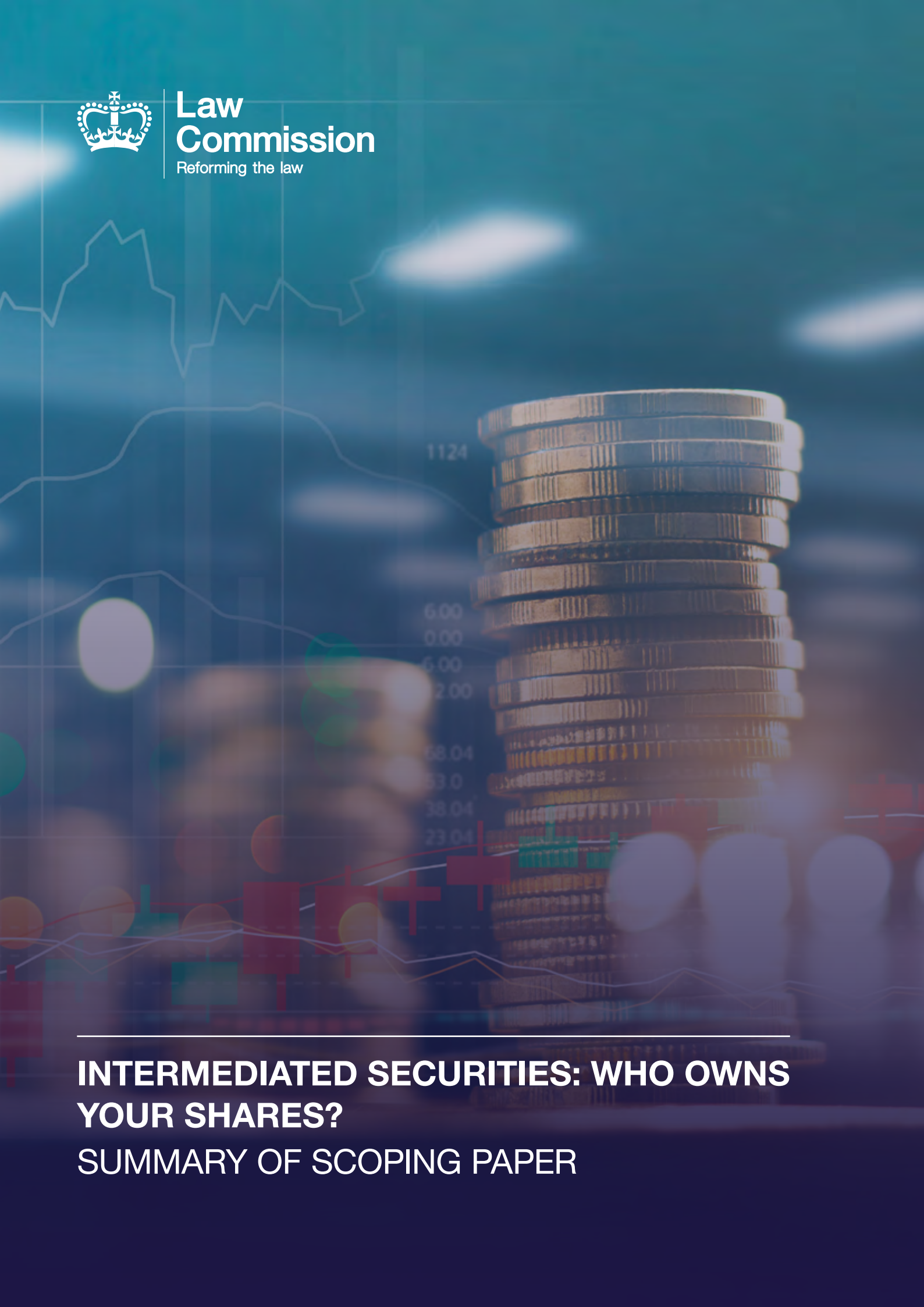


Law Commission
Reforming the law

INTERMEDIATED SECURITIES: WHO OWNS YOUR SHARES?

SUMMARY OF SCOPING PAPER

INTRODUCTION

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

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

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

This paper summarises our scoping paper, in which we analyse the law underlying intermediated securities, together with concerns of market participants, and possible solutions to those concerns. We focus solely on investments in UK-incorporated public companies whose shares may be purchased and traded by the public. The scoping paper focuses on the law in England and Wales.

