Cambridge Law Journal, **83(3)**, November 2024, pp. 519–548
doi:10.1017/S0008197324000515

DIGITISING THE UK SECURITIES MARKET: THE CASE AGAINST AND A PROPOSAL TO ENFRANCHISE INDIRECT INVESTORS

EVA MICHELER* AND ELENA CHRISTINE ZACCARIA**

ABSTRACT. *A taskforce, appointed by HM Treasury, has recently proposed legislation to eliminate certificated (paper) shares and to require the investors currently holding paper shares to hold them indirectly through nominees. It has also suggested that disclosure combined with a common messaging protocol will enable the market to improve the ability of indirect shareholders to exercise their rights. In this paper we make a case against legislation eliminating paper certificates. We argue that the industry does not need the Government to remove paper certificates. If they want paper certificates to disappear, they should develop a model for holding uncertificated shares directly that is affordable for retail investors. The Government should nevertheless intervene. It should encourage the Competition and Markets Authority to investigate the price structure of accounts for holding uncertificated shares directly with CREST, which operates as a monopoly provider for such accounts in the UK. We further explain that the current system for holding shares indirectly disenfranchises investors and argue that this not only affects investors but also deprives issuers of oversight of their governance. We use empirical evidence to explain that disclosure combined with a common messaging protocol is unlikely to cause the market to develop a system that better enfranchises indirect shareholders. Consequently, we propose legislation to give indirect investors better access to shareholder rights.*

KEYWORDS: digitising securities, corporate governance, intermediated securities, blockchain technology, investor protection.

*Professor of Law at the London School of Economics and Political Science (LSE), Houghton St, WC2A 2AE, London. Email: e.micheler@lse.ac.uk.
**Senior Lecturer at Brunel University London, Kingston Ln, Uxbridge UB8 3PH, London. Email: elena.zaccaria@brunel.ac.uk. This article relies on the empirical results acquired from 18 interviewees. We sincerely thank each of them for having taken the time to share with us their experience and opinions on the different shareholding methods. We are very grateful to Vanessa Knapp for her invaluable and extremely useful comments on the draft of this paper and to Despoina Farmaki for her precious assistance during our research. We would also like to thank the anonymous referees for their valuable comments. Any errors are entirely our own. Last, but not least, our gratitude is extended to the British Academy and the Department for Business, Energy and Industrial Strategy for supporting our research and making this project possible (ref. SRG19\190474).

I. Introduction

In July 2022, the UK Government set up the Digitisation Taskforce to eliminate paper certificates and to improve the current system of indirect share ownership.[1] In July 2023, the Digitisation Taskforce proposed to eliminate certificated shares, requiring existing holders of these shares to move them to indirect accounts. It also suggested that disclosure and a common messaging protocol will cause the market to make improvements to the position of indirect shareholders.[2]

The present article criticises this approach and adds to the debate in two ways. Firstly, it is the first academic contribution to examine the most recent initiative advanced in this area and to connect competition law with the topic of intermediated securities. Secondly, the article integrates empirical evidence into the academic legal analysis of the topic. To our knowledge, this is the first academic article to do so.[3] The existing literature discusses the advantages and disadvantages of the current system but does not support the analysis with empirical evidence.[4] With funding from the British Academy, we conducted 18 semi-structured interviews with legal practitioners, investors, custodians, registrars, technology experts and voting agents.

We selected our interviewees on the basis of their respective roles and expertise. Initial contact was made via email and informed consent was obtained, ensuring confidentiality. We prepared a questionnaire, for which we received ethical approval by the grant's host institution, covering: (1) the ability of investors to vote and exercise other corporate rights; (2) *omnibus* accounts and stock lending; (3) shortfalls (losses due to insolvency, negligence, or fraud by intermediaries); and (4) the role of technology. Interviews, conducted online, lasted 60 to 90 minutes and the questions were sent in advance. Some interviews required follow-up

[1] HM Treasury, "Policy Paper: Digitisation Taskforce – Terms of Reference", available at https://www.gov.uk/government/publications/digitisation-taskforce/155008b5-d6e1-458d-aa67-772b776fe632 (last accessed 18 September 2024).

[2] Digitisation Taskforce, "Digitisation Taskforce – Interim Report" (July 2023), 10, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1168398/digitisation_report.pdf (last accessed 19 September 2024).

[3] The Government conducted an empirical study in 2016: Department for Business, Innovation and Skills (BIS), "Exploring the Intermediated Shareholding Model" (BIS Research Paper No. 261, 2016), available at https://assets.publishing.service.gov.uk/media/5a80e45040f0b62305b8dbbb/bis-16-20-intermediated-shareholding-model.pdf (last accessed 19 September 2024). Our own empirical work integrates the results of this study and of the consultations by the Law Commission for its scoping study on intermediated securities: Law Commission, "Intermediated Securities: Who Owns Your Shares? A Scoping Paper" (November 2020), available at https://cloud-platform-e218f50a4812967ba1215eaecede923f.s3.amazonaws.com/uploads/sites/30/2020/11/Law-Commission-Intermediated-Securities-Scoping-Paper-1.pdf (last accessed 19 September 2024).

[4] See e.g. J. Benjamin, *Interests in Securities: A Proprietary Law Analysis of the International Securities Markets* (Oxford 2000); L. Gullifer, "Ownership of Securities: The Problems Caused by Intermediation" in L. Gullifer and J. Payne (eds.), *Intermediated Securities: Legal Problems and Practical Issues* (Oxford and Portland 2010), ch. 1, 1–31; J. Benjamin and L. Gullifer, "Stewardship and Collateral: The Advantages and Disadvantages of the No Look Through System" in L. Gullifer and J. Payne (eds.), *Intermediation and Beyond* (Oxford 2019), ch. 11, 215–35; E. Micheler, "Custody Chains and Asset Values: Why Crypto-Securities Are Worth Contemplating" [2015] 74 C.L.J. 505, 510.

sessions for additional clarification and depth. Although limited in number, the interviewees are representative of standard market practices due to their respective professional backgrounds and the dominance of a few large custodians with similar business models in the market. We have anonymised their contributions and refer to them by number (interviewee 1, interviewee 2 and so forth).[5] The interviews have enabled us to develop a deeper and empirically grounded understanding of the current model of holding securities.

In the following sections, we firstly explain that shares in the UK are currently held in one of four forms. We will show that only certificated shareholders and those who hold uncertificated shares directly either as participants in the central securities depository in the United Kingdom (CREST) or as sponsored CREST members have full access to the rights associated with their shares. Investors who hold shares through nominees and custodian do not have the same rights.

In Section III, we discuss the Digitisation Taskforce and its Interim Report. This is followed by Section IV, where we use our empirical evidence to analyse the ability of the market to achieve reform justifying the elimination of paper certificates and improving the intermediated holding model.

In Section V, we examine the Government's previous and failed attempt to encourage the industry to carry out reform. Section VI shows that the Shareholder Rights Directive II,[6] which imposes mandatory requirements on the industry, triggered reform, but did not improve the ability of all investors to enforce claims. The Directive does not apply to retail investors.

Section VII argues that a lack of competition may explain the poor quality of the current infrastructure. We observe that operational availability of enforcement rights is important for the oversight of issuers and argue that it would be wrong to rely exclusively on large institutional investors to oversee them.

Section VIII discusses the solutions proposed by the Digitisation Taskforce, the "Industry Group" and the Law Commission. It concludes that the "proof is in the pudding". The market does not need the Government to eliminate paper certificates. If it offers an attractive model for holding uncertificated shares directly, investors will give up

[5] Interviewees identified by role and number: interviewee 1 (legal practitioner advising custodians), interviewee 2 (proxy voting adviser), interviewee 3 (legal practitioner advising regulators), interviewee 4 (custodian I), interviewee 5 (legal practitioner advising custodians), interviewee 6 (legal practitioner advising custodians), interviewee 7 (legal practitioner advising custodians), interviewee 8 (legal practitioner advising custodians), interviewee 9 (legal practitioner advising custodians), interviewee 10 (custodian II), interviewee 11 (legal practitioner advising custodians and institutional investors), interviewee 12 (institutional investor I), interviewee 13 (institutional investor II), interviewee 14 (registrar I), interviewee 15 (registrar II), interviewee 16 (retail investor), interviewee 17 (investor communications expert) and interviewee 18 (legal practitioner advising shareholder litigants).

[6] Directive (EU) No 2017/828 (OJ 2017 L 132 p.1) (hereafter, SRD II) amended Directive (EC) No 2007/36 (OJ 2007 L 184 p.17) (hereafter, SRD).

their certificates. To facilitate this, we propose that the Competition and Markets Authority (CMA) investigate the excessively high fees charged for sponsored CREST accounts. We further believe that legislative intervention is required to impose a duty on custodians to facilitate the exercise of shareholder rights by intermediated investors. We also support the Law Commission's proposal to enfranchise ultimate investors by amending the Companies Act (CA) 2006 and the Financial Services and Markets Act (FSMA) 2000.

II. Four Forms of Holding Shares

A. Certificated Shares

Certificated shares are the traditional method through which investors hold shares. Holders of certificated shares have their name entered on the register of members of the issuer and receive a paper certificate evidencing this entry. They are considered legal owners and can hence exercise all the rights associated with their shares.[7] They receive dividends directly from the issuer, can vote and enforce any claims they have against the issuer.

Mark Austin estimated that issuers in the FTSE 100 and in the Premium Equity Commercial Companies segment of the Official List currently issue three per cent or less of their share capital in certificated form.[8] For the alternative investment market (AIM) companies there appear to be more certificated holders.[9] The Law Commission reports that registrars, who assist listed companies in maintaining their share register, indicate that there are in excess of 10 million investors who hold their shares in certificated form.[10] We understand that holders of certificated shares are typically retail investors.[11] As already mentioned, the Digitisation Taskforce has proposed legislation to eliminate this form of holding shares.

[7] CA 2006, ss. 112–113; *J. Sainsbury Plc v O'Connor (Inspector of Taxes)* [1991] 1 W.L.R. 963, 977 (C.A.) (Nourse L.J.).

[8] HM Treasury, "UK Secondary Capital Raising Review" (July 2022), [10.27], available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1091566/SCRR_Report__July_2022_final_.pdf (last accessed 19 September 2024).

