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Commercial and Common Law Team
The Law Commission

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28 October 2019

Response to Consultation on Law Commission Review of Intermediated Securities

Dear Sirs,

Here are some general comments on the above Consultation and answers to the questions posed.

I write as a director of private company and an active shareholder in public companies (more than 80 shares in my portfolio with multiple ISA, SIPP and Personal Crest accounts) and with extended experience of the problems of shareholder voting and enforcing shareholder democracy as a former director of both ShareSoc and UKSA.

Note that a good overview of the issues covered in this consultation is present in two documents published by ShareSoc in 2014 and 2015 respectively and entitled:

- Guaranteed Votes for All Shareholders
- Reforming UK Share Ownership

Those documents are available from this web page:
https://www.sharesoc.org/campaigns/shareholder-rights-campaign/ . I suggest you read them.

My detailed answers to the questions posed in the Consultation are given in the Appendix which I have also submitted via your on-line forms.

Yours sincerely

Roger W. Lawson
Managing Director

Appendix – Answers to Questions (Answers in Red)

Question 1.

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

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

Answer: It is in practice very difficult for investors, particularly almost all individual investors who are in nominee accounts, to exercise voting rights. The first problem is that investors are not told when a vote is required and available by their nominee operator so they are unlikely to know when to request a vote. That is the case even with those nominee operators such as the Share Centre who provide voting rights to the beneficial owners.

But most nominee operators do not enfranchise their shareholders in any case, i.e. do not provide an easy to use voting system or provide obstacles in their way to voting. For example a charge may be imposed, or the shareholder may have to give specific instructions in writing which is very tedious to do and deters investors from voting. ISA accounts come with a legal requirement under the ISA regulations to enable shareholders to vote but those nominee operators who do not provide voting systems (i.e. most of them) have no obligation to tell investors about this which means most of them are not aware of their rights in that respect.

Even when a voting system is provided, it is not reliable and does not work in all cases. For example, AIM companies which are technically “unlisted securities” often do not pass on the information required and have no legal obligation to do so. Even for main market companies, there is problem in that there is a limited window of time when a vote can be submitted, i.e. if an investor is informed that a general meeting is coming up and the details of the resolutions, they may not be able to vote immediately due to delays by the nominee operator in listing the meeting.

Although it is well known that few individual investors vote, even when voting systems are provided, the aforementioned issues means that few individual investors will be diligent enough to actually submit a vote and the result is most do not bother because they do not find the systems provided are reliable enough.

Note that I write the above as a user of ISA accounts with two different companies, as a user or two SIPP accounts with different companies, and in addition as a Personal Crest Member with also a few paper share certificates. I always try to vote my shareholdings but often it is very difficult to do so, or the process takes so long that I don’t bother. This is the problem most shareholders in nominee accounts face.

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

Answer: The solution is that all shareholders (including beneficial owners) should be on the share register and the company’s share registrar could then provide direct instructions of the need for a vote and a means to register that vote (on paper or electronically). That also clearly requires that all shareholders who have an email address provide it and that it is held on the register (and as part of the legal register).

However share registrars have become very reluctant to send out paper proxy voting forms of late to shareholders on the register, thus deterring shareholders from voting, or when they provide an electronic voting system this is different to other operators.

They also typically requires shareholders to register which is often a tedious and complex process upon which shareholders are reluctant to waste time. There need to be clear standards for the processes to be used, and a common national voter registration and easy-to-use voting system.

In summary the existing mechanisms for enfranchising beneficial owners are deficient both legally and operationally and cannot be resolved by minor changes to legislation or imposing new regulations. There needs to be wholesale reform that is done solely to meet the needs of the shareholders rather than the convenience or the commercial interests of nominee operators (platforms and stockbrokers).

Question 2.

2.12 Are there particular systems or models of holding intermediated securities which could better facilitate the passing back of direct rights for ultimate investors? If so, what are the current obstacles to the use of such systems?

Answer: As given in my answer to the previous Question, the simple solution is to have all shareholders (including beneficial owners) on the share register. In Sweden I understand this is enabled by the regular or timely "upload" of all beneficial owner information to a central register. Another solution is the Australian Chess system.

But there is of course no reason for a specific need to have an "intermediated" system where nominee operators legally own the shares and therefore have the rights (voting and other rights). Stockbrokers and platform operators are simply acting as the agents to perform a clerical function and it is only for historic reasons that they acquired their current role. The proposals for dematerialisation of paper share certificates proposed by the Registrars Group provide a system for electronic share registration that would remove the need for intermediation. Such a system could cover all shareholdings including ISA and SIPP accounts if the regulations associated with the latter were changed.

The existing structure of intermediated securities has arisen because of the commercial interests of nominee operators – that needs to be changed in the interests of fairness, legal certainty and the support of shareholder democracy.