This summary

In this summary:

1. we set out a short description of the intermediated holding system and the legal consequences of holding securities this way;
2. we provide an outline of some of the problems which can arise in relation to intermediated securities;
3. we summarise the potential solutions to these problems, including both overarching and targeted approaches; and
4. we highlight further work that would need to be done to take these solutions forward, including ascertaining both the costs and benefits of such work.

Pooled funds

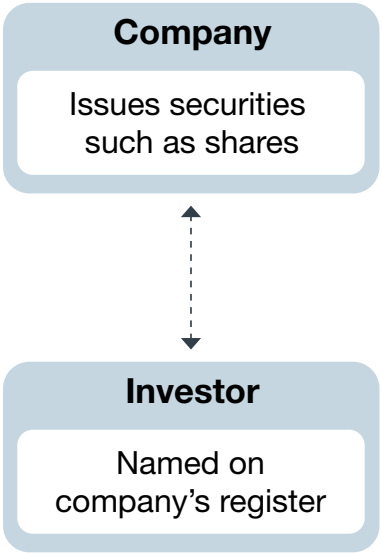
Pooled funds, such as unit trusts and open-ended investment companies, are not directly part of our work. Pooled funds collect money from investors and invest it under the management of a fund manager. Investors in pooled funds purchase a "unit" in the fund, which represents a proportion of the assets held by the fund. The assets held by the fund may include securities but they may also include other assets such as property. Although there are some similarities, we think that there are good legal and practical reasons for distinguishing between investors in pooled funds and those who choose to invest in securities of a particular company through an intermediary.

THE LEGAL NATURE OF INTERMEDIATED SECURITIES

One way to consider the law applying to intermediated securities is to compare the position of a person holding investments directly from the issuing company with the position of a person holding investments through an intermediated securities chain.

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

Holding investments directly



In contrast, when you hold your investments through an intermediary, such as a broker, an online investment platform, or a bank, you are not the legal owner of your investments.

Under the law of England and Wales, this arrangement is classified as "a series of trusts and sub-trusts" between the participants.

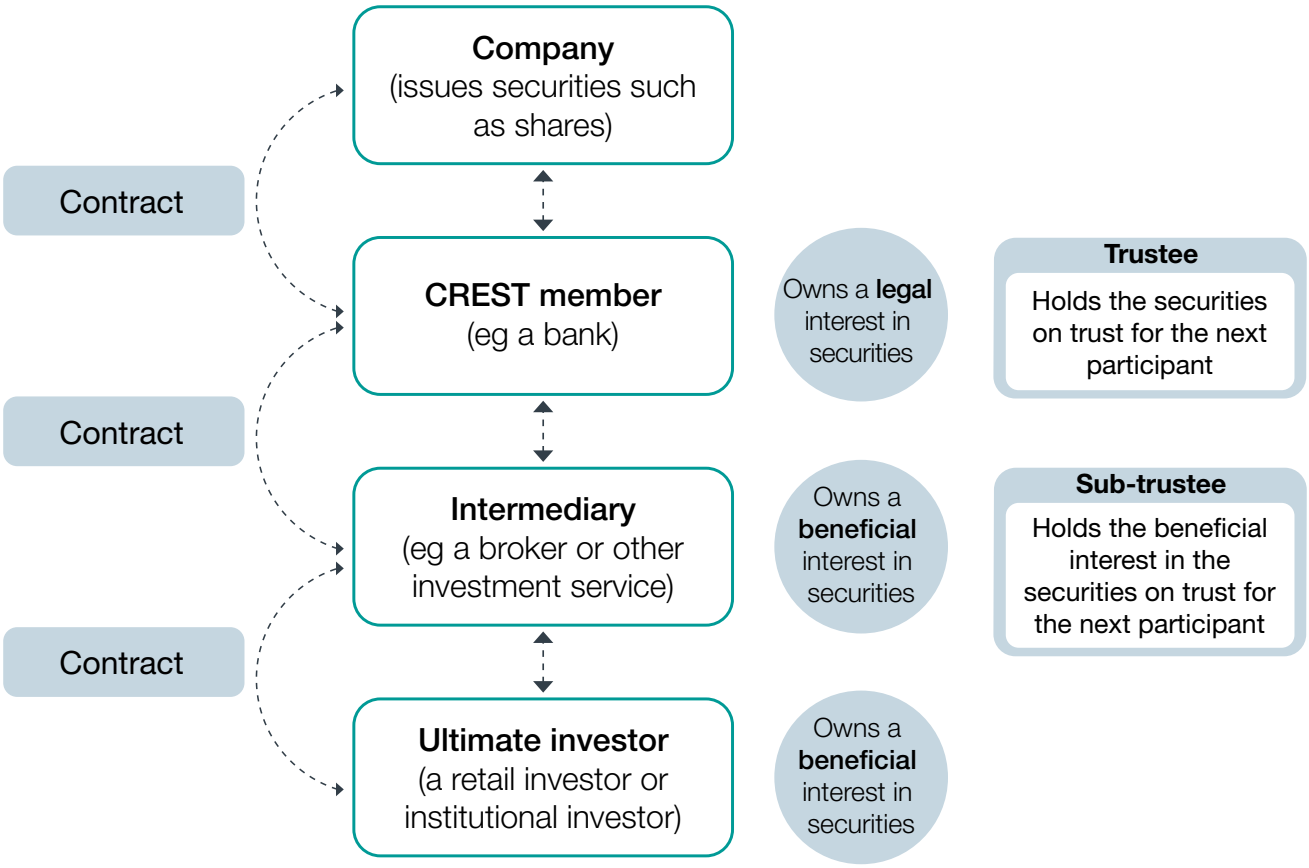
This classification means that you own only a "beneficial" interest in the investments. Each intermediary is a trustee or sub-trustee for the person immediately below it in the chain. There is also a contractual relationship between each set of parties in the chain. We refer to retail investors and institutional investors who hold their investments through an intermediated securities chain as "ultimate investors".

