The City of London Law Society

4 College Hill
London EC4R 2RB
Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 – Cheapside 2
mail@citysolicitors.org.uk
www.citysolicitors.org.uk

8th November 2019

Response of the Joint Working Party of the City of London Law Society Company Law, Financial Law and Regulatory Law Committees to the Law Commission's Consultation on Intermediated Securities

The CLLS is pleased to have the opportunity to respond to the Law Commission's Consultation. This response is submitted jointly by the Financial Law, Company Law and Regulatory Law Committees of the City of London Law Society (CLLS).

The CLLS Response

The CLLS represents approximately 17,000 City solicitors through individual and corporate membership including some of the largest international law firms in the world. The Financial Law, Company Law and Regulatory Law Committees comprise leading solicitors specialising respectively in financial transactions, corporate law and financial regulation, areas in which the law relating to intermediated securities and the regulation of intermediaries is a significant element of their practices. These solicitors and their law firms operating in the City of London act for UK and international businesses, financial institutions and regulatory and governmental bodies in relation to major financial and corporate transactions, both domestic and international. Details of the solicitors involved in the working party that prepared this response appear at the end of this document.

Our joint Working Group that has prepared this submission (which is largely drawn from Committee members and their firms) also includes distinguished retired practitioners with great experience in relation to the law on intermediated securities. A full list of working party members appears at Annexe 3.

General Observations

The three CLLS Committees involved in this response all believe that the Call for Evidence, while it asks valuable questions, does not sufficiently take account of the context in which the questions are raised. This will be apparent in a number of our responses, particularly our defence of the "no look through" principle, which is fundamentally a product of English company law, contract law and the rules of equity, as well as of UK regulation and similar approaches adopted internationally. It provides a high level of legal certainty for market participants. Adherence to this principle as part of English law has supported the development of UK securities markets, the efficient and safe operation of the UK's securities settlement system, CREST, and the attraction of securities businesses to the UK as a financial centre. This has in turn brought very considerable benefits to the UK economy.

The no look through principle is also coherent and effective in the highly international markets in which the UK financial centre operates – it is and remains an appropriate tool for a country at the forefront of 21st century global securities markets. A look through approach operating through an intermediation chain that may include intermediaries established outside the UK and trading, clearing and settling under the laws of one or more third countries, is likely to prove more problematic than the no look through step by step process of tracing an interest in UK issued securities, especially as that step by step process has grown out of the core principles of English law of property and UK company law that underpin the operation of legal transactions in this country.

Although there are certainly some areas where the law can be improved (eg with regard to section 53 of the Law of Property Act) – and we refer to these in our responses and provide a summary in response to Question 26 – we believe that the fundamental structure of the UK market for both direct holdings and intermediated holdings remains sound and that full dematerialisation of UK listed securities will not affect that position.

As Guy Morton, one of the members of our Working Group, states in Chapter 2 of *Intermediation and Beyond*, edited by Louise Gullifer and Jennifer Payne, at page 42, in the section *"Suggested Principles to Guide Further Reform":*

"It is important, in the opinion of the present writer, that any proposals for change should be assessed against the rigorous standards that govern legislative best practice generally. They should, in particular, (a) be based on the collection, examination and analysis of evidence; (b) be proportionate (appropriate to the risk posed, with costs identified and minimized); (c) be targeted (focused on an identified problem and framed so as to minimize side effects); (d) respect the traditional approach of English commercial law, that the law should facilitate legitimate commercial transactions rather that dictate their form; and (e) where market failure is identified, consider the full range of possible tools, including competition law, enhanced disclosure, encouragement of market solutions, and targeted regulatory intervention, as well as legislative and structural change."

We think that a combination of regulatory measures, with particular regard to transmission of information and quality of advice, as well as education on available holding methods and the promotion of competition between intermediaries that serve active investors, would address the perceived concerns. This would do so much more cheaply and effectively than attempting to meddle with the legal structures, a course which could not be completed quickly and which carries the risk of causing as many or more issues of legal uncertainty, than would continuation with the current system, which fits with the relevant general principles of UK and English law. We think this is the best way of husbanding the health of those markets, while ensuring the needs of active investors are met.

We would also mention at this stage, some observations on terminology, the way CREST works and a glossary of terms that we have placed in Annexe 1, but which we hope will be useful to the Commission when considering our response.

Question 1

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

As a general comment, we do not think there is a significant problem that needs to be addressed by a process of fundamental law reform. There are undoubtedly concerns about the ease with which active personal investors can exercise voting and other shareholder rights in a world of intermediation. We do not think that plans for full dematerialisation affect this position, as CREST provides a basis on which shareholders can have a direct relationship with a UK listed (or other) corporate issuer on a dematerialized basis and some corporates/corporate registrars may provide other means to maintain a direct relationship. We also believe that it would be true to say that most retail investors hold shares purely for economic reasons and are not concerned with voting them. We do not think this is likely to change much in the foreseeable future. Active investors are, however, valued by UK corporates and it is right that the exercise of rights by this group without undue expense should be facilitated: as indicated above we do not believe that this requires wholesale law reform, but rather the adoption of better practice and regulation. In this context, we note and welcome the statement by the FCA (in FS19/7 Building a regulatory framework for effective stewardship, October 2019) that it will be reviewing the activities of service providers in support of the Law Commission's work on intermediated securities.

We also note that large professional investors, such as pension funds, that do want to exercise voting rights are well advised and unlikely to face difficulties in putting in place arrangements with custodians and other intermediaries to facilitate the exercise of voting rights in relation to holdings not held directly in CREST. They will also be fully advised on the pros and cons of the investment structures that they use.

In short, we think that problems that active investors may experience are ones of non-compliance with contractual or regulatory obligations or possibly a gap in regulatory requirements and need to be tackled by regulators and regulatory policy makers. Changing the underlying legal system would not help. Also enforcement of high standards of advice to investors who wish to be active should assist them to hold their shares in a satisfactory way for the exercise of those rights.

The position described above relates primarily to interests in shares. Traded debt instruments governed by English law are overwhelmingly held through intermediaries in this country and elsewhere, almost always starting with the holder of the global security, which will be an international securities depository (ICSD), likely in practice to be either Euroclear Bank (operating under Belgian law) or Clearstream Bank (operating under Luxembourgeois law) (or a professional custodian on behalf of one of these entities). In addition, regulatory rules mean that interests in this type of instrument are increasingly held only by financial professionals. There are far fewer events requiring bondholder approval compared with those requiring shareholder approval and the one event that can be guaranteed to excite bondholder interest would be a restructuring affecting the value or nature of their holding. We believe, therefore, that the engagement of active personal investors in relation to debt securities is far smaller than in equity markets and that the cause of issues relating to exercise of voting rights arise more from bond-holder apathy and sluggish information flows than from any structural issues, real or perceived.

(*1) If so, do you have examples, or specific evidence, of difficulties experienced by ultimate investors in exercising their voting rights?*

We do not have examples in the equity markets.

In the debt markets, there may be problems with global custodians (as recipients of information from the issuer) failing to pass this on to other intermediaries, so causing prejudice to ultimate investors, particularly in the context of restructurings. Please see Annexe 2 for a case study relating to Commercial Mortgage-Backed Securities (CMBS).

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

Please see our response to Question 26 for a summary of the changes we consider could be valuable. Most important is education of these investors and regulatory backing to ensure the services they want are available to them at a reasonable price.

In the debt markets, the use of SWIFT messaging services could be improved to help solve the issue to ensure that appropriate tags are applied and the underlying information passed on, not only where the matter can be given a "REST" tag for a restructuring. For most custodians and other intermediaries their policies require them to transmit REST messages, but may not cover other events.

Question 2

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

We do not believe so.

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

We do not consider that the legal adjustments that would be needed to place a several layers of intermediation distant ultimate investor in exactly the same position as, for example, a CREST sponsored member in relation to a UK issuer could possibly be justified. In any event the result would be imperfect in the modern world, where a chain of intermediation may involve levels governed by different laws.

We believe that the emphasis should be on the identification of active investors, ensuring active investors can participate effectively and recognising that the best advice for those investors is likely to be that they should not use intermediaries who cannot take steps to provide a direct or a protected route to the exercise of those rights.

Question 3

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

As regards equity securities we do not think this is generally the case and there is a reasonable level of interest in all types of vote. Restructurings which affect the value or nature of holdings of either (or both) equity or debt securities are likely to attract a high level of interest. In debt securities where there is no benefit to the ultimate investor, sufficient voting instructions to effect a necessary change may be hard to come by.

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

In the context of equity securities, we do not see the different types of votes as materially affecting the ability of ultimate investors to exercise voting rights. One factor likely to affect the shareholders' ability to exercise voting rights is the length of the notice period for the meeting. The default notice period for UK companies is 21 clear days' notice. For annual general meetings (AGMs) of listed companies, typically 4 weeks or more notice is given (as required by the UK Corporate Governance Code 2016 and previous editions, and as now recommended by the FRC's Guidance on Board Effectiveness 2018). Publicly traded companies can reduce the notice period for general meetings (other than AGMs and class meetings) to 14 clear days, if shareholders have given permission for this at the previous AGM (see sections 307, 307A, 334 and 360 CA 2006).

In the case of listed companies, meetings other than AGMs are usually held for the purposes of approving corporate actions such as rights issues (where the company does not have sufficient authority granted at an AGM), schemes of arrangement in connection with a takeover or corporate reorganisation, or significant transactions for which shareholder approval is required under the FCA's Listing Rules, such as Class 1 transactions or certain related party transactions. In many cases, the relevant transaction will have been announced some time before the notice of meeting is sent out so that shareholders will already have access to information about the proposed transaction before the commencement of the formal notice period. The circular convening the meeting in question is also made available electronically, normally on the company's website, from the time of its publication. This ensures shareholders are able to access relevant information in a timely manner.

We would not support any lengthening of notice periods – this would be a retrograde step. Section 307A CA 2006, which, as described above, allows companies to hold certain general meetings on 14 (rather than 21) days' notice was introduced in 2009 (as permitted by Article 5(1) of the Shareholder Rights Directive 2007/36/EC). It was considered at that time that, with electronic communications and electronic proxy voting systems, 14 days would provide adequate time for shareholders to exercise their voting rights. Although some proxy voting advisors express a preference for meetings not to be held with shorter notice than 21 days, we do not believe the shorter notice period causes significant difficulties in practice. A shorter notice period benefits companies and consequently its shareholders and potential investors by allowing shorter transaction timetables for capital raisings (e.g. a rights issue) and therefore reducing the costs of underwriting share issues. It will often help companies' competitive positions to be able to obtain shareholder approval for transactions more quickly (listed companies are often at a disadvantage compared with businesses that do not have to seek shareholder approval from a wide body of shareholders). Extending the notice period could result in the UK being seen as a less attractive place in which to incorporate with a range of potentially adverse consequences flowing from this.

As regards debt securities, pass through of information in relation to restructurings is high as intermediaries may be at risk of claims if they do not make proper efforts to obtain instructions from the beneficial owner. On what are perceived to be less critical types of consent requests, it can be difficult to drum up interest - for example this is currently being experienced in resolutions to introduce new LIBOR fallbacks to bonds and loan notes, although there is regulatory pressure to move away from LIBOR in the very near future. This is not just because of intermediated holdings, however, but also because of the wide distribution of holdings. However, English law bond documentation typically provides for lower quorum and voting requirements for the passing of bondholders' resolutions if an initial bondholders' meeting is not quorate, or the initial voting threshold is not passed. Issuers, trustees and bondholders who convene bondholders' meetings are frequently faced with an extended timetable, involving the adjournment and reconvening of the meeting, and the resolutions being passed on the basis of a relatively low turnout at the reconvened meeting. Statutory amendments will not address this situation - the quorum and voting requirements are a matter of contract between the issuer and its bondholders. To the extent that there is any perceived risk for beneficial owners of bonds, we believe that this situation is more a matter for regulation than one that could be addressed by legislation which attempts structural change.