Note that I covered many of these issues in two documents published by ShareSoc in 2014 and 2015 respectively, and written by me, and entitled:

- Guaranteed Votes for All Shareholders
- Reforming UK Share Ownership

Those documents are available from this web page:
https://www.sharesoc.org/campaigns/shareholder-rights-campaign/ . I suggest you read them.

Question 3.

2.14 Do you consider that the type of vote affects the extent to which ultimate investors can exercise voting rights? If so, do you have examples, or specific evidence, of this issue?

Certainly there are problems with schemes of arrangement and where the vote relates to a Court approval. The Unilever case is one such example where voters were not fairly represented. This web page from Minerva explains the issue:
https://www.manifest.co.uk/unilever-votes-and-voices/

Question 4.

2.17 Do you consider that it is difficult for ultimate investors to obtain confirmation that their votes have been received and/or counted?

Answer: Yes – in fact it's almost impossible. Even if a registrar is contacted they may not be able to confirm votes have been recorded because they do not know where the votes came from via a possible long chain of intermediaries.

If so:

(1) What is the impact of this?

Answer: Where votes on an important issue are narrow, i.e. no very clear majority, it can lead to investors questioning the accuracy of the vote.

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

Answer: I have attended General Meetings of companies in the past where investors challenged the votes cast, i.e. claimed that their votes had not been recorded based on the numbers of proxy votes submitted for or against resolutions.

I have also attended meetings where my own votes appeared not to have been recorded for reasons unknown. Querying this with the registrar does not necessarily assist because they simply claim to have no record of receiving the proxy voting instruction.

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

Answer: see my answers to Question 2. It is intermediation and giving the nominee operator the voting rights rather than the beneficial owners that is the problem. Intermediation needs to be removed.

Question 5.

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

Answer: Intermediation by nominee operators certainly creates timing problems due to the delays inherit in the system. Delays in postal voting can also cause problems, particularly when there is more than one intermediary in the chain.

If so:
(1) Do you have examples, or specific evidence, of these problems?

Answer: I have personally had difficulties in submitting proxy votes on behalf of German shareholders due delays in obtaining details from their bank CSD operator.

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

Answer: remove intermediation by having all shareholders on the share register is the first priority. Secondly delays in postal voting could be removed by ensuring all registered shareholders have an email address recorded and by providing a universal on-line voting mechanism, as suggested previously.

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?

Answer: Yes

If so:

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

Answer: The inability of individual shareholders to easily vote their shares creates enormous difficulties when running campaigns on companies (i.e. campaigns to ensure a particular resolution is passed or defeated). This is a common problem in smaller companies such as those listed on AIM where a large proportion of the shareholders are individual investors. Resolutions to remove directors or install new ones are often thwarted simply because of the impossibility of enabling shareholders to vote who are in nominee accounts.

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

Answer: remove intermediation by having all shareholders on the share register. Note that on page 8 of the consultation document you say "….intermediaries are obliged to offer investors the option of a segregated account…." based on Regulation (EU) No 909/2014. That rather surprises me because I have never been offered that option and I believe platform operators have avoided doing so and will continue to do so. I am looking into this further but even if that regulation is made effective it will only provide a partial solution for the knowledgeable investor.

Question 7.

2.30 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?

Answer: Yes

In what way?

Answer: It can lead to perverse results. See previous mention of the Unilever case.

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? (2)

Answer: See above.

What could be done to solve these problems?

Answer: Section 899 needs redrafting to clarify the intention and intermediation of voting needs to be removed by having all shareholders on the register.

Question 8.

2.37 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?

Answer: Yes it does.

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

Answer: See the cases mentioned in the consultation document but it is a general problem that the Companies Act does not pass on all the available rights that a Member of the company has who is on the share register. The provisions in the Companies Act that allows intermediaries to pass on certain rights are only a limited solution and in practice do not force the nominee operator to do so.

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

Answer: remove intermediation by having all shareholders on the share register.

Question 9.

2.38 In practice, what, if any, are the benefits of the no look through principle?

Answer: I am not aware of any benefits whatsoever.

Question 10.

2.43 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?

Answer: No it cannot do so and has proven to be totally ineffective in doing so.

Question 11.

2.44 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?

Answer: Yes – the Companies Act does not properly represent the current operation of stock markets and the practices of stockbrokers (e.g. their use of “pooled” accounts). It was first drafted when all shareholders held a paper share certificate and were on the register of the company (issuer). Subsequent changes were made (e.g. in the 2006 Act) to try to rectify that omission but in a rather half-baked way.

Question 12.

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

Answer: Yes. It does so by imposing costs on the assets of investors, and by delaying resolution of the insolvency imposes the risk that assets are frozen for a considerable period of time. The investor loses out from missing dividends and interest payments, and from the risk of not being able to trade securities in fast moving markets.