As an ultimate investor, your name will not appear on the register of members and you are not a member of the company. You will not automatically have a direct relationship with the company. Instead, the financial institution (the "CREST member") at the top of the intermediated securities chain will be the legal owner of the investments and the legal shareholder or member of the company. They will receive information and correspondence from the company, be able to attend company meetings and vote in relation to the shares.

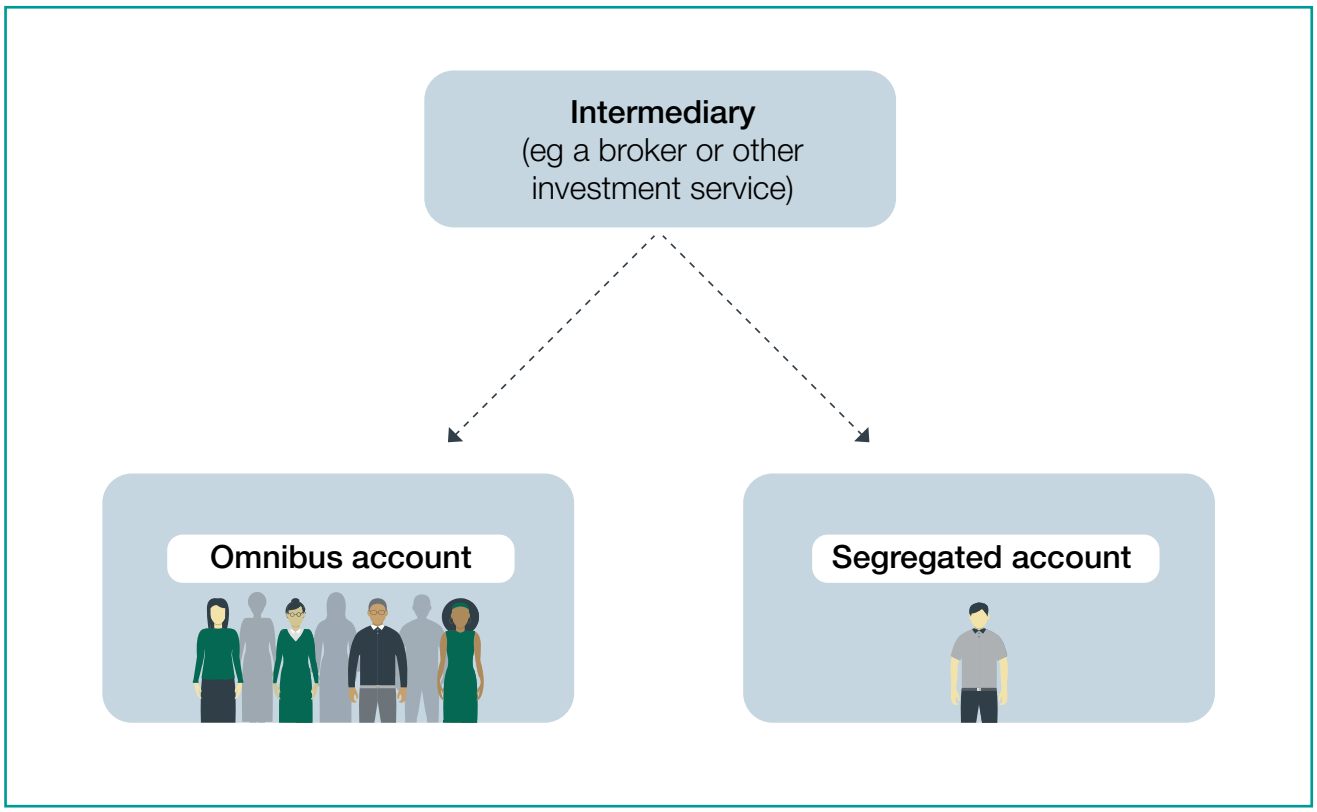
An intermediary will often hold your beneficial interests in securities in an "omnibus" account, pooled with the investments of other clients. One omnibus account may hold millions of shares for investors. Some intermediaries also offer "segregated" accounts, which hold the assets of one particular investor only.