[9] Ibid.

[10] Law Commission, "Intermediated Securities", [8.6].

[11] See e.g. "Where's Left for a CREST Account? CSD Twist the Knife!", available at https://www.lemonfool.co.uk/viewtopic.php?t=17710#google_vignette (last accessed 19 September 2024); M. Lee, "Paper Stock Certificates: Where Have They Gone?", available at https://www.investopedia.com/ask/answers/06/stockcertificate.asp (last accessed 19 September 2024); L. Walters, "How to Prepare for the Scrapping of Paper Share Certificates", available at https://www.investorschronicle.co.uk/ideas/2024/01/02/how-to-prepare-for-the-scrapping-of-paper-share-certificates/ (last accessed 19 September 2024); see also Letter from C. Henderson and M. Bentley to D. Flint (8 September 2023), [27], available at https://www.sharesoc.org/wp-content/uploads/2023/09/Flint-Report-Joint-response-from-UKSA-and-Sharesoc-2023-09-08.pdf (last accessed 19 September 2024).

B. Uncertificated Shares (CREST Participants and Sponsored Members)

Uncertificated shares are administered through the central register for all uncertificated shares in the UK, CREST,[12] which is operated by Euroclear UK & International.[13] If an investor decides to hold shares directly in uncertificated form, they can either become a CREST participant or a personal CREST member.[14]

CREST participants have a secure connection through which they send messages instructing the system to transfer securities to someone else's account, for example. They connect to their computer a hardware unit supplied by CREST, which contains unique software keys.[15] The unit authenticates the messages that are sent between a participant and the CREST system. Personal CREST members are investors who have a CREST account in their own name but operate that account through a CREST participant, who sponsors them.

In the same way as certificated shares, an investor who holds uncertificated shares directly with CREST is considered the legal owner of these shares and can exercise all rights associated with them against the issuer. When CREST was first set up, the taskforce responsible for its design and implementation stressed that the sponsored membership was important for enfranchising smaller investors.[16]

C. Uncertificated Shares Held Through an Intermediated Account

The fourth option is for an investor to hold shares in uncertificated form but indirectly through a nominee account administered by a custodian. This form of holding shares increased after the introduction of uncertificated shares and has become the most common form for holding shares not only in the UK but world-wide.[17]

In this model, the names of individual investors are not recorded on the shareholder register. Instead, CREST records the names of nominees. The custodians who operate the intermediated account directly with CREST

[12] CREST stands for Certificateless Registry for Electronic Share Transfer.

[13] "Euroclear UK & International: We Strive to Deliver What You Need", available at https://www.euroclear.com/services/en/provider-homepage/euroclear-uk-international.html (last accessed 27 July 2024).

[14] HM Treasury, "UK Secondary Capital Raising Review", [10.23]; "Private Investor Services: Euroclear UK & International", available at https://www.euroclear.com/services/en/private-investor-services/private-investor-services-euroclear-uk-and-international.html (last accessed 19 September 2024).

[15] Euroclear, "CREST Reference Manual" (October 2023), 40, available at https://my.euroclear.com/dam/EUI/Public/Legal%20documentation/CREST%20Reference%20Manual/2023-10-02-CREST-Reference-Manual-Registrar-Service-Standards-Investment-Funds-Service-clean.pdf (last accessed 27 July 2024).

[16] HM Treasury, "UK Secondary Capital Raising Review", [10.21].

[17] BIS, "The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report" (July 2012), [3.6], available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf (last accessed 19 September 2024); UNIDROIT, "Preliminary Draft Convention on Harmonised Substantive Rules Regarding Securities Held with an Intermediary: Explanatory Notes" (Doc. 19, December 2004), [2] and [2.1], available at https://www.unidroit.org/english/documents/2004/study78/s-78-019-e.pdf (last accessed 19 September 2024); HM Treasury, "UK Secondary Capital Raising Review", [10.26].

often hold accounts for a further level of custodians. Sometimes there are several levels of custodians operating between issuers and ultimate investors.[18]

As we have pointed out, only registered shareholders have legal ownership and can exercise rights directly against the company.[19] Intermediated investors have a mere beneficial right in the interests held by their immediate custodians[20] and consequently face legal and operational barriers to the exercise and enforcement of their rights.

Legal barriers arise from section 112 of the CA 2006, which requires companies to accept as shareholders only those individuals whose names are entered on the register of members. Investors who hold shares through one or more intermediaries, consequently, have no rights to vote, attend meetings, or enforce their rights against an issuer.[21] In theory, custodians should pass rights to ultimate investors,[22] but custody agreements can exempt them from relaying information and facilitating voting, or allow them to charge expensive fees for this service.[23] Intermediated accounts can also undermine the ability of investors to enforce rights against issuers. For example, in 2014 the High Court held that an intermediated investor did not have standing to enforce a remedy under section 98 of the CA 2006 (re-registering a public company as private).[24] Due to its similar wording, it is likely that courts will reach the same conclusion for section 633 of the CA 2006 (variation of class rights).[25] Intermediated investors are not able to vote on schemes of arrangement (section 899 of the CA 2006).[26] Concerns have also been

[18] J. Benjamin, *Financial Law* (Oxford 2007), [19.04]; see also L. Gullifer (ed.), *Goode and Gullifer on Legal Problems of Credit and Security*, 6th ed. (London 2017), [6-08]; L. Gullifer and J. Payne, "Introduction" in Gullifer and Payne (eds.), *Intermediation and Beyond*, ch. 1, 5–11.

[19] See note 7 above.

[20] M. Yates and G. Montagu, *The Law of Global Custody: Legal Risk Management in Securities Investment and Collateral*, 4th ed. (West Sussex 2013), 128; G. Morton, "Historical Introduction: The Growth of Intermediation and Development of Legal Analysis of Intermediated Securities" in Gullifer and Payne (eds.), *Intermediation and Beyond*, ch. 2, 27–28; Benjamin, *Interests in Securities*, [19.08]–[19.11]; Gullifer (ed.), *Goode and Gullifer*, [6.18]; Financial Markets Law Committee, "Issue 3 – Property Interests in Investment Securities: Analysis of the Need for and Nature of Legislation Relating to Property Interests in Indirectly Held Investment Securities, with a Statement of Principles for an Investment Securities Statute" (July 2004), [6.1], available at https://fmlc.org/wp-content/uploads/2018/02/Issue-3-Property-Interests-in-Investment-Securities.pdf (last accessed 19 September 2024).

[21] Law Commission, "Intermediated Securities", [3.11]–[3.16].

[22] Yates and Montagu, *Law of Global Custody*, 128.

[23] Law Commission, "Intermediated Securities", [5.73].

[24] *In re DNick Holding plc; Eckerle and others v Wickeder Westfalenstahl GmbH and another* [2013] EWHC 68 (Ch), [2014] Ch. 196, 209–11 (Norris J.). For an analysis of this case, see e.g. Micheler, "Custody Chains and Asset Values", 515–19; M. Ooi, "Re-enfranchising the Investor of Intermediated Securities" (2020) 16 Journal of Private International Law 69.

[25] See on this point Law Commission, "Intermediated Securities", [5.73].

[26] *Re Sirius Minerals plc* [2020] EWHC 1447 (Ch), at [22] (Fancourt J.); for an analysis of this case, see ibid., at [4.17]–[4.23]; on the effect of CA 2006, s. 899, on ultimate investors, see also the Unilever's proposed plan of 2018 to relocate the headquarters of Unilever plc from London to Rotterdam. The plan received considerable media attention due to the disenfranchisement of individual investors from voting on this scheme of arrangement: see e.g. D. Thorpe, "Pimfa Warns Investors Will Be Locked Out of Unilever Vote", available at https://www.ftadviser.com/investments/2018/10/02/pimfa-warns-

raised over the difficulties experienced by ultimate investors to enforce sections 338 (power to require circulation of resolutions for AGMs),[27] 570 and 571 (disapplication of pre-emption rights)[28] of the CA 2006 and also section 90A of the FSMA 2000.[29]

The operational problems caused by the current system are due to the complexity and opacity of the holding chain. There are numerous layers of intermediation (often spanning multiple jurisdictions). Neither ultimate investors nor issuers know the identity of all the intermediaries operating along the chain.[30] We will see below that this structure limits the investors' ability to benefit from the rights associated with their shares.[31]

D. Summary

The four forms through which investors can hold shares differ substantially. Shareholders of certificated shares and shareholders of uncertificated shares, who have their names entered directly on the CREST register (as participants or as sponsored members), benefit from the full set of rights associated with their shares. Shareholders who hold shares indirectly through custodians do not.[32] In the following subsection, we will discuss the proposal of the Digitisation Taskforce.

III. The Digitisation Taskforce

We have already reported that HM Treasury has appointed a Digitisation Taskforce.[33] Its terms of reference state that the existence of certificated

investors-will-be-locked-out-of-unilever-vote/ (last accessed 27 May 2024); ShareSoc, "Unilever Abandons Its Plans. Another Victory for Individual Shareholders", available at https://www.sharesoc.org/sharesoc-news/unilever-abandons-its-plans/ (last accessed 27 May 2024). While the plan was later abandoned by Unilever, it is indeed another example of a "scheme[] of arrangement on which ultimate investors wished to have their voices heard but were prevented by the tests in section 899": ibid., at [4.23].

[27] This provision grants members the power to require circulation of resolutions for AGMs. The Law Commission emphasised that "[s]ection 153 of the CA 2006 provides a procedure by which ultimate investors can make such a request[, but] stakeholders including the Share Centre have mentioned that this process does not facilitate the exercise of these rights by ultimate investors": Law Commission, "Intermediated Securities", [5.73].

[28] Ibid.

[29] Under FSMA 2000, s. 90A, indirect investors are entitled to compensation for losses suffered due to false or misleading statements made by companies: *SL Claimants v Tesco plc; MLB Claimants v Tesco plc* [2019] EWHC 2858 (Ch), [2020] Bus. L.R. 250. However, a legal practitioner advising shareholder litigants (interviewee 18) mentioned that indirect investors experience difficulties proving their status due to the complexity of the holding chain and the lack of incentives for intermediaries to assist them (often due to conflict of interest); see also *Various Claimants v G4S Plc* [2023] EWHC 2863 (Ch), where intermediated investors claiming under FSMA 2000, s. 90A and sched. 10A, were denied access to the company's documents.

