Feature

KEY POINTS

- The English law approach to intermediated securities has supported the growth of vibrant financial markets in the UK, and trading between UK markets and other financial centres.
- Legitimate concerns about the ease with which investors with an economic interest can exercise voting rights do not form a basis for abolition of the "no look through principle". There is no need for root and branch rewriting of the English law on interests in securities.
- There is considerable room for regulatory and legal improvements in the handling of securities by UK regulated intermediaries, both to streamline the exercise of voting rights, but also for the protection of investors in the event of insolvency of an intermediary. This can be done within the current legal framework.

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Intermediated Securities: the "no look through" principle will work alongside necessary changes

This article discusses the role of the "no look through" principle in the development of the law on intermediated securities, its practical value in dealing with transfers, creation of security and the settlement of disputes, as well as in trading in securities in international markets. It identifies defects in the law and regulation on the management of intermediated holdings, which may damage the interests of investors in the event of the insolvency of an intermediary. It also considers ways in which the exercise of voting rights in accordance with the wishes of the ultimate holder of an economic interest in intermediated securities could be improved, within the current legal framework of English law.

OVERVIEW OF THE ISSUES

As modern financial markets have developed, it has become the norm that investors with an economic interest in securities, both debt and equity, are not recorded as the holder of those securities in the books of the issuer, or in the books of the centralised administrator (central securities depository or CSD) of a dematerialised security holding system, such as CREST in the UK. This is the situation in economically significant financial markets worldwide. This has come with the growth of businesses that manage securities portfolios for their clients or act as custodians of portfolios. While this raises some practical issues for investors who wish to exercise the voting rights attached to the securities in which they have invested, when the registered holder may be several steps away in a chain of intermediation, it does not preclude direct holdings in equities in UK companies. Even after widespread dematerialisation (so that share certificates are no longer issued) the CREST system provides a basis on which UK shareholders can have a direct relationship with a UK listed (or other) corporate issuer. But there are real advantages for investors in intermediation in which portfolios of investments can be held and managed together, on a discretionary or instructed basis, dealing with a single intermediary, rather than with corporate registrars on a company by company basis.

The question of smooth transmission of voting decisions from the ultimate investor to the company have been a source of friction, though from different perspectives. In the case of equities in UK companies, the focus has been on concerns that the voting intentions of investors have reached the registered holder and have been effectively carried out, while for debt securities (where bond issues are held in global form on behalf of the CSD) the problem is attracting enough attention from investors to get necessary resolutions passed.

Following a thoughtful Department for Business, Innovation & Skills (DBIS) research paper in 2016,[1] during the legislative paralysis surrounding Brexit this topic has again been assigned to the Law Commission. This will be one of their major projects in 2020.

Some have argued for a "look through" principle which would give economic investors a direct right against the issuer, regardless of the length of the chain of intermediation.[2] The *Law Commission Call for Evidence* was, however, certainly influenced by the school of thought, describing the "no look through" principle as "controversial".[3]

A look-through principle would, however, require a complete rewrite of the law relating to property in securities, could not be reliably effective in relation to stages of intermediation outside the UK, and could add huge burdens to issuers/CSDs no longer shielded from dealing with competing claims, to an extent that would damage the standing of the UK as an international financial centre. It also does not sit well with underlying English law, whose provisions of company law, contract and trust law underpin the "no look through" approach.

It is not necessary to adopt such an major reform to improve the position on voting rights, to protect investors better in the event of the insolvency of an intermediary or to ensure that, in the event of corporate misfeasance, ultimate economic investors can receive the economic benefits of shareholders' claims against the company: indeed the High Court has recently held that ultimate investors do already have statutory rights against the company in such circumstances: *SL Claimants v Tesco* [2019] EWHC 2858(Ch), on statutory language in the Financial Services and Markets Act 2000 (FSMA) which protects the interests of persons with an" interest in securities" (who need not be the registered holders). In the event that the claim establishes liability on the part of the defendant, the court will also have to establish who qualifies to benefit from any successful claim against the company. However, the statutory provision provides a mechanism to ensure that claims are not lost because the immediate holders of shares have not themselves suffered an economic loss and enables those who have suffered such loss to be beneficiaries of the action. It can do this without touching on the benefits of the "no-look through" principle in identifying parties and their respective rights at each level of intermediation.