When you hold your investments through an intermediary, such as a broker, online investment platform, or a bank, you are not the legal owner of your investments.

An intermediated securities chain



Omnibus and segregated accounts



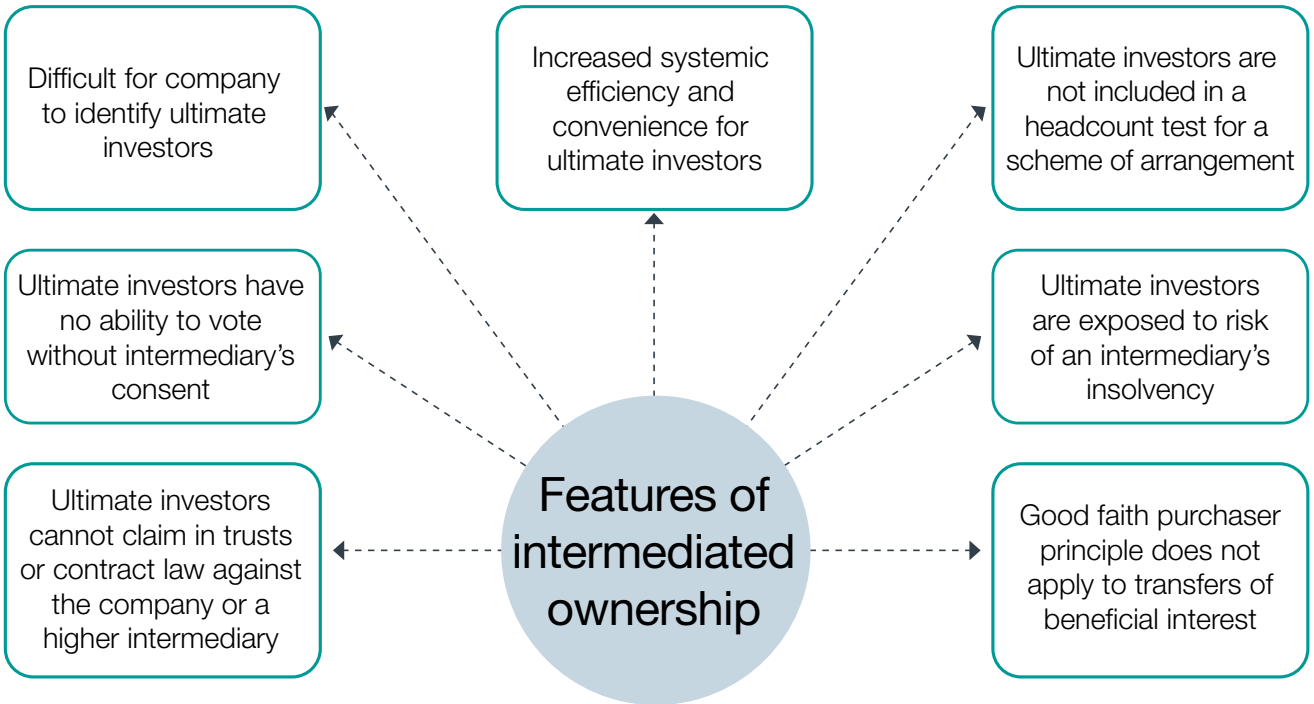
ISSUES ASSOCIATED WITH INTERMEDIATED SECURITIES