[30] E. Micheler, "Intermediated Securities from the Perspective of Investors: Problems, Quick Fixes and Long-term Solutions" in Gullifer and Payne (eds.) *Intermediation and Beyond*, ch. 12, 237–58.

[31] See Section IV(C) below.

[32] See also HM Treasury, "UK Secondary Capital Raising Review", [10.68].

[33] HM Treasury, "Policy Paper"; UK Cabinet Office, "Brexit Opportunities: Regulatory Reforms" (September 2021), available at https://assets.publishing.service.gov.uk/media/6143351bd3bf7f05b4562b49/Brexit_opportunities-_regulatory_reforms.pdf (last accessed 19 September 2024).

shares causes costly arrangements but neither quantify nor substantiate this point.[34] The Taskforce's "Interim Report" concludes that, for listed companies, paper certificates need to be removed "as a matter of urgency".[35] It recommends legislation abolishing these shares and requiring existing holders of certificated (paper) shares in listed companies to hold these through a nominee. We have seen above that this would substantially modify the legal position of existing holders of certificated shares, transforming them from direct legal owners into intermediated beneficial owners.

The proposal deviates from a model advanced by the industry at an earlier stage, which envisaged that certificates be replaced with "unique reference number[s]".[36] These were going to be used, together with other security information, to authenticate transactions on behalf of shareholders.[37] The registrars, who, in addition to CREST, assist issuers with maintaining shareholder registers, would provide digital access to the register that they maintain. The earlier proposal would have enabled the current holders of certificated shares to retain legal ownership albeit through a digital account administered by registrars, which might, with time, have attracted fees.

With a view to improving the current intermediated system of shareholder ownership, the Taskforce recommends legislation requiring intermediaries (1) to be transparent about the services they offer and (2) to use a common messaging protocol that enables messages to be distributed between issuers, intermediaries and investors. Otherwise, the Taskforce believes that we should rely on the market to make improvements.[38]

IV. The Ability of the Market to Make Improvements

A. Introduction

In this section, we examine the problems affecting the current market in more detail and assess its ability to make improvements. We base this assessment on our empirical study. In addition to our empirical results, the section also contains our own assessment and analysis, which will be clearly identified in the text.

It has already been mentioned that CREST operates in the market as the register for all uncertificated shares issued in the UK. We have also said that there are registrars, who assist companies in maintaining their respective shareholder registers. Registrars mirror the CREST register for

[34] HM Treasury, "Policy Paper"; see also HM Treasury, "UK Secondary Capital Raising Review", [10.10].
[35] Digitisation Taskforce, "Interim Report", 10.
[36] "Proposed Structure of Dematerialised UK Share Registers" (2014), 4, available at http://www-uk.computershare.com/webcontent/Doc.aspx?docid=%7Bdce7977c-c416-46df-8839-092820cd2869%7D (last accessed 19 September 2024), as cited in Law Commission, "Intermediated Securities", 150, fn. 95.
[37] Ibid.
[38] Digitisation Taskforce, "Interim Report".

uncertificated shares and manage the register for shares that are held in certificated form. In addition, there are custodians, who operate nominee accounts either with CREST directly or through other custodians.

We will see that the market for direct CREST accounts suffers from a lack of competition. The providers of intermediated accounts also appear to lack competitive spirit. This may prevent the market from providing retail investors with a service that gives them full access to the corporate rights associated with their shares. Institutional investors and high value private investors are in a better position. They can access direct forms of holding securities. Recent legislative reforms have improved the ability of institutional investors with an intermediated account to vote but have unfortunately not improved their access to enforcing rights in court.

B. CREST Participants and Sponsored Members

CREST operates the only central register for uncertificated securities on the basis of a licence by the Government, which was issued under the Uncertificated Securities Regulations 2001.[39] One interviewee pointed out that, in their view, this monopoly status increases the level of operational risks.[40] Fees for CREST participants are high. They pay an account charge of at least GBP 650 per month for low volume users and GBP 1250 per month for standard users. In addition, there are service charges for individual transactions such as, for example, settlement charges, own account transfer charges, non-settling own account transfer charges, asset maintenance charges, fee per line charges, netting fees, Central Counterparty fees, or settlement discipline charges.[41]

The market for sponsored accounts suffers from a similar lack of competition. There are only a few operators offering CREST-sponsored accounts to retail investors.[42] CREST membership is now rarely used by them. The number of individuals holding securities directly through CREST had decreased from approximately 50,000 members in 2003 to 4,200 members in 2020.[43] None of the major investment platforms offer a direct CREST account.[44] Two registrars and one retail investor told us

[39] SI 2001/3755.

[40] Interviewee 4 also questions whether the central securities depository should be owned and operated by the Government (as it was in the past).

[41] Euroclear, "Euroclear UK & International Tariff" (August 2024), available at https://my.euroclear.com/dam/EUI/Public/Tariff%20documentation/EUI%20tariff/EUI-Tariff-Brochure-October-2023.pdf (last accessed 19 September 2024); "Annex – Example fee calculations" of this document (at 37–42) illustrates how fees are calculated.

[42] Law Commission, "Intermediated Securities", [2.58]; Interviewee 7.

[43] Law Commission, "Intermediated Securities", [2.58]; see also BIS, "Exploring the Intermediated Shareholding Model", [15]–[16].

[44] Memo on file with authors; see also e.g. R. Lawson, "What Is Personal Crest Membership?" (June 2015), available at https://www.sharesoc.org/investor-academy/advanced-topics/personal-crest-accounts/ (last accessed 19 June 2024); "Where's Left for a CREST Account?". CREST accounts do not appear to benefit from the tax benefits associated with self-invested personal pension plans and individual

that stockbrokers use intermediation as the default option in their standard terms, without informing investors about the available option to hold shares directly.[45]

In 2020, the Law Commission identified only four brokers that offered personal CREST accounts at annual fees ranging between approximately GBP 400 and GBP 500.[46] This was confirmed by one retail investor who told us that in 2019 he switched from a sponsored direct CREST account to a "nominee account" when the annual account fee charged by the broker had increased from approximately GBP 10 to GBP 500.[47] Since then, fees have increased further. We identified and contacted three brokers, who currently offer this service, and requested information about their respective tariffs. Fees now range between GBP 2000 and GBP 3000 per annum.[48] Two of the brokers also require a minimum portfolio size ranging between GBP 500,000 and GBP 1,000,000, respectively.[49]

The reluctance of stockbrokers and investment platforms to offer direct CREST membership is sometimes attributed to the administrative burden associated with these accounts.[50] We note that the CREST tariff charges participants GBP 120 per year as a fee for maintaining a personal account.[51] This is high but also suggests that brokers are requesting a significant mark-up. We also learnt that intermediation provides firms with a greater control over the securities, optimising the speed at which transactions are processed and facilitating certain activities generally associated with custody, such as stock lending and high frequency trading.[52] Service providers argue, unsurprisingly, that the demand for this model is limited.[53]

The picture is different for institutional and large-scale private investors. Some institutional investors (e.g. mature sovereign wealth funds, central banks, or certain government institutions) set up their own CREST

savings accounts: "Personal Pensions", available at https://www.gov.uk/personal-pensions-your-rights (last accessed 27 July 2024); Individual Savings Account Regulations 1998, SI 1998/1870.

[45] Interviewees 14, 15 and 16; Letter from M. Sansom to Commercial and Common Law Team, Law Commission (5 November 2019), 1, available at https://www.cgi.org.uk/assets/files/branches/Registrars-Group/intermediated-securities-response-on-behalf-of-the-registrars-group-final.pdf (last accessed 19 September 2024); BIS, "Exploring the Intermediated Shareholding Model", 80, 133; UK Shareholders' Association ("UKSA"), "Position Paper on Dematerialisation" (24 December 2022), [61], [67]–[68.2], available at https://www.uksa.org.uk/sites/default/files/2022-12/UKSA-position-on-dematerialisation-published-2022-12-24.pdf (last accessed 19 September 2024).

[46] Law Commission, "Intermediated Securities", 29, fn. 65; Interviewee 16; see also UKSA, "Position Paper on Dematerialisation", [60].

[47] Interviewee 16.

[48] Memo on file with authors.

[49] Ibid.; Euroclear expressly states that personal CREST membership is more suitable for "larger clients", as it is "more expensive" than the option of using nominee accounts: Euroclear, "Euroclear UK & International: Personal Membership", available at https://www.euroclear.com/content/dam/euroclear/operational-public/EUI/MA1593_EUIntl_Personal_Membership.pdf (last accessed 19 September 2024).

[50] BIS, "Exploring the Intermediated Shareholding Model", 80.

[51] Euroclear UK & International, Our tariff, n 41 above, 9.

[52] Interviewees 2, 4 and 16; see also P. Davies, "Investment Chains and Corporate Governance" in Gullifer and Payne (eds.), *Intermediation and Beyond*, ch. 10, 190.

[53] BIS, "Exploring the Intermediated Shareholding Model", 80.

accounts and grant providers a power of attorney to operate such accounts on a day-to-day basis.[54] They sometimes also set up a contingency plan which requires the appointment of another provider that will step in and take over as an account operator in those circumstances where the first provider becomes insolvent. These plans "pop up" from time to time and are intended to avoid any type of disruption including the risk of a break down in communications with CREST.[55]

It is possible that the lack of bargaining power of retail investors, together with the lack of competition in this market, could have led to a situation where retail investors have been priced out of holding uncertificated securities directly. There is also a risk that the lack of competition may not give Euroclear and/or its participants an incentive to develop a business model improving the *status quo*.

C. Intermediated Accounts

1. Introduction

In the following subsections, we analyse the market for intermediated shareholdings. For this, we have collected empirical evidence. We will discuss pooling, securities lending, technology, the resulting levels of service standards and the attitudes of custodians.

2. Pooling

In a custody chain, each custodian records how many securities they have undertaken to hold for each of their clients. They then ensure that they themselves hold a corresponding amount of such securities at the next level. Custodians prefer to hold securities at this next level on a pooled or *omnibus* basis, where they hold the shares for several of their clients in the same account.

