



Law Society  
of Scotland



# Consultation response

## Intermediated Securities

November 2019



## Introduction

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The Law Society of Scotland is the professional body for around 12,000 Scottish solicitors. With our overarching objective of leading legal excellence, we strive to excel and to be a world-class professional body, understanding and serving the needs of our members and the public. We set and uphold standards to ensure the provision of excellent legal services and ensure the public can have confidence in Scotland's solicitor profession.

We have a statutory duty to work in the public interest, a duty which we are strongly committed to achieving through our work to promote a strong, varied and effective solicitor profession working in the interests of the public and protecting and promoting the rule of law. We seek to influence the creation of a fairer and more just society through our active engagement with the Scottish and United Kingdom Governments, Parliaments, wider stakeholders and our membership.

Our Banking, Company and Insolvency Law Sub-Committee welcome the opportunity to respond to the Law Commission's call for evidence on *Intermediated Securities*.<sup>1</sup> We have the following comments to put forward for consideration.

## Response to questions

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### **Q1. Do you consider it difficult for ultimate investors to exercise their voting rights?**

We consider it is difficult. Particular challenges arise in certain circumstances, for example in longer chains or where accounts are pooled. There are also practical difficulties where there is frequent trading.

### **Q2. Are there particular systems or models of holding intermediated securities which could better facilitate the passing back of direct rights for ultimate investors?**

We have no comment on this question.

### **Q3. Do you consider that the type of vote affects the extent to which ultimate investors can exercise voting rights?**

We have no comment on this question.

<sup>1</sup> <https://www.lawcom.gov.uk/project/intermediated-securities/>

**Q4. Do you consider that it is difficult for ultimate investors to obtain confirmation that their votes have been received and/or counted?**

Yes. As above, this is a particularly relevant consideration in the case of longer chains and where pooled accounts arise in a chain.

**Q5. Do you consider that the rules and practical arrangements relating to the timing of voting affect the ability of ultimate investors to vote?**

Yes. The issues around to longer chains, pooled accounts and frequent trading are relevant in this context.

**Q6. 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?**

We consider that the difficulties outlined above may be exacerbated in the context of detailed or complex proxy voting requirements.

**Q7. 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?**

We consider that the headcount test in s.899 is potentially problematic and may not be appropriate in all the circumstances where it applies. We do not consider that resolution of voting rules can adequately address such problems.

**Q8. 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?**

Yes. At the same time we consider that the introduction of a “look-through” capability could not be done in isolation and would require a review of overall law in this area, taking into account the breadth of proprietary security interests. Without such extensive review, it is likely that unforeseen consequences would result, which might frustrate the anticipated benefits of reform. We also note that ultimate investors may expressly wish to delegate management functions in relation to their investments to intermediaries. We therefore consider that derivative and/or ancillary rights of action might be more helpful or appropriate in addressing concerns. Such arrangements would also guard against the concerns around unintended consequences which might arise from general reform. A similar approach could be taken in the context of voting rights.

**Q9. In practice what, if any, are the benefits of the no look through principle?**

The “no look through” principle offers clarity and certainty.

**Q10. 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?**

Although the regulatory regime alone cannot eliminate the risks of intermediary insolvency entirely, we consider that it may mitigate or reduce many of these risks. The risks may be increased if particular rights are granted to intermediaries by the ultimate investor but this must be balanced against the need to ensure the system caters for commercial realities.

**Q11. 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?**

We consider that there is merit in this review. We note that the risks of unforeseen consequences relating to proprietary interests, priorities, set off and insolvency highlighted above must form an essential part of this consideration.

**Q12. Do you consider that the insolvency of an intermediary in an intermediated securities chain has the potential to cause problems?**

Yes. This is a particular concern in the context of pooled accounts or in cases where the intermediary has the right to use the assets in question. At the same time we note that there are efficiencies in pooling and re-use that may provide financial and other advantages to ultimate investors. It is important to ensure that relevant parties are aware of those risks, including where they arise further up the chain in a long chain scenario.