CURRENT POSITION

As things now stand, below the level of the CSD and/or the register maintained by the security issuer there lies a chain of intermediaries, long or short, between the ultimate investor and the issuer. Intermediaries are financial institutions, investment firms, professional security custodians and the CSDs themselves. There are very significant practical advantages for the management of transfers, creation of security interests and settlement of disputes in the application of the "no look through" principle, that treats each level of intermediation as a separate relationship.

In English law this pattern will be analysed as creating a series of trusts and sub-trusts with their terms largely or entirely governed by the contractual arrangements under which they are created: see *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 at [226].

In *Secure Capital SA v Credit Suisse AG* [2015] EWHS and [2017] EWCA Civ 1486 the High Court, both at first instance and on appeal, accepted the "no look through" principle and the English law on privity of contract as creating a logical system for dealing with intermediated relationships – in that case it enabled the matter to be decided on the basis of applicable contract law, without any need to look through to the law governing the underlying security or a higher level of intermediation. As the authors of *Goode and Gullifer on Legal Problems of Credit and Security (Sixth Edition)* say (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."

The City of London Law Society in their *Response to the Law Commission Consultation* (8 November 2019, available on the CLLS website, Financial Law Committee page), summarise these benefits, saying that they:

> "- 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."

This creates a high level of certainty which is important to the smooth operation of financial markets and enables the swift execution of instructions.

CONFLICT OF LAWS

Where intermediaries are operating in different countries, then levels in the chain may be governed by different legal systems: for example debt securities issued by UK companies are most frequently held in global form for a CSD operating under the law of either Belgium (Euroclear) or Luxembourg (Clearstream), with smaller economic holdings passing through intermediated chains in many jurisdictions, including England. This application of different systems of law at different stages of intermediation depends on the "no look through" principle and is vital to international financial operations. Legal systems, both common law and civil law, have recognised the value of this approach and apply the "no look through" principle in their own analysis of intermediated holdings and their approach to the proprietary aspects of the relationships. Considerable work has been done on this:

- The EU has adopted the "place of relevant intermediary" (PRIMA) approach in the Settlement Finality Directive 98/26/EC and the Collateral Directive 2002/47/EC, which are reflected in current UK law (and will continue as "retained EU law" after the end of the Brexit transition period). This necessarily requires each intermediary/client relationship to be looked at separately.
- The Hague Securities Convention has adopted a "party autonomy" based approach, closer to that previously adopted by the US. Although it has had limited international uptake, this Convention has been ratified by both Switzerland and the US, both homes to international securities markets, one civil law and the other common law: This Convention also considers each intermediary/client relationship separately, consistently with the "no look through" principle and allows the parties to each intermediary/client relationship to choose their governing law for all purposes so long as their choice meets certain criteria, in particular that the intermediary has a relevant office in the chosen jurisdiction, with a fallback to PRIMA type rules where there is no valid choice.

After the UK is no longer bound to apply EU law, it could choose to change its conflict of law rule: both the developed options work in conjunction with the "no look through" principle but would be impractical in relation to a "look through" principle. As a major financial centre, it is important that the UK's rules in relation to intermediated securities work effectively in an international context. A look through approach would be more difficult to apply where it had to leapfrog a level of intermediation governed by a law other than English and would be more likely to lead to inconsistent results and rival claims on the issuer or central counterparty.

The unravelling of entitlement in the *Tesco* case referred to above is likely to demonstrate the difficulties: while not insurmountable in a tortious claim against the issuer for a share of damages for misfeasance, it would be a very different matter if competing claims in contract or trust, affecting small parcels of securities, could be raised as proprietorial claims against interests in securities held at any higher level of intermediation and/or against the issuer and/or central counterparty. This would be a backward step, liable to damage the UK as an international financial centre.

WHAT DOES NEED CHANGING?

Without embarking on wholesale reform of securities law, there is plenty that can be improved in the interests of investors at all stages in the chain of intermediation. Some changes are regulatory, while others would require primary law. The CLLS in its *Response to the Law Commission Consultation* identified nine areas where change would be valuable, in some cases considerably improving investor protection (see their response to question 26). They can be grouped into three main areas:

- Voting rights and procedures.
- Insolvency of an intermediary.
- Streamlining the intermediation process.