Custodians charge lower fees for pooled accounts.[56] Pooling, however, has disadvantages. It creates a structure that is prone to errors in the handling of client voting instructions, makes it difficult (if not impossible) for issuers to link votes to specific investors, prevents investors from ensuring that their instructions have been voted correctly,[57] and may significantly limit the client's voting choices in those circumstances where intermediaries have terms whereby they vote

[54] Interviewee 4.
[55] Ibid.
[56] See also BIS, "Exploring the Intermediated Shareholding Model", 16.
[57] Personal Investment Management & Financial Advice Association (PIMFA) Response to Law Commission Intermediated Securities – Call for Evidence Background (28 October 2019), 4–5, available at https://www.pimfa.co.uk/category/pimfa-consultation-responses/year/2019-consultation-responses-year/ (last accessed 19 September 2024).

the same way for all the shares in the pool.[58] Unfortunately, investors are usually not fully aware of these disadvantages.[59]

Our study shows that, in practice, *omnibus* accounts have become the default market standard.[60] Custodians sometimes offer segregated or designated accounts, but these are more likely to be available to institutional than to retail investors.[61] The BIS study found that most retail investors are not aware that securities can be held in designated accounts.[62]

Moreover, it appears that segregation in any step of the custody chain does not necessarily resolve the operational problems that arise with *omnibus* accounts. We were told that, when clients opt in favour of a segregated account, corporate rights may be jeopardised when their immediate custodian agrees to hold the shares in an *omnibus* account with a sub-custodian placed further up the chain.[63] We have also been told that investors are not always fully aware of these implications of pooling.[64]

3. *Securities lending*

Securities lending generates income for investors, who are paid by the borrower for making their securities available to them. We have been told that pension funds, in particular, benefit from securities lending.[65] Custodians also make money by charging fees for their services in organising lending for investors, allowing them to charge lower fees.[66]

[58] Investors whose securities are commingled in an *omnibus* account are also more exposed to potential losses in the event of insolvency of one of the intermediaries in the chain.

[59] ESMA, "EMIR Review Report No.3: Review on the Segregation and Portability Requirements" (ESMA/2015/1253, 13 August 2015), 6, available at https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1253_-_emir_review_report_no.3_on_segregation_and_portability.pdf (last accessed 19 September 2024).

[60] Interviewees 2, 12, 13 and 16; see also e.g. RBC, *Europe Limited, Terms of Business for Investment and Custody Services*, paragraph 7.20(a), available at https://www.rbcwealthmanagement.com/assets/wp-content/uploads/documents/legal/terms-of-business-for-investment-and-custody-services-rbcel.pdf (last accessed 19 September 2024); BNY Mellon, "Frequently Asked Questions: Omnibus and Segregated Account Offering for European Union (EU) Markets" (July 2020), available at https://www.bnymellon.com/content/dam/bnymellon/documents/pdf/emea/csdr-omnibus-and-segregated-account-offering-for-eu-markets-faqs.pdf.coredownload.pdf (last accessed 19 September 2024); HSBC, "CSD Regulation Article 38", available at https://www.gbm.hsbc.com/financial-regulation/csdr/account-segregation (last accessed 19 September 2024).

[61] Davies, "Investment Chains", 201–02.

[62] BIS, "Exploring the Intermediated Shareholding Model", 72.

[63] Interviewees 1, 8 and 9.

[64] Interviewees 4 and 16; see also e.g. BIS, "Exploring the Intermediated Shareholding Model", 32; Law Commission, "Intermediated Securities: Call for Evidence" (August 2019), [1.36], available at https://cloud-platform-e218f50a4812967ba1215eaecede923f.s3.amazonaws.com/uploads/sites/30/2019/08/6.5925_LC_Intermediated-securities-call-for-evidence-web.pdf (last accessed 19 September 2024); PIMFA, Response to Law Commission Intermediated Securities – Call for Evidence Background, 2.

[65] Interviewees 2, 3, 5, 6, 7, 8, 9 and 10; interviewee 2 mentioned that securities lending can be incompatible with engagement policies of institutional investors.

[66] More generally, lending benefits financial markets by making available liquidity: P. Paech, "Securities, Intermediation and the Blockchain: An Inevitable Choice Between Liquidity and Legal Certainty?" (2016) 21 Uniform Law Review 612.

Lending also constitutes a source of money-market funding and plays an important role in short selling, facilitating more accurate market pricing.[67]

Like pooling, lending has disadvantages for investors. They temporarily lose ownership of the shares and need to recall them to exercise voting rights. A recall request is passed on from one custodian to the next. Information can get lost, such that a custodian further down the chain does not receive details on "which [shares] to recall and when".[68] When lending is arranged by a custodian close to the record date for a shareholder meeting, lenders may send voting instructions before they have received confirmation of the completion of a lending transaction. It can then happen that borrowers also send voting instructions through their own respective custodians and that both sets of instructions reach the issuer simultaneously. This can result in over-voting.[69]

4. Technology

Unfortunately, the operational problems that complicate the exercise of corporate rights also occur when shares are held in segregated accounts and there is no lending activity. This is because several custodians need to work together, one after the other, to facilitate the exercise of rights by ultimate investors. This can entail (1) delays and errors in passing information through the chain, (2) failure to inform the investors about corporate events, (3) difficulties in receiving voting forms or links to online voting and (4) problems for investors in obtaining confirmation that their votes have been received and/or counted.[70] One interviewee explained that the reason for this is that the procedure and technology used along the custody chain can differ from one provider to another. Some firms use automated voting systems while others use manual arrangements.[71]

We have mentioned above that the Taskforce proposes to address operational problems through a common messaging protocol. We note that this could provide all levels in the chain with greater awareness of what information is needed but does not improve the procedures and systems used by each of these intermediaries.

While it would, of course, be possible for all custodians to switch over to a shared database, an individual intermediary will only make such an investment if they have an incentive to do so. The fact that some intermediaries continue to operate manual models suggests that no such

[67] We are grateful to one of our reviewers for this point.
[68] Minerva Analytics, "Minerva Nexus Background Briefing: Sustainable Securities Lending", June 2021, 6.
[69] Interviewees 2, 12 and 13.
[70] Law Commission, "Intermediated Securities", [3.1]–[3.80].
[71] Interviewee 16; UKSA, "Position Paper on Dematerialisation", [62.4]. But see R. Uddin, "Hargreaves Lansdown", *Financial Times*, available at https://www.ft.com/content/560466f0-ecf4-4c80-82f0-0705410d7fdd (last accessed 19 September 2024).

incentive is present. It is possible that they do not experience sufficient competitive pressure to improve their respective systems.

5. Low service standards

The operational problems prevailing in the custody chain are reflected in the legal documentation underpinning the industry. During our study we identified contracts according to which, "[u]nless expressly agreed in writing", intermediaries are exempt from passing information and facilitating voting.[72] Furthermore, even in circumstances where the ability of an investor to exercise corporate rights is expressly recognised by the agreement, such rights may be subject not only to the payment of an additional fee but also to a series of other conditions. For example, contracts sometimes impose tight deadlines on submitting voting instructions to the intermediary[73] or limit the investor's ability to attend shareholder meetings. Custody contracts also frequently exclude assistance with enforcing rights.[74]

6. Attitudes of custodians

In principle, the industry possesses the technical skills and means to overcome the operational problems currently troubling the intermediated infrastructure. The problem is not the lack of suitable digital technology. The problem is that intermediaries do not have sufficient incentives to develop a better business model.[75]

The Chartered Governance Institute Registrars' Group told the Law Commission that votes are more likely to be "communicated and actioned in a timely, accurate and effective manner … when a direct financial consequence hangs on the process" (e.g. in the context of takeovers or restructuring).[76] They stress that facilitating more engagement by investors is not always a priority for custodians and that it is more "a lack of will rather than process-failure which inhibits the exercise of voting rights".[77]

[72] Europe Arab Bank, "Securities Dealing and Custody Arrangement Services Agreement", [4.4], available at https://www.eabplc.com/downloads/SecuritiesDealingandCustodyArrangementServicesAgreement.pdf (last accessed 19 September 2024).

[73] RBC, *Europe Limited*, paragraph 7.17; Law Commission, "Intermediated Securities", [3.24].

[74] Micheler, "Custody Chains and Asset Values", 510.

[75] Interviewees 14, 15, 11, 6 and 7; see also UKSA, "Position Paper on Dematerialisation", [79]–[84]. The BIS concluded that intermediaries lack incentives "to improve the accuracy of voting or to deliver vote confirmation": BIS, "Exploring the Intermediated Shareholding Model", 18. Letter from Sansom to Law Commission, 4, notes that intermediaries have no incentive to make clients more aware "of their entitlement to exercise votes".

[76] Law Commission, "Intermediated Securities", [3.70]; Letter from Sansom to Law Commission, 2–3.

[77] Letter from Sansom to Law Commission, 6; see also The City of London Law Society, "Response of the Joint Working Party of the City of London Law Society Company Law, Financial Law and Regulatory Law Committees to the Law Commission's Consultation on Intermediated Securities" (8 November

D. Summary

It is possible that Euroclear UK & International and the few intermediaries offering CREST-sponsored accounts do not experience a sufficiently competitive environment. The reason for this could be that retail investors do not have enough bargaining power to negotiate reasonable fees that would allow them to connect to CREST through a sponsor. We believe that the CMA should investigate this further.

Intermediated services are provided either through segregated or pooled accounts. The pooling of accounts and securities lending, while making custody cheaper, trigger operational problems, which severely undermine the ability of investors to exercise rights. Unfortunately, operational problems also arise with segregated accounts that do not permit lending. Custodians do not appear to have the incentives to improve the quality of their service.

V. The Previous Attempt by the Government to Encourage a Market-Led Solution

The inability of the market to make improvements is evidenced by a previous attempt to bring about a market-led solution. In 2001, the Company Law Review Steering Group observed that the existing arrangements for indirectly held securities were "obscure and unnecessarily complex".[78] They also mentioned that they had "great concern that solutions should be found"[79] and that they hoped that the market would produce these. They accepted assurances from market participants that, "in regard to the right to vote, practical advances in the use of electronic technology would very soon make it feasible, at low cost, for the intermediary who is the registered holder to collect diverse instructions from beneficial owners, reflect them accurately in proxy voting instructions passed to the company registrar, and obtain and pass back to the beneficial owners confirmation that the votes had been recorded".[80] With a view to assisting the market to produce these solutions, three provisions were added to the CA 2006. These are analysed in turn below. We will see that this enabling legislative regime did not deliver the desired result.