Question 4

D*o you believe that it is difficult for ultimate investors to obtain evidence that their votes have been received and counted?*

Yes, as there is generally no requirement for issuers to provide such evidence either to ultimate investors or to particular members or debt holders including those registered in CREST or in the books of the issuer.

If so:

(1) What is the impact of this?

We do not believe that this a significant issue. We have not come across it being a concern for smaller shareholders. While large investors are in many cases expected to vote (and report on voting) under the UK Stewardship Code, we do not think that necessitates provision of evidence by issuers of votes cast beyond the steps that they already take.

(2) Do you have examples, or specific evidence, of ultimate investors having difficulties in obtaining evidence that their votes have been received and counted?

No.

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

The focus should be on ensuring that the investors holding through intermediaries or retail investors holding through platforms have appropriate contractual and/or regulatory protections so that the service providers effectively and reliably enable ultimate investors to vote and to confirm that their votes have been cast.

We do not see that adding an extra burden on issuers to establish whether specific shares have been voted in accordance with ultimate investors' instructions would be proportionate. At the issuer level, the counting of proxy votes received is assured by the processes by which companies conduct polls and the duty of directors to conduct meetings properly. Quoted and traded companies under the Companies Act must also announce aggregate results of voting after a shareholder meeting and the members of a quoted company may require the directors to obtain an independent report on any poll taken at a meeting. Although a company could if requested confirm to a registered shareholder whether it has voted or not, it will not have the information to know whether an ultimate investor's instructions have been carried out (for more detail see the Example below). Electronic voting systems, such as the CREST voting service, also ensure that proxy appointments are not at risk of being lost or delayed en route to an issuer.

If ultimate investors are concerned as to whether their voting instructions have been complied with, we believe the solution lies in requirements (either contractual or regulatory) on those in the chain to provide such confirmations to the person giving the voting instruction. The recently published UK Stewardship Code 2020 should help by requiring service providers to support their clients' stewardship. We also note and welcome the statement by the FCA (in FS19/7 Building a regulatory framework for effective stewardship, October 2019) that it will be reviewing the activities of service providers in support of the Law Commission's work on intermediated securities.

There could also be more education that, in some circumstances, indirect shareholders who wish to exercise their voting rights and achieve accountability should consider (and bear the costs of) direct holdings in CREST, or segregated accounts with an intermediary itself registered in CREST, as the simplest way of minimising these difficulties and producing manageable regulatory burdens (bearing in mind that intermediaries in the chain may not be in England and may be contracting under other laws). There may be an opportunity for one or more intermediaries to market this service at a reasonable cost to smaller shareholders who have previously held certificated/paper shares or shares under intermediated arrangements. Declining numbers of sponsored direct CREST shareholders may show, however, that the interest of small investors in directly voting their shares appears to be waning. It is for debate whether specific regulatory rules would be needed for this category of intermediary, but legislative or other law reform solutions involving major changes to the way shares are held and the rights attached to them are exercised do not seem justified.

EXAMPLE The following hypothetical example looks at the practicalities. Where an ultimate investor wishes to vote shares that are held on its behalf by an intermediary (say, 100 shares) then, assuming that the intermediary offers this service, the ultimate investor will need to instruct the intermediary how to vote its 100 shares (say, in favour of resolution 1 at a general meeting). Where there is more than one intermediary in the chain, each will of course need to transmit a similar instruction to the next. Unless the intermediaries are part of the same organisation and/or share an integrated system, the transmittee intermediary will typically know only that it is instructed to vote 100 shares in favour of resolution 1, and not which ultimate investor originated such instruction. Where an intermediary in the chain is responsible for a larger block of shares that are ultimately owned by more than one investor (say 1,000 shares owned by 5 different ultimate investors), that intermediary could of course also receive voting instructions that originate from one or more of the other ultimate investors. If each ultimate investor were to instruct its shares to be voted in favour of resolution 1, that intermediary would instruct the next intermediary in the chain to vote all 1,000 shares in favour. Down the chain there may be further pooling of holdings, complicating the picture further. From the issuer's perspective, typically it will know only that the end intermediary (which is the registered shareholder) has voted a certain number of shares that it holds in favour of resolution 1 and, possibly, a certain number of shares against the resolution: the issuer will not know or be told which intermediaries in the chain gave instructions, what the content of those instructions was, or from which ultimate investors the instructions originated.

There would be considerable cost implications (and potential administrative and legal uncertainty) in seeking to address this, so that it would not be worthwhile unless there were significant demand for this information.

Question 5

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

Please see our response to Question 3 above on notice periods. In the context of shareholder meetings, we do not see the record date/proxy submission deadline, or the issues identified in paragraph 2.20 of the Call for Evidence, as being problematic in practice.

In the context of debt securities, once the ICSDs (as holders of the global security through their common depository) are aware of a corporate action requiring a vote, they will be prompt to advise their participants, but thereafter progress through the intermediary chain may be slow. The fact that voting events are much less regular for debt securities means that intermediaries are less geared up to passing on information. Please see the case study in Annexe 2.

If so:

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

Equity securities: no. For debt securities, please see the observations above.

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

Anyone planning to buy shares and vote them at an upcoming meeting will know the date of the meeting and the deadline for submitting proxy instructions because this information will have been announced to the market at least 14 days in advance and put on the company's website. They can therefore make decisions about the timing of a purchase accordingly. In addition, it is, at least in theory, possible for an investor to attend in person by being appointed as a corporate representative if their nominee or custodian offers this facility. The proxy deadline does not apply to corporate representative appointments. There are, however, potential difficulties if multiple corporate representatives are appointed, so this route is only likely to be used if they are the sole beneficiary of their nominee or custodian (or possibly, the only one who wishes to appoint a corporate representative).

In practice, most proxies are submitted close to the submission deadline. Companies and their boards might prefer to have earlier transparency about the way votes will be cast, but the 48 hour period seems to offer a reasonable balance between having too early a cut off time and allowing companies sufficient time to prepare for the meeting.

We note the comments on shareholder engagement in footnote 54, but in our experience, companies are likely to engage with their major shareholders significantly ahead of the proxy submission deadline and not wait until receiving proxies to ascertain their views. Good stewardship principles would also suggest that major shareholders with concerns should engage with companies in good time.

For debt securities, we consider that any concerns arising from a failure to pass relevant information or instructions through the intermediary chain are properly matters for a regulatory response – whether through the proper enforcement of existing regulatory duties or, in the case of any potential gap in the regulatory system, by policy-makers imposing appropriate regulatory obligations on regulated intermediaries. There is also no tradition of small investor action in these markets, where most securities are held for investment, often in managed or envelope funds, so that the demand for involvement is very low, even when the opportunity is there. The party prejudiced is as likely in such cases to be the issuer, who cannot get adequate voting instructions to pass a necessary resolution.

Question 6

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

Not to any great extent

If so:

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

No.

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

We believe that the proxy voting system works well for both shareholders and ultimate investors. Proxy voting facilitates the exercise of voting rights by registered members who have a statutory right to appoint a proxy to attend a meeting and vote on their behalf. While many proxy appointments by small shareholders are still in paper form, the CREST electronic voting system and other electronic “voting” services offered on behalf of issuers are proxy appointment facilities.

In appointing a proxy, the registered member may act on the instruction of another person on whose behalf they hold the securities, so enabling an ultimate investor to direct the exercise of voting rights, assuming that the entity which is the registered member and any intermediaries in the chain offer this facility at a reasonable cost.

The vast majority of proxy appointments appoint the chairman of the meeting as proxy to vote on behalf of the member in accordance with the instructions set out on the proxy voting form. Receipt of these proxy instructions gives the company transparency as to how the votes are being cast ahead of the meeting. However, a proxy can be any third party whom the shareholder wishes to entrust to vote on their behalf. The proxy (as agent owing fiduciary duties to the appointor) must act in accordance with the instructions of the appointing member. The member may change their instructions to the proxy any time up until the vote is taken, or may attend in person instead of the proxy. The proxy voting system therefore gives flexibility to members and, subject to appropriate means of instruction/communication between an ultimate investor through the chain to the registered member, gives the same flexibility to ultimate investors, again assuming the facility is provided at a reasonable cost.

Question 7

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

Yes.

In what way?

We agree that the headcount test can have unintended consequences in the context of current methods of holding securities and consider that it no longer serves a useful purpose in its current form.

It is also impossible to comply with in the context of debt restructurings where there are contingent claims and the number of claimants cannot be ascertained with any certainty.

If so:

(1) Do you have examples, or specific evidence, of problems arising out of the application of section 899 of the Companies Act 2006 to intermediated securities?

The case of *Re Dee Valley Group plc* [2017] EWHC 184 (Ch) illustrated an attempt to manipulate the test by splitting a shareholding in an attempt to defeat a scheme. In that case, the court used its discretion to allow split shareholdings to be disregarded and sanctioned the scheme.

In the debt field, 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.

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

We would support a wider separate review into abolishing this element of the requirements for a scheme of arrangement and relying 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 (as discussed, for example, in *Re Old Mutual Group plc* [2018] EWHC 1875 (Ch) and *Re Stellar Diamonds plc* [2018] EWHC 1152). 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.

A review could consider the advantages and disadvantages of approaches taken in other jurisdictions that have addressed this issue. In Hong Kong the equivalent majority in number test has now (following some instances where splitting of shareholdings occurred) been replaced with a requirement that the votes cast against the arrangement do not exceed 10% of the total voting rights attached to all "disinterested" shares in the company. Another possibility would be the use of a quorum requirement alone.

Elsewhere, the majority in number test applies but is subject to the court's discretion. For example, in Australia the court has (since 2007) had power to dispense with the headcount test. This power followed apparent attempts to manipulate the test by splitting holdings, but its use is not limited to those circumstances. The use of the test was discussed by the Australian Federal Court in *Re Boart Longyear Limited* [2019] FCA 62.

Question 8

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

We do not think this is the right starting point to examine the no look through principle. We are firmly of the view that the no look through principle is extremely valuable both legally and economically and that active investors can be accommodated without doing violence to that principle – violation of the principle should not be under discussion.

If so:

(1) Do you have examples, or specific evidence, of problems caused by the no look through principle?

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

We think that the Law Commission should start out by recognising the value of the no look through principle and address any perceived difficulties for shareholders/ultimate investors (large and small) who wish to exercise voting rights by methods that do not compromise that principle. It would require a major legislative programme to produce an alternative to the principle and the legal uncertainty caused by such a major change would be damaging to the operation of the financial markets and the wider UK economy. A look through principle would risk unnecessary litigation of a plethora of competing claims, many of which would never have arisen when each level of the chain could operate independently. We set out our concerns in more detail in the following paragraphs.