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

1. Increased efficiency and economies of scale (particularly where omnibus accounts are used).
2. Decreased costs for intermediaries, because of this increased efficiency, which may trickle down to ultimate investors.
3. Convenience for ultimate investors, who may hold a diverse, cross-border portfolio of investments through a single intermediary.

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

Some consultees told us that aspects of the current system prioritise intermediaries – which are often large financial institutions – over ultimate investors, whose money is at stake. However, there is not a realistic alternative system of holding investments directly, in particular for retail investors. Although a retail investor may obtain a CREST account, these are offered by only a handful of intermediaries and the cost of having a CREST account has risen significantly in the last five years. Ultimate investors, and particularly retail investors, may feel that they have no real option but to hold their investments through an intermediated securities chain.



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

The effect on investors' rights and corporate governance

Holding investments through an intermediated securities chain can have a profound effect on the ability of ultimate investors to exercise rights. If an ultimate investor holds investments this way, they are not a "member" of the company under the Companies Act 2006.

Exercising voting rights

In general, this means that, without the agreement of the intermediaries in the chain, ultimate investors cannot exercise the right to vote in relation to their investments, they are not entitled to attend meetings of the company and they will not receive information from the company. Even when an intermediary facilitates voting by ultimate investors, they may find it difficult to confirm that their vote was received and counted by the company. Where a company wishes to engage with its ultimate investors, it may struggle to identify them. Section 793 of the Companies Act 2006 provides a procedure for identifying ultimate investors, but consultees told us that it is not fit for purpose.

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

Some consultees told us that aspects of the current system prioritises intermediaries – which are often large financial institutions – over ultimate investors, whose money is at stake.

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

Other rights under the Companies Act 2006

Along with voting rights, an ultimate investor's status as a "non-member" affects their entitlement to other rights under the Companies Act 2006. For example, ultimate investors cannot apply under section 98 to challenge a resolution to re-register a public company as a private company. Additionally, an application under this section cannot be brought by a member who has voted in favour of the resolution. This means that intermediaries who vote both in favour of and against the resolution (for example, because they represent the opposing views of their clients who are ultimate investors), cannot later challenge the resolution on behalf of their dissenting clients. This additional requirement excludes ultimate investors from challenging this type of resolution, even where their intermediary is willing to bring an application on their behalf.

Schemes of arrangement

Another example is the question of whether ultimate investors' views can properly be taken into account in relation to schemes of arrangement (section 899). A scheme of arrangement is a binding compromise between a company and its members or creditors. Currently, a scheme of arrangement must be approved by both a majority in number (the "headcount test") and a majority in value of members or creditors. The application of the headcount test means that even when an intermediary holds shares on behalf of thousands of ultimate investors, it will only be counted as one shareholder for the purposes of the test.

No look through principle

Holding investments through an intermediated securities chain also alters the ability of an ultimate investor to bring a claim against a company or an intermediary higher in the chain. An ultimate investor can only make a contractual or trusts claim against their immediate intermediary, and not against the company which issues the securities, nor against another intermediary. This limitation, however, does not affect the ability of an ultimate investor to make a claim in tort. This is referred to as the "no look through principle".