Under section 324 of the CA 2006, a registered "member is entitled to appoint another person as his proxy to exercise … his rights to attend and to speak and vote at a meeting of the company". This would enable

2019), 9, available at https://archive.clls.org/storage/2019/11/CLLS-Response-Intermediated-Securities-11-11-19.pdf (last accessed 19 September 2024).

[78] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*, vol. 1 (2001), [3.51], Department of Trade and Industry, London.

[79] Ibid.

[80] Ibid., at [7.3].

the custodian, who administers legal ownership of the shares, to appoint the ultimate investor as a proxy, enabling them to participate in shareholder meetings. In our interviews we learnt that custodians sometimes offer this service,[81] but retail investors use it only rarely.[82] Our interviewees explained that proxy voting services are often subject to limitations and to the payment of an expensive fee.[83]

Section 145 of the CA 2006 enables a company to make provisions in its articles for a member to nominate another person "as entitled to enjoy or exercise all or any specified rights of the member in relation to the company".[84] The provision only operates if the company's constitution permits this. In practice, companies have not used this provision.[85] This has been attributed to "the complexity of arrangements required to administer this provision".[86] We were told that issuers and their agents are too concerned about the integrity of the custody chain to accept a nominated individual as the ultimate investor.[87] This occurs despite the fact that section 145 of the CA 2006 does not require the issuer or its agent to make further enquiries once a nominee has been identified by a registered shareholder.

Section 146 of the CA 2006 gives the right to a member of a company "whose shares are admitted to trading on a … regulated market" to nominate another person to enjoy certain "information rights". Information rights include "the right to receive a copy of all communications that the company sends to its members".[88] Unlike the right contained in section 145 of the CA 2006, this right is available on a statutory basis rather than on the basis of the company's constitution. The Chartered Governance Institute (CGI), previously known as The Institute of Chartered Secretaries and Administrators (ICSA) has

[81] Interviewees 2, 3, 12, 13, 16 and 17.

[82] Interviewees 2, 11, 12, 14 and 15; in addition, we were informed that proxy voting is used primarily by private investors.

[83] Interviewees 11, 12, 14, 15 and 16.

[84] Under CA 2006, s. 145(4)(a), the nominated person does not have direct enforceable rights against the company, as they can only enforce their rights through the members. This means that if the company does not respond appropriately (e.g. it does not accept the exercise by the nominee), it is the shareholder who retains the right of enforcement.

[85] Law Commission, "Intermediated Securities", [3.34], which was confirmed by interviewees 14 and 15; see CGI, BEIS Corporate Governance Reform: Green Paper – Appendix Direct Exercise of Rights by Beneficial Owners (Info Rights PLUS), 2017, 1, available at https://www.cgi.org.uk/assets/files/branches/Registrars-Group/Corporate-Governance-Reform—Green-Paper-Response—Appendix-Feb-2017.pdf (last accessed 19 September 2024); the section was used, however, in *Eckerle v Wickeder Westfalenstahl* [2013] EWHC 68 (Ch); see also J. Payne, "Intermediated Securities and the Right to Vote in the UK" in Gullifer and Payne (eds.), *Intermediated Securities*, ch. 8, 204–05.

[86] BEIS, "Corporate Governance Reform: Green Paper – Appendix Direct Exercise of Rights by Beneficial Owners (Info Rights PLUS)", 2017, 1.

[87] Ibid.; interviewees 14 and 15 told us that there are probably between 50,000 to 100,000 changes in shareholding made across the company register every day. Further down the chain, changes in shareholding can be even more numerous; interviewee 11 pointed out that a way of mitigating these concerns would be to introduce an obligation on the nominated person to confirm to the issuer that their nomination is up to date.

[88] CA 2006, s. 146(3)(a).

observed that section 146 of the CA 2006 "is not as widely used as it could be".[89] This was attributed to a perceived lack of interest from investors[90] and the failure of intermediaries to make this option available to their clients.[91]

Attempts by the Government to use enabling legislation allowing issuers (together with the respective financial services providers) to develop solutions which offer intermediated investors the full set of rights associated with their shares have failed. One proxy advisor told us that, if anything, intermediation has increased in most recent years.[92] Kathryn Judge observed that the increasing length and complexity of the financial sector has created "new opportunities for intermediaries to earn fees, increase parties' tendency to rely on intermediaries, and obscure intermediaries' profits".[93] As the structure of the market has further tilted towards intermediation since 2006, the Taskforce's suggestion to rely on market forces to achieve improvements would seem rather optimistic. We will see in the next section that legislative intervention can be successful in bringing about reform.

VI. Shareholder Rights Directive II

The Shareholder Rights Directive II (SRD II) has improved voting services for institutional investors.[94] The Directive affects UK service providers who serve customers in respect of shares of companies with their registered office in a Member State and admitted to trading on an EU regulated market.[95] We note that even in relation to institutional investors, who have bargaining power in their relationship with custodians, legislation was required to improve communication between issuers and ultimate investors. In this section, we use Proxymity and the Minerva-Nexus Model as case studies illustrating the improvements following the implementation of the SRD II.

Proxymity is a computer system set up by a consortium of well-known service providers.[96] It was set up to facilitate compliance with the intermediaries' duties under the SRD II.[97] We were told that, as of

[89] Letter from Sansom to Law Commission, 11; see also UKSA, "Position Paper on Dematerialisation", [65]–[66].

[90] Interviewee 16 argued that failure to transfer information rights is not a major concern for investors, given that part of the information (e.g. annual reports) is easily accessible via the company website; see also BIS, "Exploring the Intermediated Shareholding Model", 73.

[91] Interviewees 14 and 15; although there are indeed intermediaries who consider the service of passing information an integral part of their stewardship responsibility, there are many others who do not view this activity as a main priority.

[92] Interviewee 2.

[93] K. Judge, "Intermediary Influence" (2015) 82 University of Chicago Law Review 573, 580–81.

[94] E. Ferran, "Shareholder Engagement and Custody Chains" (2022) 23 European Business Organization Law Review 507, 526–27.

[95] SRD II, arts. 1(5), 3e.

[96] Including BNY Mellon, BNP Paribas, Citi, Clearstream, Deutsche Bank, HSBC, J.P. Morgan, Computershare and State Street.

[97] SRD II, arts. 3a, 3b, 3c; Proxymity, "Your SRD II Partner", available at https://www.proxymity.io/proxymity-products/srd-ii-solutions/ (last accessed 13 June 2024).

September 2022, the firms committed to using Proxymity represent approximately 75 per cent of the global assets under custody.[98] It does not remove intermediation or change the legal position of ultimate investors but connects issuers, intermediaries and investors and passes data (such as voting instructions, corporate information and shareholder disclosure requests) along the chain.[99] The collection of data in one single database does, nevertheless, make errors and discrepancies visible and rectifiable.[100]

From the perspective of this paper the system has two significant design limitations. It only improves voting and information sharing. It does not improve the ability of investors to enforce claims against issuers. In addition, the service is available only to institutional and high net-worth individual investors.[101] It has not been programmed to provide voting solutions for firms dealing with high volumes of individual investors.[102]

The Minerva-Nexus Model is another industry initiative set up in response to the SRD II.[103] Its aim is to facilitate the exercise of corporate rights for securities that are used for lending, assisting all intermediaries in a chain with processing recall request rights.[104]

In this section, we have observed that the market for services facilitating the relay of information and the transfer of voting rights along custody chains between issuer and investors has seen technological advancements, enhancing service quality, in response to the SRD II. This shows that legislative intervention is essential for fostering better connections between issuers and investors. We also note that the improvements are confined to voting processes. The SRD II has not aided investors in enforcing claims. Retail investors, who are outside the scope of the SRD II, have not benefitted from this reform.

VII. Why We Need Reform

A. Introduction

We could conclude that the difficulty in accessing direct share ownership and the poor quality of intermediated share services should be accepted as a normal evolution of the market. Why should we care about the enforcement of claims against issuers? Why should we care about retail

[98] Interviewees 14, 16 and 17.
[99] Computershare, "Proxymity: A Pioneering Investor Communications Platform", available at https://www.computershare.com/uk/proxymity (last accessed 19 September 2024).
[100] Interviewees 14, 15 and 17; during the reconciliation process, Proxymity can identify any potential "mismatching" in the data collected along the chain and ask custodians to rectify their records.
[101] Interviewees 14, 15 and 17.
[102] Interviewee 17.
[103] Minerva Analytics, "Minerva Nexus Background Briefing", 5, 6, 8.
[104] Interviewee 2.

investors if their numbers are small and few of them vote?[105] The reasons why we should address both topics are set out below.

B. Shareholder Preferences

It is possible that the lack of interest from retail investors in exercising their rights and the cost of providing these services are overstated. We have already mentioned that the absence of competition, combined with the lack of bargaining power of retail investors, could prevent infrastructure providers from developing business models that facilitate direct holdings of uncertificated securities at a reasonable cost and the supply of high-quality services for intermediated accounts.[106]

We are not alone in suggesting that, if retail investors had access to a straightforward way of exercising their rights, they might well be interested in doing so. Austin wrote that there is a "cogent argument" that the claims of market participants – that there is not sufficient demand amongst investors – create a "self-fulfilling prophecy".[107] Firms "do not invest in easy to use services or place high charges on them and do not actively market them".[108] This leads to such services being unattractive or unknown to retail investors,[109] "which is then used as a justification for lack of investment by intermediaries".[110]

This observation is supported by recent developments in the US. Blackrock, having embraced environmental and social investment goals, came under political scrutiny and decided to back out of the ensuing political debate by announcing a system that gives clients the "option to have a say in how proxy votes are cast at companies their money is invested in".[111] We observe that, once incentives are in place, market practice can shift.

[105] J.E. Fisch, "Standing Voting Instructions: Empowering the Excluded Retail Investor" (2017) 102 Minnesota Law Review 11, 12; see also G. Balp, "The Corporate Governance Role of Retail Investors" (2018) 31 Loyola Consumer Law Review 47, 48; BIS, "Exploring the Intermediated Shareholding Model", 74, 82; Uddin, "Hargreaves Lansdown". However, see also Ferran, "Shareholder Engagement", 509–10.