1. It is our strongly held view that, for the reasons we set out in greater detail in our response to Question 9 below, the no look through principle in fact continues to deliver considerable benefits that:
   - underpin the coherence and integrity of the English laws (including its conflict of laws) governing the holding and transfer of title to securities;
   - support the efficient, safe and legally robust provision of custody, securities issuance and securities settlement services under English law;
   - ensure that English law operates consistently with internationally accepted best standards as represented by, for example, Article 22 (*Prohibition of upper-tier attachment)* and Article 23 *(Instructions to the intermediary)* of the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the *Geneva Securities Convention*);
   - are aligned with, and reinforce, fundamental and long-standing provisions of UK companies law designed to protect the integrity of the register of securities, the liability position of the issuer of UK securities and the operator of the UK securities settlement system: see section 126, Companies Act 2006 and regulations 23(3) and 40(3) of the Uncertificated Securities Regulations 2001 (as amended, the "***USRs***"); and
   - encourage the choice of English law, and the United Kingdom as a location, to issue securities and to provide intermediated securities services.
2. Any proposal for the reform of English law that undermines or otherwise vitiates the application of the no look through principle (as properly understood) is likely to have a materially adverse impact on our corporate law and the legal framework underpinning the

smooth operation of our financial markets. In this respect, we would enthusiastically endorse the conclusion of the authors of *Goode and Gullifer on Legal Problems of Credit and Security (Sixth Edition) at para. 6- 21:*

> *"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."*

3. Further, we consider that any potential restriction on the rights of ultimate investors to bring an action against an issuing company or intermediary must be fairly assessed against the background of the following relevant considerations.

    (1) At the level of legal principle, the inability of the ultimate investor to bring an action against, or enforcement proceedings to attach the assets of, an issuing company or higher-tier intermediary with respect to those voting or other rights (derived from the contractual terms of issue of a security) is a logical expression of the English rule of privity. As properly understood, the scope and application of the no look through principle under English law is simply a consequence of the nature of the ultimate investor's rights, as constituted by contract and a beneficial interest under a trust or sub-trust.

    (2) In the UK, an investor has a real and effective choice as to whether to structure its securities holdings through maintaining a direct contractual relationship with the issuing company (for example, by being a CREST personal member using the sponsorship services of its broker) or by maintaining an indirect relationship through their intermediary (with whom it has a direct contractual and trust relationship). Subject to any considerations of regulatory disclosures or transparency (examined in (4) below) to ensure that an investor remains fully and clearly informed as to the legal and corporate governance consequences of its election, the no look through principle is in fact wholly consistent with the autonomy of the investor, the issuing company and the intermediary to choose their preferred contractual structure and the nature of the attendant contractual rights. As was made clear by both the High Court and the Court of Appeal in *Secure Capital SA –v- Credit Suisse AG* (see *[2015] EWHC 388 at [61]* and *[2017] EWCA Civ 1486 at [53] to [59]*) the no look through principle (and the associated privity of contract rule) are not only logical – they ensure that an issuing company (or, by extension, a higher-tier intermediary) are not subjected to a multiplicity of legal actions contrary to their expectations or those of participants in the financial markets or, we would suggest, any properly informed ultimate investor that has elected to structure their securities holdings through an intermediary (or chain of intermediaries).

    (3) To promulgate a rule or law under any proposed reform that would give a direct right of action (or enforcement) to the ultimate investor against the issuing company or higher-tier intermediary, with respect to rights constituted by contract or in trust (as opposed to the statutory rights of the kind considered in the *Tesco* case discussed at (7) below), would be fundamentally contrary to the legal basis of the securities issuance and holding structure freely chosen by the relevant parties. It would undermine party autonomy. In this respect, we do ***not*** accept or recognise the description in paragraph 2.35 of the Law Commission document of the no look through principle as being in any way *"controversial"*. Further, for the reasons we set out here and in our response to Question 9 below, we consider that the benefits of the no look through principle are, in fact, of wide application – including economic, legal and efficiency benefits for the ultimate investors with respect to their securities-related activities. We would ***not*** agree,

therefore, with the observation that the ultimate investors *"get the downside of the advantages that this principle confers on others".*

(4) Following on from our observations in (1) – (3) above, it is relevant for the Law Commission to consider the autonomous position of the ultimate investor with reference to existing and prospective UK regulatory rules which minimise the economic or other risks for the investor with respect to its securities holdings. In practice, as far as the UK is concerned, the ultimate investor will hold its securities through a regulated intermediary carrying on either MiFID investment business or designated investment business for the purpose of FCA conduct of business and related rules. As such, as a matter of the English law analysis, the ultimate investor in choosing the appropriate structure for its securities holding, and in gaining a clear understanding of any attendant benefits, costs or risks, should enjoy the following broad regulatory protections:

- an obligation on the intermediary to act with due regard to the interests of the ultimate investor and to treat it fairly (see FCA's *Principle 6*);
- an obligation on the intermediary to act honestly, fairly and professionally in accordance with the best interests of the ultimate investor (see *COBS 2.1.1R*);
- an obligation on the intermediary to pay due regard to the information needs of the ultimate investor, and communicate information to it in a way which is clear, fair and not misleading (see FCA's *Principle 7*);
- an obligation on the intermediary to provide appropriate information in a comprehensible form so that the ultimate investor is reasonably able to understand the nature and risks of the service being offered (see *COBS 2.2.1R*, *COBS 2.2A.2R* and *COBS 2.2A.3R*); and
- an obligation on the intermediary to arrange adequate protection for the ultimate investor's securities when it is responsible for them (see FCA's *Principle 10* and *CASS6.1.6R – 6.1.9G, CASS 6.2.1R, CASS 6.2.2R, CASS 6.4.1R, CASS 6.6.54R – 6.6.57R* and *CASS 9.3*).

It might also be possible for these existing protections for the ultimate investor from any adverse consequences of the no look through principle to be further supplemented by additional regulatory provisions imposing on intermediaries information, pass through and confirmation requirements similar to those set out in Articles 3b and 3c of the SRD II, as well as the relevant provisions of the SRD II Implementing Regulation.

(5) In essence, with particular reference to the regulatory provisions and, potentially, prospective developments we outline in (4) above, we consider that any restriction on the rights of direct action which result for the ultimate investor by the coherent and logical application of the no look through principle, with respect to rights constituted by contract and in trust, can in practice be robustly and fairly managed because:

- an appropriate application of the information and disclosure requirements of the UK regulatory system should ensure that the ultimate investor has a clear and comprehensive understanding of the structural holding options available to it and the risks (e.g. as to the loss of direct voting or other rights against the issuing company) resulting from an intermediated holding;
- the client's best interests rule should encourage the intermediary which has the direct relationship with the ultimate investor to consider what is the most appropriate holding structure for the ultimate investor and the associated pass

through or other rights with due regard to the investor's investment and corporate governance objectives; and

- although the debt markets face different problems and have very few active private investors, it would be reasonable to expect relevant intermediaries in those markets to determine, and advise upon, whether any potential disadvantages of the application of the no look through principle might be mitigated by structural developments at the issuer level– for example, the terms of issue of a debt security might include deed poll provisions of the type considered by the High Court in *Re Public Joint-Stock Company Commercial Bank "Privatbank" [2015] EWHC 3299 (Ch.)* (which is referred to in paragraph 2.36(3) of the Law Commission's document) and/or might include an obligation upon the issuer, in defined circumstances, to issue definitive notes for the benefit of the ultimate investors.

(6) If it is felt that the existing, and (with reference to the suggestion we outline at (4) above regarding additional information, pass through and confirmation requirements on intermediaries) prospective, regulatory rules are not sufficiently clear to impose the kind of disclosure and structural obligations upon an intermediary of the type we outline above, we would favour a review of the relevant FCA rules to determine how they might be further strengthened to ensure adequate protections are established for the ultimate investor. These would be developments in the areas of transparency and disclosure to ensure the ultimate investor fairly understands the risks and benefits of the no look through principle, together with an obligation on the intermediary to ensure that the chosen securities holding structure appropriately meets the individual needs of the ultimate investor. Such a review would not be concerned with the reform of corporate governance and related laws. As such, it would fall outside the terms of reference for the Law Commission's scoping study.

4. For the reasons we outline above, we would not therefore favour any reform of English law which, contrary to the no look through principle (as properly understood), seeks to give direct voting or other rights to the ultimate investor which are not accorded to it by the contractual (and trust) structure expressly and voluntarily chosen by the relevant parties in the securities holding chain. This is particularly so when one bears in mind there may be elements in the chain not governed by English law.

5. However, where the source of the ultimate investor's right is not contractual or by way of trust - but statutory - we consider that statutory provisions might be used to protect the investor's rights without undermining or otherwise vitiating the no look through principle (as properly understood) and the substantial benefits associated with it. Where the relevant right is conferred by statute, and the circumstances of the exercise of that right do not (a) seek to re-constitute contractual or trust rights as third party rights enforceable against or by a person who has no contractual or trust relationship with the ultimate investor or (b) adversely affect the efficiency and legal certainty considerations at the foundation of the no look through principle, we would not foresee any evident systemic or structural objection to putting in place or amending the relevant statutory provision to allow for the exercise of the relevant right by the ultimate investor. (This is subject, of course, to there being satisfactory rules to identify the ultimate investor: for example, an individual who has a portfolio of investments in named securities held through an intermediary is likely to be an ultimate investor, but an individual participating in an investment fund directly or via an intermediary may hold a different type of investment (in the fund) and not be an ultimate investor in the underlying assets of the fund. These situations are not always straightforward.)

6. For example, there is no reason in principle why section 98 of the Companies Act 2006 might not be amended to allow for the ultimate investors in an intermediated securities chain to apply to the court for the cancellation of a resolution to delist a company (see *Eckerle –v- Wickeder Westfalenstahl GmbH [2013] EWHC 68 (Ch.)* as considered in paragraph 2.36(1) of the Law Commission document).

7. Indeed, the recent decision of the High Court in *SL Claimants –v- Tesco PLC* [2019] EWHC 2858, which determined the rights of ultimate investors to compensation from an issuer of securities under section 90A (and Schedule 10A) of the Financial Services and Markets Act 2000, clearly demonstrates that it is possible for a statutory right of action to give direct rights to an ultimate investor against an issuer without undermining the continued application of the no look through principle with respect to those investor's rights constituted under contract or in trust (see, in particular, the comments of Hildyard J. at paragraphs [75] and [116]); and to do so without giving rise to a concern for the issuer of being exposed to indeterminate liability to an indeterminate class (see, in particular, paragraphs [74], [76], [84], [90] and [91] of the judgment).

Question 9

I*n practice what, if any, are the benefits of the no look through principle?*

1. As is likely to be clear from our response to Question 8 above, we are concerned by the apparent policy direction of Question 9 to the extent it might be taken to suggest that there are no, or limited, benefits of the no look through principle under English law. We are firmly of the view that the principle in fact delivers considerable structural, market and corporate benefits. Specifically, it:

   - underpins the coherence and integrity of the English laws (including the conflict of laws) governing the holding and transfer of title to securities and promotes legal certainty;
   - supports the efficient, safe and legally robust provision of custody, securities issuance and securities settlement services under English law;
   - ensures that English law operates consistently with internationally accepted best standards as represented by, for example, Article 22 *(Prohibition of upper-tier attachment)* and Article 23 *(Instructions to the intermediary)* of the Geneva Securities Convention;
   - is aligned with, and reinforces, fundamental and long-standing provisions of UK companies law designed to protect the integrity of the register of securities, the liability position of the issuer of UK securities and the operator of the UK securities settlement system: see section 126, Companies Act 2006 and regulations 23(3) and 40(3) of the USRs; and
   - encourages the choice of English law, and the United Kingdom as a location, to issue securities and to provide intermediated securities services.

