Intermediated securities – Call for evidence

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Introduction

1. This independent response considers various specific issues raised by the Law Commission in its Call for Evidence on Intermediated Securities. The respondent is a Solicitor of the Senior Courts of England and Wales, and was a partner of law firm Clifford Chance LLP until 2014. He has been closely involved in the legal and practical issues connected with this subject for many years. This response is made in a personal capacity as an independent expert, and does not purport to reflect the views of any organisation to which the respondent has been or is affiliated.
2. The Law Commission's attention is drawn in particular to the work of the European Post Trade Forum, which considered many issues which are pertinent to the Law Commission's Call for Evidence, and supported its conclusions with a detailed evidential study. The respondent was a member of the Forum. The report of the Forum can be found here and the supporting evidence here. In particular, EPTF barriers 9, 10 and 11 are relevant to the points raised in the Call for Evidence.
3. Any questions may be addressed to the respondent at Kellogg College, 62 Banbury Road, Oxford OX2 6PN or (preferably) by email to dermotturing@btinternet.com .

Voting Rights; Shareholders Rights Directive (CfE paras 1.5, 2.4-2.23)

4. Paragraphs 2.4ff of the Call for Evidence discuss the difficulties which end-investors may encounter when exercising voting rights.
5. Practical issues which may be encountered include the following:
    - Long intermediation chains can delay a communication between a company and its investors, especially if details of the vote need to be translated from the issuer's language. (This problem will obviously be more acute in a cross-border context, where intermediation is more likely, and a larger number of intermediaries may be involved).
    - The delay in communication may interact badly with the time-limits for responding: if an investor is to consider the matter and instruct its intermediary, more time is needed than in a simple communication between a private company and its shareholders. Intermediaries need time to collate the responses from their clients. Where only a few days is allowed between notice of a vote and the deadline for receipt of voting papers, investors may find themselves left out.
    - These challenges can nowadays largely be solved by technology. If an issuer knows who its end-investors are, and intermediaries are using up-to-date methodologies, a long chain of intermediation is not an insuperable obstacle. Work has been done at EU level to develop solutions to this issue, as referred to in the EPTF report (see page 55 and references cited there).
    - It should be noted that custodians operating in the UK are obliged to process investors' voting instructions. It would be a breach of a custodian's English-law duty to disregard a properly given instruction except insofar as there is an agreement between the custodian and its client that certain instructions need not be acted upon. Furthermore, acting as a

custodian requires a Part IVA permission under the Financial Services and Markets Act 2000, so custodians are regulated in the performance of their duties. While the FCA's Client Assets Sourcebook does not impose any obligations regarding voting rights, trade associations such as the International Securities Services Association and the Association of Global Custodians periodically issue best-practice guidance on handling issues relating to voting rights and corporate actions. Many investors are 'professional' investors (such as pension funds) whose interests ensure that best practices are followed and improved upon. For these reasons it should not be assumed that there is an inherent problem in exercising investor rights when securities are held through an intermediated structure.

- Some commentaries on the voting rights issue have indicated that it is not allowed for a shareholder to vote different ways in respect of different parcels of shares. This issue is not believed to arise under UK legal systems, so as long as issuers are ready to accept 'contradictory' voting patterns from its legal members.
- The question of a record date is, in theory, more difficult. The usual rule is that the 'record date' for voting is the date of the meeting at which the vote takes place. Intermediated securities may, however, experience a change in ownership between the intermediary's cut-off date for receipt of voting instructions and the date of the meeting. Again, a technological solution is possible: if an issuer has up-to-date details of who its end investors are, then a reconciliation between votes cast and the investors at the record date should solve the issue.