[106] See Section IV(B) above.

[107] HM Treasury, "UK Secondary Capital Raising Review", [10.67].

[108] Ibid.; but see also Uddin, "Hargreaves Lansdown".

[109] BIS, "Exploring the Intermediated Shareholding Model", 72, 74.

[110] HM Treasury, "UK Secondary Capital Raising Review", [10.67].

[111] L. Fink, "Larry Fink's 2022 Letter to CEOs: The Power of Capitalism", available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (last accessed 19 September 2024); L. van Marcke, "'Direct' Voting by Institutional Investors: A Trojan Horse?", available at https://blogs.law.ox.ac.uk/blog-post/2023/03/direct-voting-institutional-investors-trojan-horse (last accessed 19 September 2024). Since the launch, BlackRock has extended the so-called "Proxy Voting Choice" programme to millions of US retail shareholder accounts: J.A. Majeid and R. Aguirre, "BlackRock Has Expanded Proxy Voting Choice to Millions of U.S. Retail Shareholder Accounts", available at https://corpgov.law.harvard.edu/2024/04/01/blackrock-has-expanded-proxy-voting-choice-to-millions-of-u-s-retail-shareholder-accounts/ (last accessed 29 April 2024).

Finally, a generational shift is underway.[112] The demographic of those who hold shares is changing. Shareholders used to be almost exclusively white retired males. In the last few years, young and ethnically diverse investors have started to buy individual shares. These are not only growing in number but are also about to inherit significant sums of money from their parents and grandparents. They care about voting rights and exercise these not only in pursuit of financial gain but also to steer companies towards wider societal goals that they believe to be important. It would be wrong to design the mechanics of holding shares in a way that undermines the ability of this group of retail investors and (for that matter) any other individual who is (or will be) prepared to exercise rights as corporate shareholders.[113]

C. Oversight for Issuers

Secondly, the operational ability to vote and enforce claims against issuers is important for their governance. An argument is sometimes made that smaller investors (retail and institutional) are rationally apathetic. They face a collective action problem as the cost of exercising their rights is not outweighed by the benefits.

The corporate governance literature, however, discusses rational apathy not as a desirable outcome but as a problem. There is debate about how much influence shareholders should have as compared to directors or other stakeholders such as employees.[114] Corporate lawyers discuss the fine tuning of these rights.[115] Shareholder oversight may not be as effective in controlling directors as some would hope, but the discussion in corporate law assumes that there are shareholders who have the uninhibited operational ability to make use of their respective rights.

Shareholders have the role of overseeing the directors of companies. They may not do so on an ongoing basis. But this does not mean that they are uninterested when fundamental decisions are taken that affect their rights.[116] Moreover, the ability of shareholders to exercise their rights

[112] Ferran, "Shareholder Engagement", 507; see also S.A. Gramitto Ricci and C.M. Sautter, "The Educated Retail Investor: A Response to 'Regulating Democratized Investing'" (2022) Ohio State Law Journal Online 205, 207, available at https://moritzlaw.osu.edu/sites/default/files/2023-03/Online%20Vol%2083%20-%20Gramitto%20-%20Sautter%20-%20Final%20Format%20205-217.pdf (last accessed 30 August 2024).

[113] S.A. Gramitto Ricci and C.M. Sautter, "Harnessing the Collective Power of Retail Investors" in C.M. Bruner and M. Moore (eds.), *A Research Agenda for Corporate Law* (Cheltenham and Northampton, MA 2023), ch. 11, 207–30.

[114] Among others, see R.J. Gilson, "From Corporate Law to Corporate Governance" in J.N. Gordon and W-G. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance* (Oxford 2015), ch. 1, 3, 15–25.

[115] See e.g. M. Moore and M. Petrin, *Corporate Governance: Law, Regulation and Theory* (Oxford 2017), 75–79, 91–96.

[116] BIS, "Exploring the Intermediated Shareholding Model", 83; E. Maddock-Jones, "Hargreaves Lansdown Launches Electronic Voting System", available at https://www.investmentweek.co.uk/news/4063096/hargreaves-lansdown-launches-electronic-voting (last accessed 19 September 2024).

sends an important signal to directors.[117] The fact that there are shareholders who can spring into action has a disciplining effect on the directors.[118] Along similar lines, Holger Spamann recently observed that "gadfly" investors are an indispensable catalyst for shareholder votes on items not desired by either management or required by law.[119] He also pointed out that individual named plaintiff investors operate as figureheads in shareholder litigation, which forms part of an institutional ecosystem protecting the interests of all investors, including those who hold through passive funds.[120] To perform this vital function, figurehead investors require standing in claims against companies. In the UK, this means that their name has to be entered on the shareholder register.

In constitutional law, voters are also sometimes disengaged. Nevertheless, the government's knowledge that it will face the electorate from time to time ensures accountability. In a democracy, the argument that voters have different levels of competence and are sometimes passive does not justify removing voting rights or accepting a system that creates barriers to the exercise of these rights.

If small retail and institutional investors are blocked from standing in claims against issuers, the governance of companies will be exclusively overseen by large-scale institutional investors.[121] When institutional investing first rose to its current prominence, it was considered a welcome development. The expectation was that the institutionalisation of shareholding would lead to greater scrutiny of companies.[122] However, this has not been the case. The 2008 Financial Crisis has shown that the investment chain that operates between the ultimate beneficiaries of institutional investors drowns out the preferences of ultimate beneficiaries. While these have long-term goals, their service providers regularly respond to more immediate pressures. The current set-up of institutional investing transforms long-term goals into short-term signals.[123]

To increase engagement by institutional investors, the Financial Reporting Council has adopted the UK Stewardship Code.[124] The Code encourages (institutional) asset owners, asset managers and related service providers (such as investment consultants, proxy advisors, data and research providers) to exercise the governance rights they hold on

[117] Ibid.; see also R.C. Nolan, "Indirect Investors: A Greater Say in the Company?" (2003) 3 Journal of Corporate Law Studies 73, 101.
[118] Moore and Petrin, *Corporate Governance*, 96.
[119] H. Spamann, "Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings" (2022) 14 Journal of Legal Analysis 17, 37.
[120] Ibid.
[121] See also Uddin, "Hargreaves Lansdown".
[122] G.P. Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford 1996).
[123] Financial Reporting Council, "UK Stewardship Code", available at https://www.frc.org.uk/investors/uk-stewardship-code (last accessed 19 September 2024); for a similar view, see also BIS, "Kay Review of UK Equity Markets".
[124] Financial Reporting Council, "UK Stewardship Code".

behalf of their clients in a responsible way.[125] There are signs that the market participants have accepted their role as stewards and are reporting on their stewardship activity.[126]

The fact that institutional investors are adopting the UK Stewardship Code and reporting accordingly does not mean that their activity leads to effective oversight of directors. Institutional investors are not acting for their own benefit. They watch their own bottom line. This undermines their ability to provide the required quality of oversight.[127]

Moreover, asset managers have come under fire for their dominance in markets. There is an ongoing academic debate as to whether asset managers (as the "common owners" of large sections of the economy) have a negative effect on competition between their investee companies.[128] Given these uncertainties, it would be wrong to delegate the governance of companies to a highly concentrated industry whose impact on the economy we are only beginning to understand.

D. Summary

There is a cogent argument that a lack of competition, rather than a lack of interest by investors, is responsible for the market's failure to develop a cost-effective infrastructure that enables all shareholders to exercise their rights. In addition, corporate governance scholars express concern about rational apathy, but this does not lead them to recommend or condone the imposition of operational barriers for voting and exercising other shareholder rights. Indeed, the corporate governance literature stresses the importance of figurehead gadfly investors in corporate governance and litigation.

VIII. Solutions

A. Introduction

If we accept that the absence of a competitive market, combined with the desirability of oversight for issuers, justifies reform, we need to discuss how this reform should be designed. We have already seen that the

[125] D. Katelouzou and D.W. Puchniak (eds.), *Global Shareholder Stewardship* (Cambridge 2022).

[126] Financial Reporting Council, "The Influence of the UK Stewardship Code 2020 on Practice and Reporting: Research Study" (July 2022), available at https://www.frc.org.uk/getattachment/de8c91f5-c2cb-4b8b-9a98-34c31f382924/FRC-Influence-of-the-Stewardship-Code_July-2022.pdf (last accessed 19 September 2024).

[127] R.J. Gilson and J.N. Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights" (2013) 113 Columbia Law Review 863.

[128] OECD, "Common Ownership by Institutional Investors and Its Impact on Competition" (December 2017), available at https://www.oecd.org/daf/competition/common-ownership-and-its-impact-on-competition.htm (last accessed 19 September 2024); L. Enriques and A. Romano, "Institutional Investor Voting Behavior: A Network Theory Perspective" (ECGI Working Paper No. 393/2018, July 2018), available at https://ssrn.com/abstract = 3157708 (last accessed 19 September 2024); see also van Marcke, "'Direct' Voting by Institutional Investors".

Digitisation Taskforce and the "Industry" have each advanced models for the elimination of certificated shares. These will be analysed below.

With a view to improving intermediated services, the Law Commission has recently set out five options. We have put these to our interviewees and will discuss them below. We will analyse the Digitisation Taskforce's proposal further and give our own view.

B. Eliminating Paper

As mentioned at the beginning of this paper, the Digitisation Taskforce concluded that certificated shares should be eliminated "as a matter of urgency" and that existing certificated shares should be transformed into intermediated uncertificated holdings.[129] We also pointed out that this transforms direct legal ownership into intermediated beneficial ownership.