Voting rights and procedures

Regulation

The changes needed in this area are largely regulatory, to ensure that instruction can be passed up and down the chain easily and that all UK intermediaries are obliged to transmit instructions in a timely manner and also advise their clients on the steps taken in relation to their instructions. Regulatory sanctions for failure to follow rules should be real and enforced as regards all regulated aspects of intermediation.

Technology

There may be better technological methods of recording instruction paths that could assist the process. This could also help to address lack of interest on the part of the ultimate investor in debt securities, although at least one link in that chain is likely to be outside UK jurisdiction.

Headcount test

One area for potential reform is the headcount test under s 899 of the Companies Act 2006 which applies to schemes of arrangement. This works on the assumption that the share register of the company would contain all investors so that a headcount would be a valuable assessment of the acceptability of the scheme. Some jurisdictions with similar company law have already adopted alternatives to this test or allow the court to dispense with it.

Direct rights for ultimate investors

Another consideration is whether there are any areas where ultimate investors could be given direct rights of intervention: eg to object to delisting of a quoted company, but without doing violence to the "no look through" principle.

Identifying the ultimate investor

One of the important considerations in relation to exercise of any rights by ultimate investors directly against the issuer will be the establishment of regulatory or statutory definitions identifying which persons shall be deemed to have an interest in securities. For example, an individual investor, pension fund or manager of an investment fund, holding a portfolio of investments with an intermediary will be in most cases the beneficiary of a trust or sub-trust arising from the intermediary/client relationship. This would be so even if their individual portfolios were managed on a discretionary basis by the intermediary. These therefore should be regarded as holding an interest in securities.

On the other hand, the manager of an investment fund may hold its assets on trust for investors and may be a body subject to financial regulation in the UK: but it is not acting as an intermediary. The fund investors are much more analogous to shareholders in the fund (indeed they may be able to trade in units in the fund). They would not generally have any rights to instruct the manager how to deal with specific assets or have an interest in any specific assets. In that case, it would seem correct to treat the manager as the ultimate investor.

As can be seen from these examples, there are likely to be grey areas, where the question whether a particular structure creates an intermediary/client relationship will be relevant, but at the moment there is no systematic approach to the question.

Insolvency of an intermediary

This is an imperfect area, where reform could bring real benefits and security to ultimate investors, over and above that which they currently enjoy.

In the event that an intermediary becomes insolvent, interests in securities held in trust for clients should be passed rapidly to a solvent intermediary clear of any set-off or lien, so that the ultimate investor can continue to enjoy the rights associated with the securities to the extent arranged with its direct intermediary, and so that there is a complete chain of intermediated relationships up to the issuer. Although the direct intermediary may have duties to the client that require that intermediary to replace securities that are lost in the immediately higher level of intermediation, this can be very costly: the most efficient approach is to facilitate recovery of securities a failed intermediary holds in trust as rapidly as possible. However, there are obstacles to this in English law, if:

- the securities have been mixed with securities belonging to the intermediary;
- the securities have been mixed with those belonging to other clients of the intermediary;
- there is a shortfall in the quantity of securities of any particular type.

These problems can also arise if an intermediary has used a custodian to hold securities in accounts not earmarked to particular clients and that custodian becomes insolvent.

The insolvency of Lehman Brothers International (Europe) showed that currently available mechanisms (such as a scheme of arrangement) cannot be used to address issues of shortfall, and in any event this mechanism does not resolve the position quickly. A purely consensual arrangement, such as that eventually arrived at in that case, may not be possible when many parties are involved.

Regulation

The solutions may be largely regulatory but will require provisions of statutory effect.

Biog box
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Regulation could be clearer on the requirement to hold securities on trust, whether on an individual or pooled client account basis and that a resulting trust should be deemed to exist if client assets are mixed with those of the intermediary (which may happen even when this is not lawful or is contrary to regulatory and contractual obligations). This type of regulation will not in itself solve any problems of shortfall, priority and the position if an intermediary has not acted as agreed with its client or required by regulation.