Coherence and integrity of English law

2. As we have outlined in our response to Question 8 above, it is important to recognise the operation of the no look through principle under English law as a necessary and logical expression of the privity rule, freedom of contract and the party autonomy principle. The contractual rights constituted by the terms of issue of a security, as represented for example by the articles of association of the issuing company, are conferred upon, and are intended

(and understood) to be solely exercisable by, the person identified from time to time as member, shareholder or other holder of the securities on the issuer or (under the USRs) Operator register. Equally, the contractual rights constituted by the custody or other account agreement between an intermediary and its client are exercisable solely as between the parties. Where the parties to the relevant contract have elected English law to govern the rights and obligations arising from that contract, they can properly be expected to accept that the normative standards of that law (including privity, freedom of contract and party autonomy) will determine how, and against whom, such rights and obligations are to be exercised. If it is desired to confer third party rights upon a party who is not in a contractual relationship with the obligor, then it would be open to the parties to provide for such rights under English law either through a deed poll or through the Contracts (Rights of Third Parties) Act 1999. The no look through principle does not prevent or impede the grant of direct rights by an issuing company, or intermediary, for the benefit of a non-contracting party (such as the ultimate investor) if that is the commercial decision that the issuing company or intermediary wishes to make. The principle merely prohibits the ultimate investor (or other third party) from exercising, or purporting to exercise, rights that are in fact vested in and enforceable solely by another party that is in a direct contractual (or trust) relationship with the obligor. It is always open to all relevant parties to agree to the exercise of rights and discharge of obligations in a different way, but this does not change the principle.

3. The no look through principle also provides a coherent, logical and practical foundation for the English conflict of laws principles governing the holding of international securities. Under the *"place of the relevant intermediary approach"* (*PRIMA*), the law governing the rights and obligations (and issues relating to the rights and obligations) constituted or evidenced by a book-entry on a securities account held or maintained by an intermediary (including, for example, the requirements as to perfection and relevant priority rules) is the law of the place where the relevant account is maintained or located by the immediate intermediary or which otherwise governs the account agreement. This reflects the fact that, under the no look through principle, it is the law of the place of the relevant (immediate) intermediary, its accounts and account agreement that is alone constitutive or evidential of the account-holder's rights and obligations. That law is the sole *"root"* of the account-holder's entitlement in, or in relation to, the underlying securities – for conflict of laws purposes, it is the *lex creationis*. The legal and practical reality, with respect to a chain of intermediated securities holdings, is that the issuing company or relevant intermediary is only likely to have knowledge of, and to recognise that it owes contractual obligations to, the person identified as holder in the register or account maintained by or for the issuing company or (as the case may be) relevant intermediary. The no look through principle prevents the conception of the ultimate investor's rights as being somehow derived from the issuing company's articles of association or other constitutive terms of issue; and so avoids the unhelpful conclusion that such rights (and issues relating to such rights) are, therefore, governed by the issuing company's law or the place of its register of securities.

4. PRIMA finds statutory expression in English law through regulation 23 of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and regulation 19 of the Financial Collateral Arrangements (No. 2) Regulations 2003. Correspondingly, in the case of directly held shares, the root of title to the contractual rights and obligations constituted by the terms of issue is the constitutional documents of, and register maintained by or for, the issuing company; and, consistent with the no look through principle, it is the law of the company's place of incorporation (which will in practice correspond to the place of the

register) that, under English private international law rules, governs the issuing company-investor relationship (and issues relating to that relationship).

5. Equally, the now established English law characterisation of the intermediated securities holding chain as a *"series of trusts and sub-trusts"* (see *Re Lehman Brothers International (Europe) (in administration) [2010] EWHC 2914 at [226]* referred to in paragraphs 1.30 and 2.45 of the Law Commission document), is firmly based upon the application of the no look through principle. The rights in or in relation to the underlying securities are held, and are enforceable, exclusively by the trustee (as holder of legal title to securities as against the issuing company) or sub-trustee (as holder of equitable title to intermediated securities as against the relevant (immediate) intermediary); and, in exercising those rights, the trustee/sub-trustee owes its fiduciary and other equitable obligations to the immediate beneficiaries under the trust it administers. These equitable proprietary rights and obligations (in trust) complement and supplement the legal personal rights (constituted by contract) between the account-holder and its (immediate) intermediary.

Efficient, safe and legally robust

6. 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. A similar benefit of the principle applies to an intermediary acting upon the instructions of its account-holder and EUI as operator of the CREST system in response to system-member or other properly authenticated dematerialised instructions. Crucially, the issuing company, relevant intermediary and EUI have no obligation to investigate whether the holder, account-holder or CREST member is entitled to give the relevant instruction (as against any third party), provided of course the relevant instruction is in accordance with the terms of issue of the security, the account agreement or (as the case may be) the CREST rules and procedures. This allows for the swift and smooth settlement of securities transactions in the financial markets – where there is likely to be a large and rapid turnover of trades – without the addressee of the relevant instruction (in the very limited time available) being required to make further delaying enquiries or to resolve any potential claims by a third party that the holder, account-holder or (as the case may be) CREST member is acting in breach of a legal or equitable obligation (whether in contract and/or trust) to that third party in giving the relevant instruction.

7. The no look through principle, operating in tandem with PRIMA, supports the efficient and cost-effective holding by an investor of its entire portfolio of multiple international securities through one intermediary under a single governing law. The ultimate investor can choose to have a direct legal relationship with multiple issuing companies with a view to being actively, directly involved in the governance of the relevant companies under, potentially, a number of different laws. Alternatively, the ultimate investor may elect to deal solely with one intermediary for the totality of its securities activities – enjoying the intermediary's advisory, custody, administrative and collateral management services under a single applicable law across the full range of the investor's investment activities. The intermediary can, in effect, be chosen by the ultimate investor to insulate the investor from the administrative burdens and legal responsibilities associated with a direct holding of shares or other securities. It is the no look through principle that brings these related protections for the ultimate investor – as it operates both up the holding chain to prevent the **direct** exercise of rights by the ultimate investor against the issuing company (rather than by giving instructions through the chain) *and* down the chain to prevent the **direct** exercise of rights (or **direct** imposition of costs or administrative procedures as a condition to the exercise of rights) by the issuing

company against (or upon) the ultimate investor (rather than imposing costs which are passed down through the chain). The principle is fairly reflective of the commercial choice that the ultimate investor makes, namely to look to its intermediary alone to manage the investor's securities-related activities and events that occur higher up the holding chain. It would of course remain important for the services provided by the intermediary to be offered at a reasonable cost to the investor.

Internationally accepted best standards

8. In its *Further Updated Advice to HM Treasury (May 2008) on the adoption of the Geneva Securities Convention*, the Law Commission emphasised that while it must be a key objective of the English law principles governing intermediated securities to be internally robust and coherent, the international nature of the global securities markets also requires consistent and predicable outcomes under English law when considered as part of the cross-border activities of financial market participants (see paragraph 1.20 of the Further Updated Advice). We consider that this second objective is facilitated by the continued primacy of the no look through principle under English law because it reflects two core provisions of internationally accepted best standards for the substantive laws relating to intermediated securities, as evidenced by Articles 22 (*Prohibition of upper-tier attachment*) and 23 (*Instructions to the intermediary*) of the Geneva Securities Convention.

9. We regard the prohibition on upper-tier attachment provisions of Article 22 of the Geneva Securities Convention as a natural legal corollary to the no look through principle. The article provides that no attachment of intermediated securities of an account-holder may be made against or otherwise affect: (a) the issuing company of the underlying securities, (b) any higher-tier intermediary or (c) a securities account of any person other than the account-holder. This reflects the *"root of title"* aspect of the no look through principle we have discussed above, namely that it would be wrong to allow for upper-tier attachment for an account-holder's execution or other creditors because the account-holder's rights and interests are solely constituted as personal rights against, or equitable proprietary interests in or in relation to assets held as trustee for the benefit of the account-holder by, its immediate relevant intermediary. The account-holder has no relevant rights, interests or other assets susceptible to attachment at any other level in the holding chain.

10. Equally, the provisions of Article 23 of the Geneva Securities Convention that an intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities of an account-holder given by any person other than the account-holder (subject to certain limited exceptions) is a clear expression of the principle.

11. It is true, of course, that the Convention has had limited political ratification, but it represents the most comprehensive body of work in the area by a large cross-section of legal experts drawn from a broad range of disparate common law and civil law systems. As such, we believe that it provides the best evidence of those standards that are likely to be expected and understood by investors and their legal advisers internationally. For this reason, we consider that its provisions support the no look through principle as facilitative of the use of, and market confidence in, English law in international securities transactions. The principle produces consistent and predictable outcomes for those participating in the global financial markets.

Consistency with long-standing provisions of UK companies law

12. It has long been a policy position of UK companies law that:

- no notice of any trust, expressed, implied or constructive, is to be entered on the register of shares or other securities, or a part of such a register, or be receivable by the person who maintains, enters and keeps up the register (see section 126 of the Companies Act 2006 and regulation 23(3) of the USRs); and
- the person who maintains, enters and keeps up the register is not bound by or compelled to recognise any express, implied or constructive trust or other interest in respect of the relevant securities, even if that person has actual or constructive notice of the trust or interest (see regulation 40(3) of the USRs).

13. It is also common for the terms of the account agreement between an intermediary and its client to include similar contractual provisions with respect to the securities accounts maintained by the intermediary for its account-holders. (In passing, we would note that the recent decision of the Court of Appeal in *JP Morgan Chase Bank N.A. –v- The Federal Republic of Nigeria* [2019] EWCA Civ. 1641 was concerned with a different issue to the issue we discuss here. The exclusion and other clauses in Chase Bank's depository agreement examined in that case were analysed with a view to determine whether, on their proper construction, they excluded the *Quincecare* duty of care owed by a banker/intermediary to its customer. This is a duty of care rooted in the contractual relationship between the banker/intermediary and the account-holder. The case is not, therefore, relevant to an examination of the potential duties - absent any contractual exclusions of liability or limitations on the scope of those duties - that might otherwise be owed by an intermediary to a third party beneficiary with whom it is not in any contractual relationship.)

14. These provisions reflect the principle that the issuing company or intermediary should be able with impunity, and without any requirement for further inquiry, to act solely upon the instructions given by the holder, account-holder or (as the case may be) CREST member and so as to be neither bound by nor entitled to give effect to any contrary or other instruction from a third party. These provisions of English company and contract law relevant to (intermediated) securities support the efficient, swift and safe transfer of title to (intermediated) securities, as well as the exercise of the rights attached to such (intermediated) securities. They minimise the risk for the issuing company, intermediary or (as the case may be) EUI as operator of the CREST system that, in acting upon an instruction from the holder/account-holder/CREST member (given in accordance with the terms of issue, account agreement or CREST rules and procedures), they might be held liable for facilitating any breach of trust (or other legal obligation) owed by the holder/account-holder/CREST member to a third party (e.g. a beneficiary under a trust) because they have not prevented or delayed execution of the instruction to investigate or resolve any adverse claim or dispute affecting the relevant (intermediated) securities. The no look through principle is at the foundation of these statutory and contractual provisions designed to minimise potential liability as a constructive trustee, in negligence or for some other tort.

15. We consider these protections to be sufficiently important in ensuring the safe, timely and efficient processing of securities transactions that we would recommend the reform of English law so as to replicate, with respect to securities accounts maintained by intermediaries, the provisions of section 126 of the Companies Act 2006 and regulations 23(3) and 40(3) of the USRs (as applying to the register of securities). This would put onto a statutory footing the liability protections that, in practice, are contained in the account agreements put in place between intermediaries and their account-holders. The added benefit for intermediaries of this reform would be, of course, that such statutory protections will bind all relevant affected parties and will not be limited by the privity concerns affecting the corresponding contractual provision.

United Kingdom as a location of choice for securities-related services

16. We are confident that the specific benefits of the no look through principle that we have outlined above play a key role in continuing to ensure that English law remains a highly attractive choice to govern security issuance and custody (or similar intermediated securities) arrangements, and for the UK as a location to carry on securities-related business.