There are some statutory exceptions to the no look through principle. For example, section 90A of the Financial Services and Markets Act 2000 allows a person who has acquired "any interest" in securities to bring an action against a company for including misleading information in a company prospectus or other published information. The High Court recently held that "any interest" included the interest held by ultimate investors in *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch). However, commentators and market participants argue that section 90A should be amended to make this explicit.

These types of legal issues will also be relevant to the corporate governance of companies. Corporate governance, at its simplest, is "the system by which companies are directed and controlled" (Cadbury Report (1992)). Laws which determine who can vote and exercise other corporate rights (such as challenging resolutions) will have a material effect on the governance of the relevant company.

A need for increased legal certainty

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

For example, when an intermediary becomes insolvent, the general position is that an ultimate investor's assets are protected because they are held on trust for the ultimate investor. Those assets are not therefore included within the intermediary's assets for distribution among creditors. However, where an intermediary holds an ultimate investor's assets in an omnibus account with assets of other ultimate investors, there is a risk that the intermediary may not have enough assets in that account. This may occur for a variety of reasons. Although commentators seem to agree that any loss would be borne by all the ultimate investors in the account on a proportionate basis, it is not certain and a court could decide differently.

Other examples of legal uncertainty in the context of intermediated securities include the following.

1. If intermediated securities are wrongly sold (for example, where the real owner did not consent to the sale), ultimate investors who purchase them will generally be vulnerable to a claim by the real owner. This is the case even if they have acquired the investments in good faith and have no notice of any other claims to them. This is not the case for good faith purchasers of the legal, rather than beneficial, interest in securities. In 2008, the Law Commission recommended a statutory amendment to address this problem.
2. Where there is a transfer of intermediated securities between investors, it is not certain whether that transaction must be in writing and signed, in accordance with the formality requirements under section 53(1)(c) of the Law of Property Act 1925.
3. There is potential uncertainty in relation to whether intermediated securities can be "possessed" and how that might affect an intermediary's ability to take security over these assets to secure a debt owned by an ultimate investor to an intermediary (for example, in relation to unpaid fees). There is also uncertainty as to whether an intermediary has sufficient "possession" or "control" of an ultimate investor's intermediated securities under the Financial Collateral Arrangements (No 2) Regulations 2003.

THE LAW COMMISSION'S VIEW ON INTERMEDIATION

An intermediated holding system for investment securities provides obvious benefits. However, as we explain throughout the scoping paper, this system can also impact negatively on ultimate investors who, after all, are the individuals and organisations providing money to companies through their investments. They are also the ones who take the financial risk.

One option to improve the position of ultimate investors would be to remove intermediation entirely, making all ultimate investors the legal owners of their investments (discussed below). We think that there would be certain benefits to that model. However, our preferred approach would be to retain the current system, with further work into certain targeted changes which could alleviate some of the problems caused by intermediation while retaining its benefits. We think that this approach would be a proportionate response to the issues which we have identified.

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

A RANGE OF POSSIBLE SOLUTIONS

The Government asked the Law Commission to provide a "range of possible solutions" to the problems which arise in relation to intermediated securities.

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

Possible targeted solutions for further consideration

Enhanced investor rights and improved corporate governance

Any future review of voting rights should consider:

- the creation of a new obligation on intermediaries to arrange for ultimate investors, upon request, to attend meetings, vote and receive information that the company sends to its members.
- the extension of the application of the Shareholder Rights Directive II to enhance the rights of ultimate investors.
- potential improvements to the procedure under section 793 of the Companies Act 2006, enabling companies to identify ultimate investors.
- potential amendments to facilitate the confirmation to ultimate investors that their votes have been received and counted by the company.

Any future review of schemes of arrangement should consider:

- removing the "headcount" test in section 899 of the Companies Act 2006.
- whether other measures should be put in place to protect minority shareholders.

Any future review of the "no look through" principle should consider:

- amending section 98 of the Companies Act 2006, which is not fit for purpose in the context of intermediated securities.
- whether a legislative amendment should be made to clarify the application of section 90A of the Financial Services and Markets Act 2000 to ultimate investors.
- whether the Law Commission should review the Companies Act 2006 and the Financial Services and Markets Act 2000 to identify provisions which inadvertently disadvantage holders of intermediated securities.