We believe that the urgency for the elimination of paper certificates is overstated. The number of certificated shares in listed companies is relatively small.[130] We agree with the UK Individual Shareholders (ShareSoc) and UK Shareholders' Association (UKSA) that "forced dematerialisation of the remaining certificated shareholdings is not being proposed to meet any real needs of certificated shareholders, since by and large they are happy with the current position. (Otherwise, they would already have dematerialised their shareholdings)".[131]

The Taskforce's proposal reflects the preferences of issuers,[132] registrars and other intermediaries.[133] The Digitisation Taskforce has neither quantified nor substantiated the cost associated with certificated shares. Arguably, most expense arises when investors trade their shares or when certificates are lost, stolen, or damaged. In both cases, costs are passed to investors through (1) higher brokerage fees for trading and managing paper certificates,[134] and (2) replacement fees for issuing new paper certificates in cases of loss, damage, or theft.[135] Some brokers also charge transfer fees when converting electronically purchased shares to paper certificates.[136] Once a share certificate is issued there are no more costs to brokers, issuers, or anyone else and consequently investors pay no fees for holding a share certificate. Paper certificates are a highly

[129] Digitisation Taskforce, "Interim Report", 10; Walters, "How to Prepare"; J. Roberts, "Two Potential Drawbacks of Holding Share Certificates", available at https://www.hl.co.uk/investment-services/insights/two-potential-drawbacks-of-holding-share-certificates (last accessed 13 June 2024); "Dematerialisation of Paper Share Certificates", available at https://brigroup.co.uk/dematerialisation-of-paper-share-certificates/ (last accessed 13 June 2024).

[130] Law Commission, "Intermediated Securities", [2.11], [8.6].

[131] Letter from Henderson and Bentley to Flint, [8].

[132] M. O'Dwyer, "BP and Shell Among UK Companies Mounting Push to Ditch Paper Shares", *Financial Times*, available at https://on.ft.com/4cREs1O (last accessed 27 July 2024).

[133] Letter from Henderson and Bentley to Flint, [8], [30]; see also "Where's Left for a CREST Account?".

[134] Walters, "How to Prepare".

[135] Ibid.

[136] "Where's Left for a CREST Account?".

cost-effective option for holding shares in the long term.[137] ShareSoc reports that typical holders of certificated shares are retail investors who have held their shares for a long time and who prefer direct ownership and value direct communication from companies.[138] Eliminating paper certificates would significantly affect them.[139] They would not only lose direct access to corporate rights but also become exposed to the risk of losses caused by the insolvency, negligence, or fraud of any one of the intermediaries in the chain.[140]

We have reported earlier that, under the "Industry Model", certificated shareholders would receive a unique reference number for their shares instead of a paper certificate. They would also open an account with the issuer's registrar. The proponents of the model are reported to have said that investors "would not be charged for holding their investments" but that "fees for actions such as effecting transactions would remain".[141]

This proposal is better for shareholders than that of the Digitisation Taskforce. It nevertheless puts investors in a position where they need to rely on registrars to give them access to the digital system through which they hold their shares, without necessarily being in a bargaining position to resist fee increases once certificated shares have been eliminated. ShareSoc and UKSA favour digitisation in principle, provided that individual investors can continue to hold shares in their own name at reasonable costs.[142] The Law Commission also stressed that the overall cost associated with the model should be "proportionate".[143]

Both the Digitisation Taskforce and the proponents of the "Industry Model" are confident that it is possible to eliminate paper certificates,

[137] Ibid.

[138] Ibid.; see also C. Weight, "Dematerialisation of Shares – Certificates to be Abolished", available at https://www.sharesoc.org/sharesoc-news/dematerialisation-of-shares-certificates-to-be-abolished/ (last accessed 6 June 2024).

[139] HM Treasury, "UK Secondary Capital Raising Review", [10.68].

[140] Law Commission, "Intermediated Securities", chs. 6, 7; Letter from Henderson and Bentley to Flint, [27], [28], [29].

[141] Law Commission, "Intermediated Securities", [8.82]–[8.83]; interviewees 14 and 15, with whom we shared a draft of this paper, contacted us to stress that a similar model operates in Ireland, which could be adapted to the UK and at a cost that would not result in extra fees for investors.

[142] C. Weight, "Press Release 122: UK Shareholders Welcome and Support Treasury Report on Secondary Market Placings", available at https://www.sharesoc.org/sharesoc-news/press-release-122-uk-shareholders-welcome-and-support-treasury-report-on-secondary-market-placings/ (last accessed 19 September 2024). In 2019, they also supported the Industry Model, ShareSoc-UKSA, Joint Response to the Law Commission's Consultation on Intermediated Securities, 5 November 2019, 24–25, available at https://www.uksa.org.uk/sites/default/files/2019-11/Law-Commission-UKSA-ShareSoc-response.pdf (last accessed 19 September 2024). However, they also point out that the consequences of dematerialisation "very much depend on how the UK Government chooses to implement dematerialisation" as "[t]he issue is not the loss of paper certificates. The issue is how to ensure that private individuals can continue to own company shares": UKSA, "The Private Investor" (Issue 192, January 2018), 4, available at https://www.uksa.org.uk/sites/default/files/TPI-Issue-192.pdf (last accessed 19 September 2024). ShareSoc and UKSA believe that a central principle of implementing full dematerialisation in the UK "must be the preservation of key elements of the existing share registration model for paper certification – albeit without the need for paper certificates", ShareSoc-UKSA, Joint Response to the Law Commission's Consultation on Intermediated Securities, [9].

[143] Law Commission, "Intermediated Securities", [8.82]–[8.86].

trusting that the market can deliver a cost-effective dematerialised way of holding shares. We would point out that the "proof is in the pudding". If, despite the lack of competition and past performance, the market succeeds in developing an attractive uncertificated way to hold shares directly, there will be no need to abolish certificated shares. Investors will of their own accord take up that model. In recent years, we have all switched from predominantly using cash to using card payments almost exclusively, precisely because of the inconvenience associated with paper bills and metal coins. The market can improve the existing model of sponsored CREST membership, enhancing the system to the point where paper certificates become undesirable and obsolete.

The Government should nevertheless intervene, but not by eliminating certificated shares. As we have mentioned, the fees for direct personal membership in CREST have recently increased steeply. CREST operates the only system in the UK for uncertificated securities. Only a very limited number of brokers offer sponsored CREST membership. The CMA has the authority to open an investigation, if it has concerns about service providers abusing their dominant position in the market.[144] The European antitrust regulator has recently investigated similar cases, which resulted in a settlement where Thomson Reuters, Markit, the International Swaps and Derivatives Association, Inc. and others modified the terms for their main products.[145] We recommend that the CMA investigate the provisioning of CREST-sponsored accounts.[146]

C. Improving the Intermediated Holding Model

1. Introduction

We have argued above that certificated shares should be retained to enable those who prefer to hold shares directly to do so at a reasonable cost. We also believe that intermediated holdings require reform. The legal and operational problems affecting the current market have been acknowledged by the Company Law Review Steering Group,[147] the Kay Review,[148] the (then) Department for Business, Innovation and Skills (BIS), the Law Commission and, more recently, Austin's "UK Secondary

[144] Competition and Markets Authority, "About Us", available at https://www.gov.uk/government/organisations/competition-and-markets-authority/about (last accessed 19 September 2024).

[145] P. Stafford, "EC Agrees Deal with ISDA, Markit over Credit Default Swaps", *Financial Times*, available at https://www.ft.com/content/461b7347-0211-360c-acc9-6db84340c838 (last accessed 19 September 2024); European Commission Press Release, "Antitrust: Commission Accepts Commitments by ISDA and Markit on Credit Default Swaps" (20 July 2016), available at https://ec.europa.eu/commission/presscorner/detail/en/IP_16_2586 (last accessed 19 September 2024); European Commission Press Release, "Antitrust: Commission Renders Legally Binding Commitments from Thomson Reuters" (20 December 2012), available at https://ec.europa.eu/commission/presscorner/detail/en/IP_12_1433 (last accessed 19 September 2024).

[146] See also UKSA, "Position Paper on Dematerialisation", [62], [69].

[147] The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy*, [3.51].

[148] BIS, "Kay Review of UK Equity Markets", ch. 3.

Capital Raising Review" report.[149] In 2016, the BIS confirmed that the voting process in custody chains is "opaque" and "of questionable accuracy".[150] The UK Law Commission has, over an extended period of time, done work in this area evidencing the existence of significant and persistent problems.[151] Austin concluded that the "level of intermediation and specialisation has … arguably become a barrier … for end users of the system".[152] He also observed that the "ability for underlying owners to exercise entitlements around voting or to participate in fundraises is not uniformly enabled across retail platforms" and that there can be "breakdowns in information flows … relat[ing] to voting at meetings and exercising entitlements in connection with a pre-emptive offer".[153] We believe that the infrastructure through which the majority of investors hold shares should enable these investors to oversee issuers adequately.

2. Technology

We have explained earlier that the Digitisation Taskforce recommended a common messaging protocol. The Law Commission wrote that distributed ledger technology ("DLT") could "enable the creation of a direct relationship between investors and companies",[154] but stressed that

[149] HM Treasury, "UK Secondary Capital Raising Review".

[150] BIS, "Exploring the Intermediated Shareholding Model", 18, 119, 124, 125.

[151] Law Commission, "Intermediated Securities"; previous work on intermediated securities includes Law Commission, "Fiduciary Duties of Investment Intermediaries: A Consultation Paper" (Consultation Paper No. 215, October 2013), available at https://cloud-platform-e218f50a4812967ba1215eaecede923f.s3.amazonaws.com/uploads/sites/30/2015/03/cp215_fiduciary_duties.pdf (last accessed 19 September 2024); Law Commission, "The UNIDROIT Convention on Substantive Rules Regarding Intermediated Securities: Further Updated Advice to HM Treasury" (May 2008), available at https://s3-eu-west-2.amazonaws.com/cloud-platform-e218f50a4812967ba1215eaecede923f/uploads/sites/30/2015/03/intermediated_securities_advice_May2008.pdf (last accessed 19 September 2024); Law Commission, "Law Commission Project on Intermediated Investment Securities. First Seminar: Objectives for a Common Legal Framework" (March 2006), available at https://s3-eu-west-2.amazonaws.com/cloud-platform-e218f50a4812967ba1215eaecede923f/uploads/sites/30/2015/03/Intermediated_Securities_seminar1.pdf (last accessed 19 September 2024); and Law Commission, "Law Commission Project on Intermediated Investment Securities. Second Seminar: Issues Affecting Account Holders and Intermediaries" (June 2006), available at https://s3-eu-west-2.amazonaws.com/cloud-platform-e218f50a4812967ba1215eaecede923f/uploads/sites/30/2015/03/Intermediated_securities_seminar_2.pdf (last accessed 19 September 2024); see also the study on intermediated holding arrangements in respect of crypto-tokens undertaken by the Law Commission: Law Commission, "Digital Assets: Final Report" (Law Com. No. 412, 2023), 148–82.

