 2; World Bank, *Distributed Ledger Technology and Blockchain* (2017) chs 1 and 3. We discuss the potential relevance of DLT to intermediated securities from para 9.57 above.

2 The consensus mechanism may differ depending on whether the DLT system is "permissionless" or "permissioned": see from para 4.6 of this appendix.

3 The Bitcoin blockchain is a distributed ledger which records transactions in the bitcoin cryptocurrency. It is called a "blockchain" because of the way transactions are recorded on the distributed ledger: in timestamped "blocks" which are mathematically linked or "chained", via the consensus mechanism, to the preceding block on the ledger: see Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008) 3, at https://bitcoin.org/bitcoin.pdf.

4 This is known as "proof of work".

5 By "resources", we refer to the electricity required to power computers and air condition the rooms of servers. The process of generating hashes for proposed blocks is called "mining". Nodes are incentivised to

When a solution is found and verified by the nodes, the block is added to the ledger.[6] The result is that all the blocks recorded on the Bitcoin blockchain are mathematically linked via their hashes.[7] No block (and by extension its hash) can be amended without having to re-solve the mathematical problem for all subsequent blocks in the chain – a task which would be beyond the computing capabilities of any single node.[8] The consensus mechanism ensures that, once a bitcoin transaction is recorded on the distributed ledger, it cannot, for practical purposes, be amended.

BENEFITS OF DLT COMPARED TO CENTRALISED LEDGERS

4.5 DLT offers three potential advantages over a centralised ledger.[9]

(1) *Security*: in a centralised ledger, the central administrator is a "single point of attack": if the administrator is hacked, then the hacker can gain control of the ledger and tamper with its data.[10] In contrast, in a decentralised ledger maintained by consensus, there is no single point of attack. The ledger is the collective responsibility of the nodes, which makes it more difficult for a hacker to infiltrate and tamper with the ledger.

(2) *Immutability*: as noted above, the consensus mechanism ensures that data, once recorded on the ledger, is very difficult to amend. The data is said to be "immutable". The immutability of the ledger means that nodes can trust in its veracity and transact with one another in confidence, despite the absence of a central administrator. For example, the immutability of transactions recorded on the Bitcoin blockchain ensures that no participant can "double spend" a bitcoin. Any attempt to double spend a bitcoin would be contradicted by the ledger (which would contain an immutable record of the previous spend), and the proposed transaction would be rejected by the nodes as invalid.[11]

(3) *Efficiency*: in a centralised ledger, participants have to rely on a central administrator to maintain and update the ledger. Inconsistencies may arise

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engage in mining because they are rewarded with bitcoins upon generating a valid hash for a proposed block: Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008) 4, at https://bitcoin.org/bitcoin.pdf; P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) pp 25 and 26.

6 The nodes also check that the transacting participants have sufficient bitcoin in their accounts to engage in the proposed transactions: Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008) 3, at https://bitcoin.org/bitcoin.pdf.

7 Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008) p 1 to 3, at https://bitcoin.org/bitcoin.pdf.

8 Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008) p 3, at https://bitcoin.org/bitcoin.pdf; World Bank, *Distributed Ledger Technology and Blockchain* (2017) p 18; P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) p 25.

9 See World Bank, *Distributed Ledger Technology and Blockchain* (2017) ch 5; P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) ch 2.

10 Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008) p 2; World Bank, *Distributed Ledger Technology and Blockchain* (2017) pp 5 and 6.

11 Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008) pp 1 and 2; P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) p 26.

between the central ledger and the participants' copies, requiring reconciliation. In contrast, in a decentralised ledger, each participant's copy of the ledger is automatically updated as data is added and the need to reconcile data across ledgers is removed, given that participants hold identical copies of the ledger. This potentially increases the speed and reduces the cost of transactions.

PERMISSIONLESS AND PERMISSIONED DLT SYSTEMS

4.6 DLT systems can be permissionless or permissioned.[12] In a permissionless DLT system, nodes do not need permission from any entity to participate in the network and propose transactions. All that is required to participate is a computer installed with the relevant software.[13] Once a participant has joined the network, it can view transactions and propose and verify new data entries. As participants on a permissionless DLT system are unknown to one another, these systems typically employ a rigorous consensus mechanism to enhance security and trust among participants.[14] The Bitcoin blockchain is an example of a permissionless DLT system.

4.7 In a permissioned DLT system, nodes cannot participate in the network until they receive permission from a central administrator, who controls network access and enforces the rules of the ledger. Participants typically have to verify their identity before they can join the network. As participants in a permissioned DLT system are typically pre-selected, known to one another, and trusted, these systems tend to employ a less rigorous consensus mechanism.[15] Permissioned systems are likely to be more appropriate in certain industries, such as the finance industry, where the law requires the identities of the transacting parties to be disclosed.[16]

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12 World Bank, *Distributed Ledger Technology and Blockchain* (2017) ch 4; P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) pp 31 and 32.

13 The software that supports permission-less systems such as the Bitcoin blockchain is open source and can be downloaded for free from a website.

14 For example, the "proof of work" consensus mechanism described at para 4.4 of this appendix.

15 For example, some permissioned ledgers use a "proof of stake" consensus mechanism, where transactions can be validated by a subset of nodes who hold a "stake" in the transaction: P de Filippi and A Wright, *Blockchain and the Law: The Rule of Code* (2018) p 57, n 90.

16 World Bank, *Distributed Ledger Technology and Blockchain* (2017) 19 (referring to "Know-Your Customer" laws in Anti-Money Laundering/Combating the Financing of Terrorism regulations).