**Q13. Do you consider that there is uncertainty about how assets would be distributed in the event of an intermediary’s insolvency?**

We consider that it would be beneficial to provide greater clarity around the rateable distribution of pooled accounts where there is no agreed alternative distribution on shortfall.

**Q14. Do you consider that there is a need for better education of ultimate investors about the risks of an intermediary's insolvency, and better awareness about the application of the Financial Services Compensation Scheme?**

See above.

**Q15. What could be done to reduce the exposure of ultimate investors in the event of an intermediary's insolvency?**

See above.

**Q16. 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?**

We consider that is clear under Scots law that set off is not possible between an ultimate investor and an issuing company. It may be specifically prevented between the issuing company and the first level owner/trustee under the terms of the trust arrangement, unless the counterclaim of the issuing company is addressed to the first level owner in its capacity as trustee. At the same time, we are not aware that this causes particular problems in practice.

**Q17. 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?**

We note that the concept of equitable ownership does not exist in Scots law and accordingly the potential disparity does not have the same significance under Scots law. New general rules regarding ownership of the securities in question (eg those in CREST) could be introduced to provide protection to both parties.

**Q18. 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?**

See above. Scots law is different in this area as there is no concept of equitable interest and the Law of Property Act 1925 is not applicable. At the same time, parallel issues of formality can arise under the requirements that a trust declared by a person over their own assets must be in writing and that notice of an assignation (assignment under English law) of a right must be given to the relevant counterparty for the assignation to take effect.

**Q19. Do you consider that distributed ledger technology has the potential to facilitate the exercise of shareholder rights?**

Yes. However, rules would be needed to ensure that the effect of any DLT actions and how they would be evidenced were clear if this was not already dealt with in sufficient detail by the governing contract.,

**Q20. 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.**

We have no comment on this question.

**Q21. Has the market started to prepare for dematerialisation that would be required under CSDR?**

We have no comment on this question.

**Q22. 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?**

We are concerned that alternative approaches may create a risk of confusion in relation to other parts of property and insolvency law. Our preference would be to use the CREST model to replace the legislation relating to current ownership mechanisms as this has been seen to work well.

**Q23. Are there concerns about imposing dematerialisation on long-time shareholders currently holding paper certificates, when they may not be confident users of technology?**

We have no comment on this question.

**Q24. 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.**

Although financial regulation is reserved to the UK Parliament, the interaction with property law and related laws around proprietary interests (such as trusts, set-off and personal and partnership insolvency law) mean that interaction with devolved areas of law is an important consideration. It is of particular importance

to note that the concept of equity is not recognised in Scots law and therefore rules around equitable interests are not an appropriate way to address issues in a Scottish context. Although trusts do exist, the law which governs them is quite different – for example trustees do not have direct a proprietary interest in trust assets. This means, for example, that a solution predicated upon conferring a direct equitable interest to “bridge the gap” between the top and bottom of the chain would fail as a matter of Scots law.

It also necessitates an appreciation of the distinction between real and personal rights as in an intermediary chain, trust beneficiaries have only personal rights and no direct interest in the shares is recognised.

It is possible that an English trust could be created in relation to Scottish shares and this would be recognised by the Scottish courts in principle. However, there are exception to this set out in the Recognition of Trusts Act 1987 and practitioners have identified a number of uncertainties in the legislation. Both as a matter of principle and practice, we do not therefore consider that this offers an appropriate solution.

#### **Q25. What other jurisdictions should we consider and why?**

We have no comment on this question.

#### **Q26. We welcome suggestions from consultees as to other issues which arise in practice which should be included in our scoping study.**

We consider that it will be necessary to consider all (or at least competing) proprietary interests as a whole if changes to any specific set of proprietary interests is in contemplation.

#### **Q27. 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?**

We have no comment on this question.

#### **Q28. 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?**

We have no comment on this question.

**Q29. 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?**

We have no comment on this question.

**For further information, please contact:**

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