Shareholder Rights Directive

6. The revised Shareholder Rights Directive (SRD2) has the avowed intention of facilitating the exercise of 'shareholder' rights (see recital (7) of SRD2 and article 1(1) of the revised SRD). The Law Commission notes (para 1.5) the intention of the UK Government to interpret the concept of 'shareholder' in SRD2 as meaning the legal member of a company rather than an ultimate investor. This is consistent with the interpretation adopted for SRD1. However, it is hardly consistent with the intentions of the directive: recitals (3), (4) and (5) (to name just a few) explain clearly that the purpose of the directive is to connect companies with their end-investors in cases of intermediated holdings. If 'shareholder' means the legal member of a company much of the revised text in the SRD appears to become meaningless – consider for example article 3a(2) "Member States shall ensure that … intermediaries communicate without delay to the company the information regarding shareholder identity".
7. The expected UK interpretation is thus not only an outlier (see EPTF report, pages 52 and 55) but probably wrong. While it is, of course, open to the UK to go its own way once it leaves the EU, it should be noted that the restrictive UK approach to who is a 'shareholder' for the purposes of SRD2 would remove a simple way of alleviating some of the issues and potential issues identified in the Call for Evidence. Notably:
    - Investor identification – CfE para 2.9; addressed by SRD art 3a.
    - Information transmission – CfE para 2.10; addressed by SRD art 3b.
    - Vote confirmation – CfE para 2.15; addressed by SRD art 3c(2).
    - Proxy voting – CfE para 2.22; addressed by SRD art 10.
8. To apply SRD2 consistently with the interpretation adopted in remaining EU Member States will also facilitate cross-border holding of securities, whether of UK securities held by foreign investors or vice versa. The intermediation problem, as noted, tends to be most acute in a cross-border context,

and a harmonized interpretation of SRD2 is therefore to be desired regardless of the practical solutions it offers.

Look-through (CfE paras 2.31-2.38)

9. The analysis of the 'look-through' issue in the Call for Evidence might be complemented by the following observations.
10. It is important to distinguish contractual and property law analyses of the relationship between an investor and an issuer. Under the law of trusts, a person who is not in privity of contract with the issuer may nonetheless have a proprietary (equitable) interest in the chose in action represented by the contractual rights. As regards securities, the bundle of rights would (in shorthand or casual speech) be referred to as a 'bond' or a 'share', but those expressions typically refer to the equitable entitlement rather than the passive entitlement of a legal holder who enjoys privity of contract. For the purposes of identifying the person in privity with the issuer, there is no real distinction in English law between debt securities and shares, since the Companies Act 2006 (sections 113, 33) specifies that a registered shareholder's relationship with the issuer is a contractual one, and (section 127) obliges the issuer of a share to disregard the existence of any trust.
11. One consequence of the privity-of-contract analysis is the assertion that English law does not allow 'look-through' a chain of intermediaries from the end-investor to a higher tier of intermediary. But what is meant in such statements is limited to this privity question: considerations of property law are different, and require an analysis of the equitable proprietary interest of the person or persons asserting entitlement.
12. The Call for Evidence invites comment on the question whether investors would be constrained in taking proceedings against an issuer. The following observations might be made:
    - Custodians would not ordinarily be obliged to engage in litigation without being indemnified, but subject to that restriction there should not ordinarily be a problem if an investor seeks to take action.
    - As regards contractual claims, the issuer may assert that the legal holder has suffered no loss, and there is no privity with the equitable owner. For debt securities or debt amounts due in respect of shares, this causes no difficulty because the debt is due to the legal owner who holds the fruits on trust for the equitable owner.
    - More difficulty arises where the equitable owner asserts a breach of contract and claims damages. In these cases the privity defence would say that the legal holder has suffered no loss. However, cases where breaches are asserted seem to be rare, implying that there is no substantial issue at stake; and in any event, there are workarounds:
    - One option for an end-investor is to bring a claim in tort. While the result will depend on the facts underlying the claim and thus the particular tort, the principal concerns are likely to be the nexus of a duty of care to end-investors and the foreseeability of loss. Both ought to be present in a modern environment where an issuer goes to lengths (cf. SRD2) to know its end-investors.
    - As a fall-back, it would appear that custodians can be obliged under the FCA's rules to re-register shares into a client's name (see CASS 6.2.3R).
13. In other respects the interposition of intermediaries is bound to alter the experience which an investor has. As regards corporate actions, the experience of the investor will depend on the terms of the custody agreement. Voting rights are considered above. Other details, such as timing of deadlines, fractional entitlements, and so forth, are likely to differ from a direct holder's experience. Furthermore, FCA rules give a custodian the right to dispose of unclaimed or disclaimed client assets (see CASS 6.2.10R and 6.7.2R). (An investor holding via an intermediary also has a less solid