17. Bearing in mind the importance of the principle in facilitating the delivery of these substantial benefits to the UK economy and market confidence in the UK's financial system, we would counsel against any law reform that might undermine or otherwise vitiate the principle's core role as part of English (intermediated) securities law. When set against the positive effects of the no look through principle, we would certainly approach with caution counter-arguments that might be made against it on the basis of investor protection considerations derived from its impact on the direct enforcement of rights by the ultimate investor against the issuing company (or a higher-tier intermediary):

    - first, we consider that regulatory steps are available (or could be made available) that would substantially reduce any unexpected consequences or risks for the ultimate investor in an intermediated securities chain with respect to the exercise of the rights attached to the underlying securities;
    - second, we believe that once the ultimate investor is appraised of the risks and benefits of the securities holding options available to it under English law, the no look through principle in fact properly forms a part of a comprehensible and readily understandable basis to explain those options for the client and to facilitate an informed choice for the option that best meets its individual needs; and
    - finally, to the extent that there are specific statutory provisions that have been or may come to be identified as creating concerns for ultimate investors with respect to the direct exercise of rights against the issuing company, we think that those provisions should be capable of amendment to meet those concerns without producing any adverse impact upon the continued application of the no look through principle as part of English (intermediated) securities law: see *SL Claimants v Tesco Plc* (as discussed in our response to Question 8 above). If there are other residual issues, the solutions may be well be regulatory rather than statutory. In other words, it should prove possible to operate the amended statutory provisions in tandem, and so as to dovetail, with the no look through principle (as properly understood as reflective of the rights and obligations derived from the contractual and trust/sub-trust relationships between each set of immediate parties in the holding chain). As indicated above, however, it is important any such statutory provision does not seek to re-constitute statutory, contractual or trust rights or interests as rights or interests directly enforceable by or against a third party contrary to the intention of the immediate parties to the original contractual or trust arrangement.

Question 10

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

No.

Please expand on your answer

There are two key issues that we consider should be addressed, that are not adequately catered for at present:

- the absence of a mechanism for automatic transfer of an intermediary's claims and liabilities in respect of securities held for others (i.e. its clients); and
- the absence of a prescribed mechanism for addressing a shortfall in specific lines of securities held by an intermediary.

<u>Transfer of Claims</u>

The first defect in the regulatory regime addressing the insolvency of an intermediary is the need to create a mechanism whereby an intermediary’s claims and liabilities in respect of securities held for others can be automatically transferred to a successor free and clear of any set-off, lien or withholding without the need for third party consent. Clearly, such an action would require court supervision, but it would facilitate the immediate substitution of a solvent party in the chain of ownership and minimise disruption and delay.

The current regime does not allow for this. Further, the current regime still creates the prospect that a creditor in the chain of ownership can seek to exercise a lien or other remedy against securities in the name of a failed intermediary held on behalf of third parties.

This can be an issue with international dimensions where securities are held through a chain of ownership involving intermediaries, custodians or depositories located outside of the UK.

The most convenient way to address this may be by a law linked to the insolvency regime of the failed business - see our response to Question 12.

<u>Absence of a mechanism to address shortfalls</u>

In relation to the second defect, as noted in the response to Question 12, 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. This is discussed further in the responses to Questions 12 and 14.

This contrasts with the position under the regulatory regime for client money, under which a statutory trust prescribed by the regulator specifies that any shortfall is suffered rateably by clients that are beneficiaries under the statutory trust (leaving the affected clients with claims against the intermediary's unsecured estate and/or against the FSCS).

Question 11

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

Yes.

Please expand on your answer

Please see our response to Question 10.

Question 12

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

Yes.

In what way?

Please see our response to Question 10.

We should also like to note with reference to paragraph 2.48 of the Call for Evidence, that it is a misapprehension to regard securities lent with the consent of investor(s) for whom the relevant intermediary holds those securities as resulting in a shortfall in the intermediary's pool of customer securities. Securities lending transactions are invariably entered into on a title transfer basis, the right of the lender being a right to receive equivalent securities on the termination of the loan. Accordingly, the securities lent will leave the pool of customer securities and the securities account(s) maintained by the relevant intermediary in the names of the investor(s) concerned will be debited. Whether the debit will be reflected in the portfolio statements which the intermediary provides to the investor(s) is a different question. Because of the right to receive equivalent securities at the maturity of the loan, the economic value, and effective composition, of the investor(s)' portfolio is unaffected and details of any outstanding securities loans may therefore be noted separately. This is a matter for agreement between the intermediary and the relevant investor(s) and for regulatory requirements on client consent, systems and controls, record keeping, and reporting to clients (for example, in the FCA's case, CASS 6.4.1 and 6.4.3 and COBS 16A.5.1). There is, of course, scope for factual confusion if the requirements on record keeping are not observed, and for confusion on the part of clients if the reporting requirements are not observed or, perhaps, if the information provided is not understood, but any concerns on this head are primarily matters of regulatory policy.

If so:

(1) Do you have examples, or specific evidence, or problems arising out of the insolvency of an intermediary in an intermediated securities chain?

Please see discussion of the Lehman insolvency below.

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

This raises a broader question about the failure of an investment firm.

The English law analysis based on a stock line by stock line trust analysis should be compared against the US law treatment under the Securities Investors Protection Act ("**SIPA**"). Generally, SIPA produces a swift and high recovery solution.

The treatment of costs is also an issue. There is a credible argument that the unsecured estate should bear the costs of managing the customer estate in the insolvency. The alternative is the *Berkeley Applegate* approach where the customer estate is treated as if it were a fund and bears the costs of its own administration, although this may be at odds with the contractual position pre-insolvency where the failed business will charge separate administrative fees, and is also likely to place any pooled assets into deficit, even if there is no initial shortfall. The *Berkeley Applegate* approach is used, however, for client money trusts according to CASS 7.

An attempt was made to address the inadequacy of the trust regime in the UK administration of Lehman Brothers International (Europe) by compromising claims for intermediated securities through a Scheme of Arrangement. However, the Court of Appeal held that was not possible as it would constitute an interference in proprietary rights. As a fall-back, a consensual solution was adopted by private contract on effectively the same terms as the proposed scheme amongst the estate and the customers. It turned out to be a workable solution, but the need to go through this ad-hoc exercise showed the need for the law to provide a better structure and we consider this area would benefit from legislation.

If the law and regulatory regime prescribed an approach to shortfalls in lines of stock we consider that the costs of distributing assets would be reduced and the process significantly less time-consuming.

Question 13

Do you consider that there is uncertainty about how assets would be distributed in the event of an intermediary's insolvency?

Yes.

If so, how could this uncertainty be resolved?

Where there is uncertainty, it arises from the fact that in some cases the facts do not match the intended legal and regulatory position of segregated trust holdings on a stock line by stock line basis. In a failed firm that is more likely as records may be out of date, the segregation may be incomplete or ineffective and there may have been misconduct. Even where the failed firm has been largely compliant with its obligations, record keeping may well be a secondary consideration for management focused on saving their business, and the records rapidly become outdated.

To resolve the uncertainty, a much clearer division needs to be established between segregated assets and firm assets with clear review and governance. There should be clear accountability and lines of responsibility, and both civil and criminal sanction on intermediaries and their directors.

These measures would be part of the financial services regulatory regime, rather than insolvency law and would also require contracts to be clear on the status of assets held for clients, whether the client is another intermediary or an ultimate investor. Clear explanation at the time the contract is entered into should be a training and regulatory focus.

Question 14

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

Yes.

Please expand on your answer

Education, in itself, is unlikely to add significant value, particularly where the issues are complex and there is a common reluctance to consider the consequences of insolvency in balance against perceived advantages immediately available. The position in relation to the Financial Services Compensation Scheme (FSCS) exemplifies another area where investors with indirect holdings should be advised on the risks in relation to the insolvency of an intermediary and (as the law currently stands) should at least consider a direct CREST membership, whether or not they wish to exercise voting rights.

The FSCS limit is £85,000. If the UK wishes to encourage a savings culture and for individuals to act prudently to address their future needs, the CLLS is of the view that this is 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.

Investors are encouraged to use a single investment platform both for cost and convenience reasons. The limits under the FSCS regime gives a contradictory message and the encouragement to use a single platform does not appear to be good advice for investors with higher value portfolios, who require more sophisticated advice. It would also be beneficial to investors if it were clearer and simpler to assess whether protection under the FSCS would be available in a particular scenario. The rules would benefit from simplification.

Although this is not a new issue, a specific concern arises where a sub-custodian, rather than a custodian, has failed. In that context, investors may not be able to benefit directly from the FSCS, and would instead be relying on the custodian to make a claim and for any benefit to be shared amongst the investors. Even if investors are able to benefit from the FSCS, there may be a significant shortfall in these circumstances. This issue may become more pronounced post-Brexit if additional entities are inserted into custody chains to facilitate investment business between the UK and the EU.

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

Merely setting out the risks in a disclosure document is hopelessly inadequate. No one reads it and the issues are complex. Examples can be cited of consents being sought from investors through solicitation documents distributed through the systems where sophisticated investors voted contrary to their own economic interests because they failed to read the materials. Consumers are unlikely to act more prudently.

The best way to reduce exposure is to have a strong regulatory regime that requires (at least for the assets of individuals) complete segregation of customer property, coupled with an unlimited compensation protection regime primarily funded by the industry. The SIPA in the USA gives an example of how this can work to protect consumers.

It might also be beneficial to consider whether the requirement to have a Single Customer View might also be applied to investment firms. This could provide greater clarity in the event of insolvency.

Question 15

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

Yes.

If so:

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

Please see our answer to Question 10.

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

These problems vary a good deal and can arise at different levels in a chain, especially when an insolvent intermediary cannot rapidly be removed from the chain as discussed above.

In practice, however, set off is rarely used by ultimate holders to recover claims under intermediated debt securities.

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.

The existence of intermediation of the debt securities is likely to be secondary matter in determining whether or not mutuality exists to permit an insolvency set-off. More critical points will turn on the wording of the particular debt instrument itself and the fact that it may be constituted through a global note.

Apart from reduction of issues in the chain by adopting a SIPA-like solution, we think the general law should apply.

Question 16

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

Yes.

If so:

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

Please see below.

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

1. In evaluating the impact of the disparity in treatment between the good faith purchaser/transferee of legal title, and the good faith purchaser/transferee of equitable title, it is important to bear in mind the need in the financial markets for a high degree of legal certainty on any matter that might affect the integrity or finality of settlement of securities transactions. This fundamental policy position is reflected, for example, in Principle 1, Key Consideration 1 and Principle 8 of the *CPMI-IOSCO Principles for financial market infrastructures (April 2012)* (the *PFMIs*). The PFMIs represent internationally recognised standards for the operation, management and supervision of financial market infrastructure. We consider it to be undesirable, from the perspective of the UK's standing in the international financial markets and of market confidence in the legal framework supporting the holding and transfer of title to intermediated securities, that there should be any potential inequality in the protections afforded to a transferee of securities dependent upon whether the transferee acquires legal title (for example, through CREST) or equitable title (for example, by credit to a securities account of the transferee with a custodian).