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

Answer: You give the example of Beaufort securities in the consultation document but it affects almost all defaults of retail stockbrokers. It also proved to be a major problem in the bankruptcy of Lehman Bros – see http://ukscblog.com/case-comment-in-the-matter-of-lehman-brothers-international-europe-in-administration-and-in-the-matter-of-the-insolvency-act-1986-2012-uksc-6/

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

Answer: Pooled accounts are a major problem as they often frustrate the identification of ownership of assets and when that is attempted it is often apparent that there is a shortfall against all the claims. This then results in complex legal proceedings and long delays in returning assets that were nominally held in trust to the owners. One answer is therefore to outlaw pooled accounts and enforce that all assets held by nominee operators are held in "designated" accounts where the owner is clearly recorded.

Having all shareholders, including beneficial owners, on the share register would provide prima facie evidence of ownership of the assets.

Question 13.

2.62 Do you consider that there is uncertainty about how assets would be distributed in the event of an intermediary's insolvency? If so, how could this uncertainty be resolved?

Answer: Yes. There is certainly uncertainty at present which has often to be resolved by Court action even if the Special Administration regime is invoked. The uncertainty could be resolved by only permitting designated accounts as indicated in my answer to the previous question.

Question 14.

2.63 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?

Answer: I do not see that more education of ultimate investors would help as they have little choice about how they purchase stockbroking services and almost all operators have similar contracts with all using pooled nominee accounts. As defaults of intermediaries are relatively rare it might be a number of years, if ever, before an individual investor faced such an insolvency and therefore they are unlikely to take that risk into account or ensure they are well educated in the subject. But such events can have a devastating impact on a few investors (or tens of thousands for example in the case of Beaufort).

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

Answer: Clearly identification of who owns what assets would assist. Higher requirements for balance sheet strength (i.e. asset ratios) of stockbrokers would help but this might prove to be anti-competitive as it would deter new entrants to the market and also impose additional costs on investors.

Note that the Financial Services Compensation Scheme (FSCS) does provide some protection to a shortfall but in practice it is very limited in scope and size. It does not cover all assets and the limit of £85,000 does not cover most pension assets for an individual. The limit would need to be many millions of pounds to provide adequate coverage which would put a significant burden on the Scheme and be difficult to fund.

As all investors ultimately pay to fund that Scheme, increasing the compensation available is not the best solution to protecting assets. Better regulation of operators and clearer identification of assets are the best solutions.

Question 15.

2.70 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?

Answer: I am not aware that this is a problem in practice.

If so:
(1) Do you have examples, or specific evidence, of such problems?

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

Question 16.

2.76 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?

Answer: It would certainly seem to be a legal anomaly although I have not personally experienced any problems in practice. It may be more of a problem for stockbrokers who might currently cover any shortfall in their clients' exposure. However I am aware of past problems arising from failings to settle contracts to sell or purchase securities. For example the Room Service case where so far as I recall there were more shares promised to purchasers than the company had actually issued. See here for more information: https://en.wikipedia.org/wiki/Evolution_Group

If so:
(1) Do you have examples, or specific evidence, of such problems?

Answer: See above.

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

Answer: Naked short selling (i.e. where sellers sell stock they do not own as opposed to selling stock they have borrowed) would close one loophole.

Question 17.

2.80 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?

Answer: Yes. I have not previously been aware of this issue but it would certainly appear to be a potential problem. Transfers directly between ultimate holders are relatively rare.

If so:
(1) Do you have examples, or specific evidence, of such problems?
(2) What could be done to solve these problems?

Question 18.

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

Answer: No. As a former IT professional, I can say that there is no need to use distributed ledger technology to provide a system to directly record share ownership and transfers. It can be done with traditional IT software – as for example already used in the CREST system. DLT also has potential problems in relation to very large database sizes and transaction volumes.

I covered the issue of using DLT (otherwise known as Blockchains) and the mooted use in Australia in this blog article: https://roliscon.blog/2019/04/01/argo-blockchain-and-ft-letter/

Are there any other jurisdictions we should look to as examples?

Answer: No

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.

Answer: Part of the problem is that the current arrangements for transfers of securities (other than the CREST system itself) and voting arrangements are often based on conversion of previous paper/manual processes into IT software. This is partly because the Companies Act is based on the assumption of manual processes. If the Companies Act was revised to support fully electronic communication, rather than as an afterthought, it could be made a lot simpler. In other words, instead of an IT system being devised after the Companies Act was drafted and put into law, the IT system should be devised first and then the Companies Act and associated regulations then be written to support the adopted IT system.

There might clearly be an issue that all investors would need to be capable of electronic communication but that is now true of the vast majority of investors. The few exceptions could be handled by provision of agency services.