proprietary position than a direct shareholder: there is a risk on insolvency (considered below); secondly there are risks to the quality of the investor's title (also considered below). However, these points are not strictly matters which arise because there is 'no look-through', or to be more exact, no privity of contract.)

Shortfalls and insolvency (CfE paras 2.39-2.64)

14. Shortfalls may arise through error or fraud as noted in para 2.49 of the Call for Evidence. However, a further source of shortfalls should perhaps be noted. Settlement instructions are typically generated automatically when confirmed matched trades emanate from organised trading platforms. The result may be an automatic debit from the relevant securities account, which might be prevented only if positive intervening action is taken by the custodian/intermediary concerned. Ordinarily this will not be a problem, since most short selling is not permitted unless covered by an incoming delivery of the relevant securities (see articles 12 and 13 of Regulation EU No 236/2012, which apply to listed shares and government debt securities – that is to say, a significant proportion of securities held in intermediated chains.) However, where that incoming delivery fails – which may be through no fault of the short-seller, for example where a repo fails to unwind on time, or the counterparty to the incoming delivery transaction defaults – there may be a debit from the relevant securities account nonetheless in order to satisfy the seller's delivery obligation. This can give rise to a shortfall if the seller's securities are held in an omnibus account – a situation known as 'borrowing from the pool'. In such a case, duties arise for both seller, who must obtain the missing securities, and the intermediary, who must replenish the pool whether or not the seller does so.
15. FCA rules (see CASS 6.6) require a custodian to keep accurate records and to carry out reconciliation. A custodian should adhere to the principles of 'no credit without credit' and 'no credit without debit'. ('No credit without credit' means that the custodian should not credit the investor's account without there being a corresponding credit to its own client account at the CSD or other upper-tier intermediary. 'No credit without debit' means that the custodian should not credit the investor's account without making a debit entry in its books; if the securities were transferred from another client, the principle is obvious, but the same idea applies even if the transferor was not a client, since the custodian should record on its own books, as a debit item, its view of its holdings at the CSD or other upper-tier intermediary. See further the EPTF Report, EPTF Barrier 9.) Perhaps these two principles should be expressly set out in FCA rules; but there would not seem to be a need for a change in the general law for what is essentially a regulatory matter.
16. The handling of a shortfall, in accordance with the practices just outlined, would lead to a different result from that implied by para 2.50 of the Call for Evidence. Ordinarily a custodian does not accept responsibility for the failure of an upper-tier intermediary, contrary to what is said in para 2.50. Some explanation may be helpful:
    - The role of a custodian as trustee of intermediated securities recorded on the books of a higher-tier intermediary should be correctly understood. The custodian never 'receives' a fixed parcel of securities from the issuer. The 'receipt' is nothing more than the credit of the custodian's account on the books of the higher-tier intermediary. This limits the 'trust property' to that credit, not the underlying securities which are represented by that credit.
    - What is credited to the custodian's client account on the books of the higher-tier intermediary is beyond the custodian's operational control. It is a variable thing in terms of extent (unlike land) – so the responsibility of the custodian is limited to safekeeping whatever that thing is, from time to time. If it turns out that the upper-tier intermediary's books are in error, the lower-tier custodian is not itself liable for anything. The 'trust property' which it is obliged to safekeep is the book-entry on the upper tier books, and if

that book entry misrepresents holdings further up the chain there is no further duty to 'hold' securities which are not in fact held by the upper-tier intermediary. Paragraph 2.50 implies that the 'trust property' is something other than the chose in action against the higher-tier intermediary, possibly even the legal title to the securities, which is not the usual interpretation of a chain of sub-trusts.