2. This legal and operational uncertainty with respect to finality of settlement creates an irrational distinction between the two potential securities holding models (direct holding –v- indirect holding) under English law. This potentially results in inappropriate distortive incentives for market participants when choosing which model to use with respect to their securities trading activities. In practice, having regard to the speed and volume of transactions in the financial markets, there is no possibility for purchasers/transferees of securities to investigate the seller's title prior to the transaction or its settlement. The concern that a transferee's acquisition of equitable title might require reversal or vest subject to prior claims (due to circumstances, in practice, undiscoverable by the purchaser/transferee), in cases where a corresponding acquisition of legal title would not require reversal or be subject to prior claims, might encourage investor election of a direct-holding of the relevant securities. While it is reasonable to make such a choice on the basis of an assessment of the respective advantages, disadvantages and risks of each holding model, there is no proper policy reason why a good faith purchaser/transferee of intermediated securities should not benefit from the same protections, against competing prior claims or grounds for reversal, as a good faith purchaser/transferee of legal title. The

method of settlement of a securities transaction does not alter the fundamental position that, in the fast moving securities markets, the purchaser/transferee cannot be expected to investigate the seller's title to the purchased securities prior to the transaction or its settlement.

3. Further, we consider that the continued presence of this distinction in English law raises a material question-mark as to whether the UK Government has fully and properly implemented Article 49 of the CSDR. The purpose of Article 49 is to remove Giovannini Barrier 9 (*Restrictions regarding the location of securities*) (*GB9*) to post-trading in the European Union. The relevant *travaux preparatoires* indicate that one specific restriction targeted by GB9 is the "restriction on importability" – which finds expression in Recital (56) of the CSDR. Specifically, a relevant restriction on importability arises:

   > *"where the law governing the CSD treats securities which are constituted under a different law less favourably than domestic securities, or there is a risk of this happening"* (see paragraph 15.3.2.2 of the Second Advice of the Legal Certainty Group).

4. The USRs form part of the corporate or similar law of the UK and, as such, those regulations cannot (consistent with Article 49(1) of the CSDR) be used to hold and transfer title to securities constituted under a non-UK, EEA law under issuer CSD services. The second paragraph of the article makes it clear that the exercise of an EEA issuer's right to arrange for its securities to be recorded in any CSD outside the issuer's home state does not prevent the continued application of the corporate or similar law of the EEA state under which the securities are constituted. In practice, this means that if an EEA issuer wishes to access a UK CSD, an intermediated/immobilisation model would be required to hold and transfer the securities in the CSD, and the relevant issuer CSD services would be provided outside the scope of the USRs. In consequence, those services would not benefit from the statutory provisions that operate, under the USRs, to support the safety and integrity of settlement of UK securities – including the innocent transferee provisions of regulation 35 and the express disapplication of sections 53(1)(c) and 136 of the Law of Property Act 1925 (the "***LPA***") provided for in regulation 38(5).

5. In the absence of reform to English law taking effect outside of the USRs – so as to extend, for example, the innocent purchaser/transferee provisions of the USRs or common law to intermediated securities - the issuers of non-UK securities wishing to use issuer CSD services of a UK CSD (or otherwise under English law) will be treated *"less favourably"* than issuers of UK securities under the USRs (or common law). UK securities benefit from statutory rules (under regulation 35 of the USRs) or common law rules that provide important protections underpinning their safe and final transfer and, therefore, liquidity. Such protections are not available to non-UK securities settling under an intermediated or immobilisation model governed by English law outside the statutory scheme of the USRs. There is, therefore, an existing "restriction on importability" under English law for the purposes of Article 49 of the CSDR. Further, the continued existence of the restriction could, in practice, prevent or impede an EEA issuer from exercising its rights under Article 49 by accessing a UK CSD, or any CSD providing its issuer CSD services under English law, under arrangements of the type contemplated by the article. This is because, for so long as the legal and operational uncertainties created by (amongst other things) the absence of an innocent purchaser/transferee rule for intermediated securities subsists, any intermediated/immobilisation holding model provided by a CSD (as part of its issuer CSD services) would not potentially benefit from a robust and well-founded legal framework complying with PFMIs 1 and 8 (in contrast to the position for directly-held UK domestic

securities under the USRs or common law) – and with particular reference to the requirements as to *"adequacy"* of the issuer CSD's settlement model for the purposes of Article 23(4) or (as the case may be) Article 25(4)(d) of the CSDR.

6. If it is necessary to ensure a full and proper implementation of Article 49 of the CSDR to extend the innocent purchaser/transferee rule to intermediated securities held and transferred at the top tier level of the CSD (as part of its issuer CSD services), then it would seem appropriate from a policy and legal certainty perspective to extend that protection to intermediated securities held and transferred (under English law) at each lower tier.

7. For all these reasons, we would strongly favour a reform of English law to provide for innocent purchaser/transferee protections for intermediated securities (held outside a "relevant system" under the USRs). This protection might be based on the drafting of Article 18 of the Geneva Securities Convention. However, in order to ensure equal treatment between uncertificated units of a security held in a "relevant system" under the USRs (e.g. CREST) – which benefit from the "actual notice" test set out in regulation 35 of the USRs – we would favour an "actual knowledge" test for intermediated securities (and not the "constructive knowledge" test – *"ought to know"* - proposed by Article 18 of the Geneva Securities Convention). We consider that an "actual notice/knowledge" test provides more robust protection for the finality of settlement of securities transactions under the different securities holding models. This further enhances market confidence in the settlement infrastructure supporting securities trading activities in the UK's financial markets.

8. We would emphasise that any reform of the law for innocent purchasers/transferees of intermediated securities should expressly exclude intermediated securities held as uncertificated units of a security in a "relevant system" governed by the USRs (e.g. CREST). Any transfer of such units will (and should continue to) benefit from the tailored and specific innocent transferee rules set out in regulation 35 of the USRs. Any reform should be clear in excluding uncertificated units of a security held in CREST to ensure the system continues to operate with the high degree of legal certainty, on this aspect of settlement finality, required by PFMIs 1 and 8.

Question 17

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

Yes.

If so:

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

Please see our response to Question 16 and further below.

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

1. For similar reasons to those set out in our response to Question 16 above, we would strongly favour a reform of English law to remove the legal uncertainties created by the potential application of section 53(1)(c) of the LPA to the holding and transfer of intermediated securities. We would also note that we consider it right to remove any uncertainty as to the potential application of section 136 of the LPA to such a transfer. This is because, in addition to any equitable proprietary interest in or in relation to the underlying securities, legal contractual rights constituted by an account agreement are intended to vest and be given effect by the credit of the intermediated securities to the transferee's securities account.

2. We are aware that good arguments can be employed to conclude that these sections do not, as a matter of law, apply to the holding and transfer of intermediated securities (see, for example, the *obiter* comments of Hildyard J. in *SL Claimants –v- Tesco PLC* [2019] EWHC 2858 (Ch.) at [116] with respect to the potential application of section 53(1)(c)). However, FMIs operating immobilisation systems must operate under a legal framework that achieves a *"high degree of legal certainty"* (see PFMIs, Principle 1, Key Consideration 1) and, notwithstanding the arguments that are available on this issue, there remain residual concerns of legal uncertainty that these sections could be applied by a court in the absence of a clear statutory disapplication of them. The potential application of either or both of these statutory provisions potentially vitiates market confidence in the effectiveness of the electronic settlement (by book-entry credit) of the intermediated securities to the securities account of the transferee. If those sections apply, there would be a material concern that the writing formalities of these provisions required to render a disposition of an equitable interest valid or the assignment of a legal chose in action effective against third parties (to the extent applicable) might not, in practice, be satisfied in relation to a transfer of intermediated securities across an intermediary's books.

3. We consider that such a reform is necessary or appropriate:

   (1) to support the high degree of legal certainty that internationally recognised standards require of the legal framework underpinning the post-trade infrastructure for the UK's financial markets;

   (2) to ensure continued market confidence in the use of intermediated securities holding models by removing any legal or operational risk that formal rules requiring "written" dispositions or other transfers of interests or rights might prevent or impede the effective, final and binding transfer of intermediated securities across the books of an intermediary; and

   (3) to provide for the full and proper implementation of Article 49 of the CSDR into English law by removing any restriction on importability derived from the disparity in treatment of uncertificated units of a UK security in CREST (which, as a "relevant system" under the USRs, benefits from the express disapplication of sections 53(1)(c) and 136 under regulation 38(5)) and non-UK securities held in intermediated form and transferred outside of CREST (or any other "relevant system" under the USRs).

4. We would favour a reform of the law so as to clearly and finally remove any potential risk of impractical and unworkable formality requirements applying to the electronic holding and transfer of intermediated securities (which are not held as uncertificated units of a security in CREST or other "relevant system" under the USRs). We would foresee this being drafted in terms wider than simply disapplying sections 53(1)(c) and 136 of the LPA to any transfer of intermediated securities. We would suggest a reform along the lines of Article 11 of the Geneva Securities Convention. This provides that, subject to certain clearly defined exceptions, intermediated securities are acquired by an account-holder by the credit of the securities to that account-holder's securities account, and without the requirement for any further formal step to make the transfer effective against third parties.

5. Depending on the approach taken in any law reform proposals for the innocent purchaser/transferee and the disapplication of potential formality requirements for the transfer of intermediated securities, we consider it possible that consequential additional provisions may be required to govern the related issues of acquiring and disposing of intermediated securities by other methods (see Article 12 of the Geneva Securities Convention), unauthorised dispositions, invalidity, reversals and conditions (see Articles 15

and 16) and priority among competing interests (see Articles 19 and 20). It would be important, if these wider consequential provisions are indeed required, to ensure that they are developed with due reference to other market initiatives impacting upon this area – for example, the CLLS Financial Law Committee's work on a proposed Secured Transactions Code.

Question 18

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

Maybe.

Please expand on your answer

Many of the issues around exercising shareholder rights discussed in this Call for Evidence could be mitigated by better information flows and communication systems. Cost is likely to be a deterrent to individual intermediaries making changes to remove inefficiencies in communicating information or verifying authorities to give instructions. Technological solutions might be able to provide better systems at a reasonable cost, although the initial costs of establishing such systems may still be a disincentive. We do not see, however, that the issues would necessarily require the specific functionality of DLT to solve them.

Even if technological solutions are available, it may also be necessary to ensure that there are clear obligations on those in the chain to pass on information and act in accordance with instructions. These obligations could be at a contractual level between intermediaries and their clients or be imposed by regulation.

It should be noted that the CREST system is adapted to the UK company law framework (and vice versa) for settlement of trading and other corporate actions. A lot time was spent over a number of years (both before and after CREST was launched) to analyse legal issues associated with the introduction of CREST and its impact on corporate actions. It may be preferable to see what system changes can be made within existing legal frameworks to address any perceived issues rather than introducing a new technology which requires changes to the law.

(2) Are there any other jurisdictions that we should look to as examples?

*T*he law on DLT is in early stages of development in most jurisdictions, including the UK's jurisdictions. At this stage, this is an obstacle to adopting this technology as legislation and regulatory moves would be required to provide adequate legal certainty. The perceived advantages of this technology in commerce are an obstacle to its adoption in circumstances where a high degree of accountability would be desirable.

Question 19

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

Please see our answer to Question 18.

Question 20

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?

The Joint Law Society and CLLS Law Committee CREST Working Party has engaged over a number of years with initiatives by UK registrars, issuers and other market participants to develop an industry model for dematerialisation in preparation for complying with the requirements of the CSDR. BEIS were also engaging with this work but this engagement was put on hold as a result of Brexit. The Working Party broadly supported the principles that were adopted for this work, including (1) the preservation of the basic structure of the registered model of ownership, (2) that dematerialisation should not force direct shareholders into an intermediated model, and (3) that the rights and obligations of issuers should not be affected including as regards recognition of the registered holder (and no obligation to look beyond the registered holder), and the mechanics of shareholder communications, transparency and efficiency of voting, dividend payments and other corporate actions.