[152] HM Treasury, "UK Secondary Capital Raising Review", [10.3].

[153] Ibid., at [10.63], [10.64].

[154] Law Commission, "Intermediated Securities", [9.67]–[9.69]; see also ibid., at 19; E. Micheler and L. von der Heyde, "Holding, Clearing and Settling Securities Through Blockchain/Distributed Ledger Technology: Creating an Efficient System by Empowering Investors" (2016) 11 Journal of International Banking and Financial Law 652, 654; P. Paech, "The Governance of Blockchain Financial Networks" (2017) 80 M.L.R. 1073; S. Green and F. Snagg, "Intermediated Securities and Distributed Ledger Technology" in Gullifer and Payne (eds.), *Intermediation and Beyond*, ch. 16, 337–58; E. Schuster, "Cloud Crypto Land" (2021) 84 M.L.R. 974. But see e.g. Jurisdiction Taskforce, "Legal Statement on 'The issuance and transfer of digital securities under English private law'", available at https://27221500.fs1.hubspotusercontent-eu1.net/hubfs/27221500/UKJT%20work/UKJT%20legal%20statement%20on%20the%20issuance%20and%20transfer%20of%20digital%20securities%20under%20English%20private%20law%

technology does not change the legal position of ultimate investors and will only enhance their rights where intermediaries are motivated to invest in it and use it for this purpose.[155]

Our interviewees said that DLT has the potential to enhance investors' rights but requires a substantial transformation of the market and this takes time.[156] Two interviewees further pointed out that the development of DLT could also be adversely affected by the role played by the intermediaries in financial markets.[157] Intermediaries are unlikely to be interested in investing in the technology if it undermines their ability to generate returns.[158] Three of our interviewees felt that it was more realistic to expect immediate improvements from legislative intervention.[159]

A common messaging protocol will ensure that all intermediaries are aware of which data points are relevant at other levels in the chain.[160] However, it does not prevent errors, which occur as information is transferred from one organisation to another. A standard messaging protocol also does not provide intermediaries with an incentive to provide the services of enabling the exercise of rights by shareholders.

We are not hopeful that DLT will change anything. We have seen above that custodians currently lack sufficient incentives to take advantage of existing technology to improve links between them. We doubt that they will invest in DLT. Moreover, the current opportunity for the use of DLT for this purpose appears to be going to waste. The Bank of England and FCA are jointly working on the Digital Securities Sandbox ("DSS") aimed at supporting new business models for trading and settling securities based on developing technology (such as DLT). They state that they aim to streamline the processes of issuing, trading and settling securities, and to reduce the need for intermediaries. But the guidance for service providers envisage outsourcing and consequently intermediation and do not require applicants to provide avenues for investors to hold

20(1).pdf?__hstc=251652889.82ea00cfab60ca24e7b6ea9890d5a420.1726737643978.1726737643978.1726737643978.1&__hssc=251652889.22.1726737643978&__hsfp=79725722 (last accessed 19 September 2024); Financial Services and Markets Act 2023 (Digital Securities Sandbox) Regulations 2023, SI 2023/1398 and FCA, PS24/12: Digital Securities Sandbox joint Policy Statement and Final Guidance, 30 September 2024, available at https://www.fca.org.uk/publications/policy-statements/ps24-12-digital-securities-sandbox-joint-policy-statement-final-guidance (last accessed 22 October 2024).

155 Law Commission, "Intermediated Securities", [9.76], [9.52]–[9.54]; for an excellent explanation of the technology, see Appendix 4.

156 Interviewees 2, 4 and 17; see also A. Lafarre and C. Van der Elst, "The Viability of Blockchain in Corporate Governance", available at https://blogs.law.ox.ac.uk/oblb/blog-post/2023/07/viability-blockchain-corporate-governance (last accessed 19 September 2024).

157 Interviewees 2 and 4.

158 See also M. Mainelli and A. Milne, "The Impact and Potential of Blockchain on the Securities Transaction Lifecycle" (SWIFT Institute Working Paper No. 2015-007), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2777404 (last accessed 19 September 2024); Micheler and von der Heyde, "Holding, Clearing and Settling Securities", 654.

159 Interviewees 14, 15 and 17.

160 This proposal did not exist when we conducted our interviews; interviewee 11 nevertheless mentioned that a standardisation of communication between intermediaries would be useful.

digital securities directly.[161] Disappointingly, the sandbox appears to be designed with a view to replicating the current intermediated market structure.

3. Legal interventions

Proposals by the Law Commission and the Digitisation Taskforce. The Law Commission observed that no progress had been made since the Company Law Review Steering Group pointed out the problem,[162] and proposed that a statutory obligation be imposed on intermediaries to arrange, upon request, for an indirect investor to exercise shareholder rights.[163] Austin endorsed this proposal.[164] Alternatively, the Law Commission suggested to draw inspiration from the SRD II.[165] The SRD II contains provisions imposing on intermediaries a duty to offer companies the right to identify their shareholder, to pass information between the company and shareholders, and to facilitate the exercise of voting rights.[166] As a substitute to hard law, the Law Commission considered the introduction of a "non-binding set of principles of best practice or code of practice".[167] Along similar lines, the Digitisation Taskforce recommended a requirement for intermediaries to disclose their service levels.

In addition to facilitating voting, the Law Commission proposed to amend the CA 2006 and the FSMA 2000 to enable ultimate intermediated investors to better exercise and enforce shareholder rights. This would entail, for example, changes to sections 98,[168] 899,[169] 633, 338, 570 and 571[170] of the CA 2006. It would also involve clarifying section 90A of the FSMA 2000.[171]

Our interviewees. Our interviewees were against a "non-binding set of principles of best practice or code of practice".[172] They believe that hard law better enhances investors rights.[173] They also rejected the model

[161] Interviewee 18. FCA, PS24/12: Digital Securities Sandbox joint Policy Statement and Final Guidance, 30 September 2024, now mentioned in footnote 154.
[162] Law Commission, "Intermediated Securities", [9.8].
[163] For detail, see ibid., at [3.81]–[3.105].
[164] HM Treasury, "UK Secondary Capital Raising Review", 19; see also Nolan, "Indirect Investors", 91–92.
[165] Law Commission, "Intermediated Securities", [3.106]–[3.126].
[166] SRD II, art. 3.
[167] Law Commission, "Intermediated Securities", [9.2].
[168] The Law Commission considers two ways in which this provision can be reviewed: (1) removing the words "but not by a person who has consented to or voted in favour of the resolution" (thus allowing intermediaries to bring actions along the chain on behalf of ultimate investors); and/or (2) granting ultimate investors the power to bring claims directly against issuing companies: ibid., at [5.61] and at [5.65].
[169] The Law Commission proposes to remove the "headcount" test in CA 2006, s. 899, and consider additional measures to enhance the protection of minority shareholders: ibid., at 76.
[170] Ibid., at [10.6], [5.75].
[171] Ibid.
[172] Interviewees 2, 3, 5, 6, 7, 11, 14, 15 and 16. The Law Commission also pointed out that, "[i]n general, stakeholders were not enthusiastic about this approach": ibid., at [9.9].
[173] Interviewee 11.

adopted by the SRD II,[174] favouring statutory intervention to impose obligations on intermediaries to facilitate voting and to amend the CA 2006 and FSMA 2000. Most of them said that this solution would be a step forwards to improve the practice of intermediated securities.[175] They observed that, without the introduction of a formal obligation, intermediaries lack an incentive to make improvements.[176]

Our view. We have seen that the market promised to solve the problems of intermediated securities 20 years ago but has yet to deliver a solution. We argue that a lack of competition undermines service providers' ability to develop business models that better serve investors and issuers. We predict that infrastructure providers will, like they did before, express intentions to improve, only to find they lack sufficient incentives. Better transparency by intermediaries does not address their underlying incentives and disclosure does not give small-scale investors the bargaining power to demand better service at lower costs.

The ability of the market to make promises of any kind is further undermined by the fact that the market infrastructure is constantly changing. These changes are frequently carried out through the outsourcing of activity.[177] One proxy voting advisor mentioned that fund managers are increasingly outsourcing administrative functions and compliance tasks (including voting activities) to third parties, which adds another layer of complexity to the system.[178] This development is likely to continue.[179] From the perspective of this paper the effect of this is that any promises made by current market participants will not, of course, bind intermediaries to whom the activity will be outsourced in the future.

We note, further, that the recent improvements of corporate communication services occurred in response to the obligations imposed by the SRD II rather than through voluntary industry-led improvements. We believe that it is unlikely that the market will succeed in creating a model that makes it possible for retail investors to exercise, at a low cost, the corporate rights associated with shares held through custody chains.

We mentioned above that our interviewees largely agree that a formal legal duty is necessary to improve intermediated holdings. We note here that there is a difference between saying that statutory intervention will help and volunteering to accept a formal duty imposed upon oneself.

We therefore believe that a duty should be imposed on intermediaries requiring them to assist their clients, who hold securities through a

[174] See also HM Treasury, "UK Secondary Capital Raising Review", [19]–[20].
[175] Interviewees 1, 5, 6, 7, 8, 9, 11, 14, 15 and 16; interviewee 11 suggested that the obligation should be added to the FCA Handbook.
[176] Interviewee 11, 6 and 7.
[177] Interviewee 2.
[178] Ibid.
[179] Judge, "Intermediary Influence", 580.

nominee account, to exercise their rights against the issuer of shares. We also endorse the Law Commission's proposal to clarify the wording of section 90A of the FSMA 2000 and to modify the CA 2006. Further work will be needed to define ultimate investors for this purpose. This will not be straightforward,[180] but, as *Secure Capital S.A. v Credit Suisse A.G.* has shown,[181] other legal systems have been able to find a workable solution.

IX. Summary

In this article, we argue that paper certificates should not be eliminated. The industry does not need the Government to intervene to present retail shareholders with a cost-effective model for holdings shares directly. Instead of removing paper the Government should encourage the CMA to investigate the price structure for CREST accounts. We also believe that legislation is required to remove the barriers that currently prevent intermediated investors from voting and otherwise exercising rights against issuers.

[180] Interviewee 11.
[181] [2017] EWCA Civ 1486, [2018] 1 B.C.L.C. 325.