Increased legal certainty

In order to increase legal certainty in relation to intermediated securities transactions, the Government should consider:

- whether a legislative or regulatory amendment is necessary to confirm that distribution of an insolvent intermediary's assets to ultimate investors should be effected on a proportionate basis.
- further work to implement the Law Commission's previous 2008 recommendations in relation to the purchase of intermediated securities by a purchaser in good faith and without notice.
- amending the law to clarify that the formalities requirements in section 53(1)(c) of the Law of Property Act 1925 do not apply to transfers of intermediated securities.
- amending the Financial Collateral Arrangements (No 2) Regulations 2003 to remove potential uncertainty in relation to whether an intermediary has sufficient "possession" or "control" of an ultimate investor's intermediated securities.
- how best to support the Law Commission's current work on digital assets, which considers whether intangible property (such as intermediated securities) can be "possessed".

Changing the holding system through implementation of dematerialisation.

Considering the potential benefits of a distributed ledger system.

Addressing specific legal issues, for example:

- Creating an obligation on intermediaries to facilitate the exercise of rights by ultimate investors.
- Amending the Companies Act 2006 to solve specific problems in relation to schemes of arrangement (s 899) and challenging certain resolutions (s 98).
- Extending the good faith purchaser principle to cover all intermediated securities transactions.

DEMATERIALISATION

As well as, or instead of, possible solutions which address specific problems, the Government could take a systemic approach, moving away from the current intermediated system, and making all ultimate investors the legal owners of their investments.

We consider this option in the context of "dematerialisation", which includes the processes of issuing securities in electronic form, without paper certificates, and transforming existing paper securities into electronic form. Currently, millions of shares exist only in paper form. If the Government were to decide to move to an entirely electronic system of shareholding, this move could provide opportunities to enhance the rights of investors.

There are two obvious approaches to dematerialisation which could enhance the rights of investors.

1. An approach which would remove intermediation altogether, and under which all securities would be held directly and all investors would be named on the register of members (a "name on register" system).
2. An approach which represents a less fundamental change, retaining the current intermediated arrangements but also introducing a genuine alternative in the form of an affordable avenue for investors to hold their shares directly if they so wish.

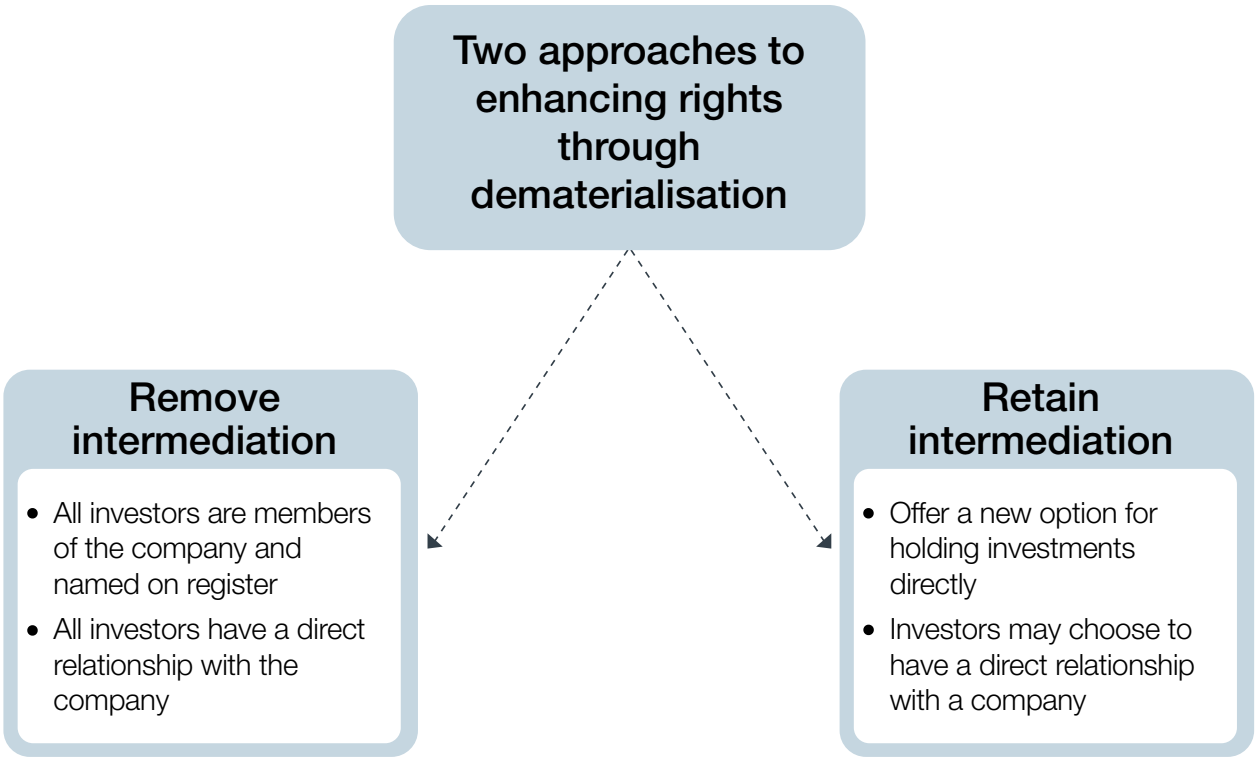
Following consultation with stakeholders, we conclude that, whilst a "name on register" system would ensure all investors benefited from being a "member", the second approach may be more proportionate. Rather than requiring profound changes, it would retain the current system and benefits of intermediation, whilst offering a realistic option to those investors wishing to hold securities directly. However, the Government should consider how to ensure the affordability of transactional fees charged by intermediaries under this model.