Question 20.

2.99 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?

Answer: I am not aware of recent activity in this area, although there was a Working Group to look at dematerialistion that was active for some years and of which I was a Member. There was a public consultation run by ICSA which resulted from the work – see https://www.icsa.org.uk/assets/files/pdfs/Policy/dematerialisation-of-shares.pdf and the Registrars Group in ICSA produced some specific proposals which were supported by many stakeholders. See http://www-uk.computershare.com/webcontent/Doc.aspx?docid=%7Bdce7977c-c416-46df-8839-092820cd2869%7D

I fully support dematerialisation and the principles followed in the Registrars Group proposals but progress seems to be minimal in firming up and implementing a solution.

Regrettably some stockbrokers appear to consider that the problem will go away if they defer action long enough, with their solution being to simply stuff anyone still holding share certificates into nominee accounts. That would be anathema to certificate holders unless share registration and voting systems are reformed.

Question 21.

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

Answer: Perhaps, the key is that there should be a "name on register" solution for dematerialisation and designated (not pooled) accounts.

Question 22.

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

Answer: No in essence so long as a good quality system to replace paper is put in place that protects shareholders interests. Most shareholders should welcome the higher security and faster clearing times enabled by an electronic, i.e. dematerialised, share registration system. But they do not like nominee accounts which takes away rights and introduces doubts about legal ownership. See the ICSA survey mentioned previously and I can also provide copies of presentations I did in 2006 on this subject.

Question 23.

2.105 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.

Answer: I am not aware of any.

Question 24.

2.107 What other jurisdictions should we consider and why?

Answer: As previously mentioned, the Australian CHESS system is worthy of review and is currently being revised I understand to improve it further. The Swedish system should also be reviewed, and US system. The latter is claimed to be expensive and is claimed to be vulnerable to "over-voting" (i.e. more shares voted than on issued), but does provide a very easy to use system for most individual shareholders.

Question 25.

2.110 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:

(1) A summary of the problem.

Answer: One issue barely covered in your consultation is the problem of companies ((issuers) or other shareholders being able to find out who the ultimate shareholders are in a company, and communicate with them. This is exceedingly important not just for issuers when they are subject to a takeover bid or other "corporate action" event but when shareholders wish to reform the activities of a company (e.g. remove directors or install new ones). The current provisions in the Companies Act cover those shareholders on the register reasonably well (apart from the lack of being able to communicate electronically due to the lack of email addresses on the register), but is woefully inadequate in identify those beneficial holders in nominee accounts. I refer to what is known as those in a "register of interests disclosed" as maintained by companies under Section 808 of the Companies Act. The ability to obtain such registers is often frustrated as companies have no made requests and it is difficult to force them to do so. In addition even when such information is obtained it is often practically useless.

These difficulties in identifying shareholders and communicating with them add enormously to the costs of campaigns on companies. For example Alliance Trust spent about £3 million in defending an attack by Elliott to reform the company, and Elliott probably spent a similar amount. Alliance lost the battle so that money, which was the shareholders assets, was effectively wasted.

(2) An explanation of and evidence of the effect of the problem in practice.

Answer: As someone who has run "shareholder action" groups in the past on several companies, I can advise that this problem totally undermines shareholder democracy. It is very difficult to overturn the votes controlled by management or a few large investors due to the problem of obtaining information on beneficial owners.

These difficulties defeat "shareholder engagement" which almost everyone agrees contributes positively to company performance.

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

Answer: All beneficial owners should be put on the share register, and with an email address where it is available (all stockbrokers now have email addresses for their clients). The cost would be minimal as these are electronic system so operating costs would be very low with only some initial development cost. The benefits would be large in terms of simplicity of voting, the improvement in the governance of companies (and stopping such abuses as excessive pay), in improved security and the prevention of criminality (it would enable better tracing of assets for example).

Question 26.

2.115 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?

Answer: Stockbrokers claim there are financial and operational benefits from the use of nominee accounts, and particularly pooled ones. But I have always questioned those claims. All transactions are individually processed through the CREST system so there is no cost advantage. In reality stockbrokers like the current intermediation system because it locks in their clients to their service as shareholders cannot sell shares via other brokers. It also hides their clients from those wishing to communicate with shareholders which stockbrokers are somewhat paranoid over. These are benefits for stockbrokers only, when the interests of shareholders (the ultimate beneficial owners) should take priority.

The disadvantages are wasted effort by shareholders, and inability to exercise their rights.

Question 27.

2.116 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?

Answer: I believe I have answered these questions in my previous responses.

Question 28.

2.117 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?

Answer: This is best answered by the service providers, and it obviously depends on which approach is taken but there were costs associated with dematerialisation of securities which covered in work by the Dematerialisation Working Party previously mentioned.