Distribution of pooled assets held on trust

Except for assets held in an individual earmarked account for a client, it will require legislative action to enable the position on pooled assets in shortfall to be resolved – this could be financial services law, which insolvency law is bound to respect, rather than specific insolvency rules. In this case, the UK could take a leaf out of the book of the US and also draw on existing law dealing with client moneys held in a segregated account. The US law treatment under the Securities Investors Protection Act (SIPA), allows for the distribution of available pooled client assets to clients with an interest therein, according to the relative value of their holdings, regardless of where any shortfalls lie. Generally, SIPA works well and speedily.

This measure should produce a similar position as the current regulatory regime for client money, under which a statutory trust ensures that any shortfall is suffered rateably by the clients concerned and enables a swift distribution of available funds: see the Financial Conduct Authority's *Client Assets Sourcebook* (CASS) Client Money Distribution Rules (CASS 7A) made under powers contained in FSMA.

FSCS threshold

There is a question whether the Financial Services Compensation Scheme (FSCS) can provide adequate protection to individual investors who hold substantial portfolios with an individual intermediary, as the economies of administration and the regulatory framework tend to encourage. The financial compensation limit is set at £85,000, but a substantial number of individuals have holdings above that value, especially in the field of provision for retirement through personal arrangements. The clearer and more comprehensive the trust arrangements which pass assets back to the client, the lower the calls on the FSCS, as a failed trust will result in an unsecured claim. That situation needs review, so as to ensure investors are best protected.

Early regulatory guidance

Ahead of this review, regulatory guidance on the options that best protect investors with holdings valued above £85,000 would be extremely timely.

Streamlining the intermediation process

The measures suggested here are aimed at increasing legal certainty in the operation of transactions in intermediated securities and include:

- the extension of innocent purchaser/transferee protections to transfers of intermediated securities, in the same way as they exist for registered holders who have legal title in securities.
- Treating intermediaries' securities accounts as of the same status and entitled to the same legal protections as provided by s 126 of the Companies Act 2006, and Regs 23(3) and 40(3) of the Uncertificated Securities Regulations.
- Clarification that formality requirements, such as those for "writing" contained in ss 53(1)(c) and 136 of the Law of Property Act 1925 are satisfied in the case of electronic transactions. There are order making powers in s 8 of the Electronic Communications Act 2000, including to amend primary legislation, which may be appropriate for this purpose.

The international element

In all this, we should not forget that securities in UK companies are traded internationally, so that parts of a chain of intermediated relationships may be governed by different legal systems, while English intermediaries may hold securities of foreign issuers in client portfolios. Even within the UK, there are other jurisdictions, and for an intermediary based in Edinburgh PRIMA would apply Scots law, not the law of England.

Of course, UK legislators and financial regulators can ensure equally beneficial outcomes for investors dealing with Scottish intermediaries, but they cannot legislate for the approach of foreign systems: the best way to ensure consistency is to continue to show leadership as a leading example of international best practice, working with commonly accepted principles, including the "no look through" principle. ■

The views expressed are the author's own, but in most respects coincide with the submission made by the CLLS to the Law Commission in response to its 2019 Consultation. That submission, dated 11 November 2019, can be found on the Financial Law Committee page of the CLLS website.

1 Exploring the Intermediated Shareholding Model, BIS Research Paper number 261, January 2016.

2 I do not read the article by Daniel Harris 'Intermediated Securities: Let's Not Panic' (2019) 11 JIBFL 733 as one of those; he, like the CLLS, appears to argue for improved regulation of the intermediated chain and the use of statutory powers to ensure appropriate rights for economic investors.

3 See para 2.35, Intermediated Securities Call for Evidence August 2019 available on the Law Commission website and the works there cited: Richard Salter QC 'Intermediated securities and the rights of the ultimate investor' (2016) 3 JIBFL 153 at 154 and V Dixon, 'The Legal Nature of Intermediated Securities: An Insurmountable Obstacle to Legal Certainty?' in L Gullifer and J Payne (eds), *Intermediation and Beyond* (2019) p 53.

Further Reading:

- Intermediated securities: let's not panic (2019) 11 JIBFL 733.
- Intermediated securities and the rights of the ultimate investor (2016) 3 JIBFL 153.
- LexisPSL: Banking & Finance: Intermediated securities: taking stock.