In the future the Government may wish to consider the potential long-term systemic benefits of a "name on register" system, particularly where it could be paired with new technology such as distributed ledger technology ("DLT"), which we discuss below.

Opportunities offered by dematerialisation

Any future work on dematerialisation could consider:

- the long-term systemic advantages offered by an approach which would remove intermediation altogether, and under which all securities would be held directly and all investors would be named on the register of members (a "name on register" structure).
- an approach which represents a less fundamental change, retaining the current intermediated arrangements but also introducing a genuine alternative in the form of an affordable avenue for investors to hold their shares directly if they so wish. This approach would require additional consideration of how to ensure that it remains an affordable option for both retail and institutional investors.



COSTS AND BENEFITS OF REFORM

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

Costs and benefits for further consideration

Any future work on possible solutions should include:

- analysis of the potential costs, including implementation, transitional and ongoing costs; and
- analysis of the potential benefits, including increased certainty for investors as to their rights, increased clarity of the current law, increased efficiency in operations and increased confidence in the intermediated holding system.

DEVELOPMENTS IN TECHNOLOGY

The Government also asked us to provide "a summary of technological developments that might make it easier for underlying investors to exercise shareholder rights". We have focused generally on the use of DLT which, at its simplest, is a method of recording and sharing data across a network. The distinguishing feature of DLT is that the ledger of data is not maintained by a central administrator. Instead, it is "distributed" and maintained collectively by a network of computers ("nodes").

We think that there are clear potential benefits to using this type of technology in the financial services market. Using DLT could enable the creation of a direct relationship between investors and companies, which would solve or improve most of the issues we discuss in the scoping paper. For example, investors would have the ability to bring a claim against a company or exercise voting rights in relation to shares. However, there are certain legal and regulatory aspects of DLT that should be clarified in order to increase legal certainty and confidence in this technology.

Technological developments

Future work in relation to the use of DLT in the financial services market should include consideration of the following issues.

- The nature of DLT, spread across a number of "nodes" which may be anywhere in the world, means that there could be uncertainties in relation to conflict of laws issues.
- The "legal qualification" or legal nature of the issued instrument on the ledger is uncertain. Does it constitute, or merely evidence, a property right?
- Whether an issuer would be able to issue securities under the legislation of any jurisdiction, independently of their location.
- How to ensure that the obligations of system participants are clearly conceived and articulated.
- How actions taken on DLT would be evidenced and what their legal effect would be.

NEXT STEPS

We have published our scoping paper which highlights particular problems and possible solutions. It is now for the Government to decide whether there should be further work, either by the Government or by the Law Commission, on these potential solutions.

FURTHER INFORMATION

Details of our work on intermediated securities, including the entire scoping paper and our call for evidence, can be found at: **https://www.lawcom.gov.uk/project/intermediated-securities/**