On the proposed model, the requirement for a stock transfer form would be replaced by the ability to use an electronic form to transfer shares, and the issuer's register of shareholders would be maintained as the basis of legal title, so as to ensure legal certainty for issuers and holders, but no share certificates would be issued. Instead, registered shareholders would be given a Holder Key (a unique password) which would be required to access their holding so as to deal in shares.

Important concerns from a legal perspective are to ensure that the dematerialisation model would offer security and protection from fraud for both issuers and shareholders, with legal certainty as to liability and obligations in relation to matters such as fraudulent transfers. So far as possible, the legal model for dematerialised shareholdings should mirror the way in which shares are held and transferred when in certificated form (as there would be no requirement to change this for companies that are not traded on a trading venue and within the scope of the CSDR) or under the Uncertificated Securities Regulations (which were likewise designed to mirror the law for certificated securities).

The use of the Holder Key raises issues around security and liability which have not been, to our knowledge, fully explored or resolved. For example, what happens if a Holder Key is improperly obtained by a third party and used to transfer shares or change a name on the register? What steps would be needed if a Holder Key is lost or forgotten: how do shareholders or their personal representatives recover it? In what circumstances will shareholders, their broker, the issuer or its registrar be liable for losses caused by negligence or fraud? In addition, the stamp duty/SDRT implications of dematerialisation need to be considered.

Question 21

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

The significant change that dematerialisation involves is replacing the legal function of the signed stock transfer form and paper certificate when transferring shares with non-paper based alternatives. Most other interactions between companies and their shareholders can be carried out by electronic communications (including provision of information, dividend payments and proxy appointments). It is these communications which need to be improved in the context of chains of intermediaries, and we do not think that dematerialisation processes are necessarily of any relevance to that issue.

Question 22

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

Yes, to some extent.

Please expand your answer

The concerns around security and liability in the case of fraud referred to in answer to Question 20 could be particularly relevant to more vulnerable shareholders. However, the risks of cybersecurity breaches could affect any shareholder and not only those who are less familiar with dematerialised processes.

Question 23

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

As English lawyers, we cannot comment on the position in relation to the law of devolved jurisdictions, save to say that Scots law in our experience is most likely to differ from English law in ways material to this question.

Question 24

What other jurisdictions should we consider and why?

We consider it would be useful to look at jurisdictions that have developed statutory regimes underpinning the holding and transfer of intermediated securities, including the USA, Belgium and Luxembourg. It would be important, however, when deciding whether any useful lessons could be learned from these other regimes to bear in mind the different legal and regulatory policy positions that different jurisdictions may, for perfectly valid commercial, cultural and other reasons, apply in determining the form and content of legislative or other solutions for the issues addressed by the Call for Evidence.

Question 25

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

a. A summary of the problem.

b. An explanation of and evidence of the effect of the problem in practice.

c. Suggestions as to what could be done to solve the problem, and any evidence of the costs and benefits of the solution.

We have the following additional comments on the issues raised in the Call for Evidence:

Nature of Relationship

Paragraph 1.30 says the basis of the relationships in an intermediated holding chain is a series of trusts and sub-trusts but this may not always be so. There may be intermediaries who are governed by the laws of another jurisdiction and operating on a contractual basis. This factual element needs to be borne in mind - a complete solution/end-to-end consistency of relationships will not exist where some intermediary relationships in a chain are governed by the law of another jurisdiction. In the 21st century financial markets, this situation cannot be avoided, which is one of the reasons why a "look through" approach is impracticable.

Segregated Accounts

Paragraph 1.35 - We do not think that companies will always know when a segregated account is being used by a custodian acting for an ultimate investor. Strictly under the Companies Act 2006 (and the USRs), as we point out in our response to Question 9, the Company must not enter notice of any trust on its register of members. The same applies to the Operator of a relevant system which maintains an Operator register of securities. Even in cases where an entry is included in a register that a custodian's holding is for the account of another person, the identity of the underlying investor may not be apparent to the company or the system operator from the way in which the account is named. The company may be able to ascertain their identity if it chooses to use the procedures under section 793 of the Companies Act 2006.

Paragraph 2.9(3) - The company can use the Companies Act (section 793) provisions to ask about the identity of anyone interested in shares if they want to know who the ultimate investor is (though in practice this may be time consuming). There is public access to the list of information the company gets as a result of such inquiries so ultimate investors could look at this information.

Regulation of Intermediaries

Paragraph 2.41 - It is obviously sensible to concentrate on the FCA – but in practice there may be other regulators involved in regulating those in the chain, including the PRA in the UK and a wide range of regulators in other jurisdictions around the world.

Terminology and system operation

We have concerns that some of the terminology employed in the Call for Evidence and its description of system operations (particularly in CREST) may elide concepts that have different meanings. We have some suggestions how greater clarity could be achieved when discussing these complex topics going forward. We attach an Annexe containing some comments on these issues, together with a Glossary of terms used in our response, which we hope will be helpful.

Question 26

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?

1. We consider that there are strong systemic, operational and legal certainty benefits associated with the existing legal and regulatory systems governing the holding and transfer of intermediated securities under English law. We have highlighted those benefits:

(1) in our responses to Questions 8 and 9 (with respect to the operation of the no look through principle); and

(2) in our responses to Questions 16 and 17.

2. It is our view that English law in this area, applied in conjunction with the relevant provisions of the UK regulatory system, is substantially fit for purpose, responsive to the practical needs of the ultimate investor and supportive of the pre-eminence of the UK as a location for securities issuance and the carrying on of intermediated securities business. We would strongly counsel against wide-ranging legal changes that might appear superficially attractive by seeking to enhance the rights and powers of, or protections for, the ultimate investor, in circumstances where:

- there may not in fact be a strong investor demand for such enhanced rights, powers or protections;
- in practice, the interests of the investor can be adequately and robustly supported through less disruptive structural, legal and regulatory changes to the English legal and regulatory systems; and
- there is a material risk that such wider changes are likely to undermine the legal certainty, market efficiency and party autonomy benefits that are strong elements of the existing English laws governing the holding and transfer of intermediated securities.

3. However, we believe that it would be desirable to introduce certain limited reforms to English law where such developments could further enhance its, and the UK's, attraction to domestic and international issuers, intermediaries and investors. Aside from any potential regulatory review that may be required to ensure that regulated intermediaries meet the information, voting and other reasonable expectations of clients at a reasonable cost and that appropriate risk disclosures are made to the ultimate investor (to enable a clear understanding of the risks associated with an intermediated holding model), the legal reforms and regulatory steps that we would support in this context are:

- a review of the headcount test under section 899 of the CA 2006 (see our response to Question 7);
- the replication of the statutory protections for register integrity and against liability for issuers (and the Operator of a "relevant system" e.g. EUI as operator of CREST), as provided by section 126 of the Companies Act 2006 and regulations 23(3) and 40(3) of the USRs, for the benefit of intermediaries with respect to their maintenance of securities accounts (see our response to Question 9);
- potential changes to statutory provisions so as to give direct rights to ultimate investors, provided the changes do not undermine the continued application of the no look through principle to rights constituted by and claims derived from, contract or trust in the holding chain and provided that it is possible to devise appropriate principles or definitions to give certainty in determining which parties interested in shares or other securities should properly be regarded as the “ultimate investor” for the purposes of the relevant statutory provisions;
- introduction of a SIPA style system to protect individual investors in the event of the insolvency of an intermediary (see our response to Questions 10-14);
- review of the adequacy of the FSCS compensation thresholds and regulatory guidance on the advice that should be offered to indirect holders whose holdings

with a single intermediary are valued in excess of the scheme threshold. Regulatory guidance can be given ahead of any review of threshold (see our response to Question 14);

- the extension of the innocent purchaser/transferee protections to transfers of intermediated securities (see our response to Question 16);
- clarification that formality requirements, such as those for "writing" contained in sections 53(1)(c) and 136 of the LPA, do not apply to the transfer of intermediated securities (see our response to Question 17);
- review of regulatory sanctions for intermediaries who neglect their duties to their clients; and
- regulatory guidance on the advice that should be given to investors wishing to be active voters in relation to their holdings, including on the methods of holding most likely to facilitate the process, as well as encouragement of competition to provide such services to smaller investors. This does not need to await any changes to the law or regulatory system.

Question 27

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?

For the reasons stated above, particularly in answer to Questions 8 and 9, we consider this is the wrong question. The question is how should an investor who wishes to exercise rights and remedies be advised to hold those securities. The system already provides holding methods (both direct (CREST holders effectively have direct rights) and indirect through intermediation with a limited chain and designated accounts) that enable an investor to exercise those rights very reliably – it is regulation and education that will ensure both availability and uptake of such rights and ensure that they are available at a reasonable cost. A wholesale reform would be much more hugely costly in very many ways, but would bring no benefits not already available to such investors.

Question 28

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?

As detailed in our answers to Questions 8 and 9, the costs direct and indirect of ensuring that no matter how distant the ultimate investor is from the issuer, it should have exactly the same direct rights and remedies as the immediate holder of the securities would be immense. It would require a complete change to large parts of the UK's securities, company trust and contract law and regulation to achieve this and would in any event be imperfect when a foreign element entered into the chain. The resultant likelihood of legal uncertainty and inherent unsuitability of this change to modern securities trading would be likely to damage the UK as a financial centre and reduce GDP.

On the other hand, the more modest changes suggested in our answer to Question 26, and particularly regulatory efforts, could reinforce the availability of holding methods both direct and indirect which would be robust for active investors, bearing in mind large active investors are skilled professionals (hedge funds, investment funds, pension funds, discretionary fund managers) and that small active investors are a relatively small proportion of the securities owning public.

ANNEXE 1

Terminology and Operational Factors

1. We think it would be helpful if the Law Commission maintained the distinction between the disparate (but closely related) concepts of "dematerialisation", "intermediation" and "immobilisation". The Call for Evidence has a tendency to use the terms inter-changeably, which is confusing.

    - Under a dematerialisation model (e.g. as operates in CREST), participating securities are held and transferred without a written instrument but, as EUI does not interpose itself into the holding chain for domestic securities, there is no break of the investor-issuer relationship between the CREST member and the participating issuer. A CREST member does not assume custody risk on EUI, as the UK CSD, with respect to dematerialised (or, in the language of the USRs, "uncertificated") units of a domestic security held in CREST. EUI as CSD does not "hold" any title to the participating domestic security – it does not need to be "treated" as not holding title. CREST, through its direct-holding dematerialised model (and CREST personal memberships) already delivers, at the technological level, many of the benefits that some have claimed for distributed ledger technology, as at the operational level, CREST securities are essentially "tokenized" securities.
    - In contrast, a CSD that operates an immobilisation model will intermediate itself (or its nominee) into the securities holding chain so as to break the issuer-investor relationship between issuer and participant in the CSD. In a CSD that operates an immobilisation model, the participant (unlike in a dematerialised system) will assume custody risk on the CSD.

    This means that while all immobilisation systems are intermediated models, a dematerialisation system is not – save, of course, to the extent that the security in CREST is itself a securitised intermediated entitlement (as occurs with depositary interests). The practical significance of this is that in the UK, which offers dematerialised holdings for UK securities through the CREST system (and personal CREST memberships), investors do have a meaningful choice to stay on the register of securities and to avoid any real or perceived disadvantages of immobilised/intermediated holding models. These points are relevant to the observations of the Law Commission at paragraphs 1.1, 1.23, 1.24 , 2.6, 2.9, 2.81, 2.83 and 2.84 of the Call for Evidence document.

2. On a related point, it would be helpful if the Law Commission used the term "uncertificated" only to refer to units of a participating security in the CREST relevant system. It should not be used as a term synonymous with "dematerialised".

    Under regulation 3(1) of the USRs, "uncertificated" is given a very specific meaning in the UK, namely a security or unit of a security title to which is recorded on an Operator register of securities maintained by the Operator of the UK securities settlement system in accordance with the USRs.

    This means that not all securities that might operate without a certificate or written instrument of transfer are considered "uncertificated" for the purposes of UK company law – only securities title to which may be held and transferred through the CREST (or other) relevant system are "uncertificated". This point of clarification is relevant to paragraphs 1.21 and 2.91.

3. We would also question the comment in paragraph 1.21 that *"with dematerialisation has come increasing intermediation".* This suggests that there is some necessary causal nexus between dematerialisation and intermediation. In fact, this is not logically correct for two reasons.
    - First, as explained in 1 above, dematerialisation in fact offers a securities holding option that is, at the level of principle, opposed to intermediation. It allows the investor to maintain a direct legal relationship with the issuer. It neither encourages nor compels investors to adopt an intermediated holding structure.
    - Second, we believe that it is in fact the certification and immobilisation of securities that encourages intermediation because it is convenient for investors, who would otherwise be required to hold/possess certificates or instruments of title, to deposit them with a CSD operating an immobilisation model or other intermediary. We would suggest that the increase in intermediation may in fact have occurred by reason of factors unrelated to the dematerialisation of securities in the UK e.g. commercial incentives for brokers and other intermediaries to offers such services.

4. In footnote 18 of the Call for Evidence, it is suggested that even where an individual is a CREST personal member, *"some intermediation may be inevitable".* This misunderstands the operation of a CREST personal membership. The broker acts as a "CREST sponsor" for the individual CREST member, but this is not an "intermediation" as the term "intermediation" is properly understood to refer to an arrangement under which the legal relationship between the issuer and the individual (as investor) is broken. A CREST personal member has a direct legal relationship with the issuer and it is the individual personal member's name and other details that is held on the register of securities (and not that of the broker or its nominee).

    The CREST sponsor services provided by the broker relate solely to the communication facilities that are maintained by the broker, as CREST sponsor, that enable it to send and receive electronic instructions to and through the CREST system as agent for and on behalf of the CREST personal member. The CREST personal member does not assume custody risk on the broker with respect to the securities held in his/her CREST account as the broker is not safeguarding any title to the securities, which at all times remain held in the name of the personal member.

GLOSSARY

Term	Definition
Account-holder	A person in whose name a CSD or an intermediary provides and maintains a securities account.
Central securities depository or CSD	An entity that operates a securities settlement system and provides either or both of (1) a service for the initial recording of securities in a book-entry system and (2) a service for the provision and maintenance of securities accounts at the top tier level, and may provide certain supplementary, incidental or ancillary services.
CREST personal member	An individual who (1) is permitted by EUI to transfer by means of the CREST relevant system title to uncertificated units of a security held by that individual, and (2) uses the services of a CREST sponsor to send and receive by means of the CREST relevant system electronic instructions attributable to and on behalf of that individual; and includes, where relevant, two or more individuals who are jointly so entitled.
CREST relevant system	The relevant systems operated by EUI which enable title to units of UK securities and, as the case may be, Irish securities to be evidenced and transferred without a written instrument subject to the UK USRs (with respect to UK securities) and the Irish USRs (with respect to Irish securities).
CREST sponsor	A person who is permitted by EUI to send electronic instructions attributable to another person through the CREST relevant system and to receive electronic instructions through the CREST relevant system on another person's behalf.
Dematerialisation	A process that enables title to units of a security to be evidenced and transferred without a written certificate or other instrument and that, in contrast to intermediation, does not by itself affect the direct holding relationship between the investor and the issuer of the security.
EUI	Euroclear UK & Ireland Limited, the CSD for the United Kingdom and Ireland, and Operator of the CREST relevant system.
Immobilisation	A process for concentrating the location of a security in a CSD so as to enable the intermediated holding and transfer of title to the security through securities accounts provided and maintained by the CSD.
Intermediation	A process for enabling the holding and transfer of title to securities through securities accounts provided and maintained by a person that holds the underlying securities, or an interest in or in relation

	to the underlying securities, for the benefit of the account-holders to whose securities accounts those securities are credited from time to time; and the term *"intermediary"* shall be interpreted accordingly.
Irish USRs	The Companies Act, 1990 (Uncertificated Securities) Regulations, 1996 (as amended).
Operator	A person who operates a relevant system as, or as part of, the securities settlement system operated by it as a CSD.
Relevant system	A computer-based system, and procedures, which (1) enable title to units of a security to be evidenced and transferred without a written instrument, and facilitate supplementary and incidental matters, and (2) is operated subject to the UK USRs (with respect to securities constituted under the law of any part of the United Kingdom) or the Irish USRs (with respect to securities constituted under Irish law).
Securities account	An account provided and maintained by a CSD or an intermediary for its account-holders and on which securities may be credited or debited from time to time.
Securities settlement system	A system with common rules and standardised arrangements for the execution of settlement instructions for the transfer of title to securities, or interests in or in relation to securities, by means of a book-entry on a register or securities account, and for the execution of payment instructions related to securities recorded in and transferred by means of the system.
UK USRs	The Uncertificated Securities Regulations 2001 (as amended).
Uncertificated	With respect to a unit of a security, a unit title to which is permitted by an Operator to be held and transferred by means of the relevant system operated by it.

ANNEXE 2

CMBS – Debt Market Case Study

We have remarked on a number of occasions on the problems faced in the debt markets. This is exemplified in the market for Commercial Mortgage-Backed Securities (CMBS). This illustrates also the highly international nature of the debt markets (some of these problems relate to relationships constituted under other legal systems) and also the ability of a set of likeminded investors to address shortcomings.

Some of these solutions may be available to groups of investors in the UK: for example, the "Noteholder Forum". Several of these are described below).In the years following the credit-crunch, CMBS transactions in Europe experienced unusually high default and distress levels. This arose because of a combination of factors including an average decline in real estate values during the credit crunch of around 30 per cent., the high loan-to-value ratios of pre-credit crunch real estate loans (often exceeding 85 per cent.) and the non-granular nature of CMBS compared to other types of securitisation (meaning that default on a single loan often resulted in default on the whole CMBS transaction).

These default and distress levels resulted in a series of high-profile and complex enforcements and restructurings. Many of these processes required interaction with bond investors. Most frequently this involved consultation exercises to establish what investors wanted to be done and formal resolutions approving changes to the transaction or the adoption of particular courses of action. In some cases, investors formed committees and negotiated directly with transaction parties including the borrowers on the underlying loans.

These interactions led to the discovery of a variety of shortcomings in the standard documents for these transactions which hindered the ability of investors to participate in these processes.

In 2012, in an effort to restore investor confidence in CMBS in order to assist in its revival, the Commercial Real Estate Finance Council (CREFC), an industry body representing a wide variety of participants in the real estate debt market including the CMBS market, launched a wide-ranging consultation exercise to identify issues in CMBS and solutions to the same. The proposals made in this became known as CMBS 2.0.

The final Report can be found at the following link:

http://www.crefceurope.org/wp-content/uploads/2015/02/Market-Principles-for-Issuing-European-CMBS-2-Final.pdf

Note that only parts of this report are relevant to this Call for Evidence.

Particular issues addressed are;

Communication problems and the institution of an on-line "Noteholders' Forum". (See section 3 of the Report). This would enable company notices to be posted to a website, so that investors in using the site could check at a central source whether they should be giving voting instructions in relation to any company in which they held an interest - we would have thought something of this sort might be available already. Depending on the scope of the website it would need to be more or less secure and this would have cost implications. For example, for the CMBS Forum various protections were devised to ensure that this website could not be misused (this has been a problem on other securitisations where third parties have been able to send misleading notices to investors in attempts to extract financial benefits for themselves. See, for example*, Fairhold Securitisation Limited v Clifden (IOM) No 1 Limited* and others (https://businessrestructuringandinsolvency.lexblogplatform.com/wp-content/uploads/sites/325/2018/10/F*airhold-Securitisation-Limited-v-Clifden.*pdf

However, a Noteholders' Forum will not always provide a complete answer, though it may mitigate uncertainty, particularly where more than one legal system is engaged: for example, in the case referred to above, securitised debt was listed on the Irish Stock Exchange (now trading as Euronext Dublin) and some announcements were made via the RNS service of that Exchange; it transpired that there was no mechanism in the rules of the Irish Stock Exchange that would require the listing agent (who would usually post RNS announcements) or the Stock Exchange itself to check whether an announcement made with respect to the listed securities had been approved or authorised by the issuer of the securities. There are justifiable reasons why it should not always be necessary for an issuer of listed debt securities to authorise or approve announcements to the market relating to those securities, but this does mean that both issuers and holders of the debt securities have to be vigilant as to the source of any public announcements pertaining to the securities; and the use of a "Noteholders' Forum" would not prevent third parties from making announcements via the Stock Exchange's regulatory news service. If there is a deficiency perceived with this outcome, it lies in the rules of the Stock Exchange on which the debt securities are listed. Changes to UK law or regulation would not be likely to change this outcome, but the ability of noteholders to pass on information to each other may mitigate problems in highly international situations.

Refusals of key transaction parties, such as Trustees, to engage or take instructions from investors – eg to call an event of default, even when payments from the borrower are long overdue. The solution to this proposed in CMBS 2.0 is for clear simple mechanisms to replace the transaction parties to be included in transaction documents. The recommendation was for 10% of investors by value) to be given the right to call for a vote on this with the replacement being effective if approved by a 50% majority. This solves the problem experienced on some deals where intransigent parties refused to take action and could not be replaced. (See section 4.3 of the Report).

Complex voting and quorum provisions that cause voting delays and confusion (see section 7.1 of the Report).

Apathy regarding votes on highly technical matters Votes on such matters are sometimes insisted upon by trustees and tend to attract little interest from investors and as a result often fail for lack of the required quorum (at least for the initial meeting) leading to cost and delays. CMBS 2.0 sought to address this through a novel mechanism known as "negative consent" which has now been widely adopted for all types of securitisation. This involves the issue of an explanatory notice to investors, with the vote being deemed to have passed unless at least 25% of investors (by value) object to the same in writing within a defined period. If such objections are made, the matter can be put to a more formal vote. This is set out in section 7.2 of the CMBS 2.0 Report.

ANNEXE 3

Members of the Joint Working Party

Dorothy Livingston – Herbert Smith Freehills - Chair of the CLLS Financial Law Committee and of the Working Group

David Pudge – Clifford Chance LLP - Chair of the CLLS Company Law Committee

Karen Anderson – Herbert Smith Freehills LLP - Chair of the CLLS Regulatory Law Committee

Hannah Meakin – Norton Rose Fulbright LLP

David Ereira – Paul Hastings (Europe) LLP

Mark Evans – Travers Smith LLP

Sarah Smith – Dechert LLP

Victoria Younghusband – Charles Russell Speechlys LLP

Peter Bateman – Slaughter and May

James Bresslaw – Simmons & Simmons LLP

Martin Webster – Pinsent Masons

Vanessa Knapp - independent

Caroline Meinertz – Clifford Chance LLP

Guy Morton – independent

Lucy Fergusson – Linklaters LLP

Richard Ufland – Hogan Lovells LLP

Sam Bagot – Cleary Gottlieb Steen & Hamilton LLP

Richard Everett – Travers Smith LLP

Mark Simpson – Baker McKenzie LLP