- Consequently, if the custodian itself is not at fault there is no responsibility to ensure that the upper-tier intermediary is not running a shortfall, or to indemnify the custodian's client in respect of any errors or malpractice at the upper tier. Insofar as any such responsibility might be implied, it would ordinarily be excluded by contract.
- There are modern statutory exceptions to the absence of responsibility for upper-tier errors which have diluted these basic principles. In particular, where the client of the custodian is a UCITS or AIF (in which case the custodian is called a 'depositary') the upper-tier intermediary is regarded as a delegate and must police the delegate's behaviour (see for example section 3.7 of the FCA's FUND sourcebook, implementing article 21(11) of AIFMD). However, even in that case, there is no blanket indemnity in favour of the client.

17. The concern regarding shortfalls is only a real issue in the event of insolvency or fraud. It is the duty of a custodian to ensure that any reconciliation error is rectified immediately: so temporary no-fault shortfalls such as those just described will not cause practical issues for any of the parties involved. Fraud shades into insolvency: because a fraudulent intermediary will conceal its tracks, and in practice the problems will emerge only when the fraudulent party fails to perform its obligations; in the regulated sector this means, in practice, when the fraudulent intermediary has gone into an insolvency process and its books are being examined independently. Thus, only if the intermediary cannot perform its obligations will the difficulties arise.
18. The principal practical issues arising on insolvency can be listed as follows:
    - The books and records of the failed intermediary may not clearly indicate what is held and for whom. This will require an investigation and reconciliation exercise, typically performed on behalf of the possible client asset claimants, and that exercise will entail some cost.
    - Even if the books are in perfect order, some cost will be involved in the assessment of client claims and the distribution of client assets to the persons entitled.
    - Following the introduction of the Investment Bank Special Administration Regulations 2011, in respect of an 'investment bank' the costs will be paid by liquidating some part of the assets concerned. Inevitably, therefore, there will be loss to the clients. In other words, the very institution of the insolvency process will give rise to a shortfall. In the event of a pre-insolvency shortfall (where the total of legitimate client claims exceeds the amount of assets available for distribution) the law now specifies a pro rata distribution, creating much greater certainty and simplicity as compared with the previous law.
    - If the intermediary is not an 'investment bank' the position is much less certain. The respondent is not aware of any significant class of intermediaries which would not constitute 'investment banks' (as defined in section 232 of the Banking act 2009).
19. It is not obvious that any solution, different from the one adopted in the 2011 Regulations, would achieve a better or fairer result. (It might be noted that if an insolvency process had been avoided, distribution costs would be borne out of the general assets of the intermediary; in other words, the policy of the 2011 Regulations is to shift the burden from the general estate to the owners of the distributable securities.) The choice is essentially between the costs and shortfall being borne (a) by the affected investors; (b) by the general body of creditors; or (c) funded by some statutory third party such as the FSCS. In the cases of (b) and (c) someone else has to pay, so that the investors can

achieve a preferential status in the insolvency. Whether that is desirable is not a question of securities or custody law but of policy.

Set-off (CfE paras 2.65-2.70)

20. Set-off is not permitted as between an end-investor and an issuer. Notwithstanding para 2.65 of the Call for Evidence, the law of England and Wales would appear to be as follows.
21. A 'legal set-off' (a defence to a claim for an unpaid debt) cannot be asserted where the debtor's claim arises under a negotiable or similar debt instrument. Numerous authorities for this are cited in Gullifer and Goode, *Legal Problems of Credit and Security*, 6th edition (Sweet & Maxwell, 2017), para 7-57. But the key point is that a freely tradeable debt instrument cannot, as a policy matter, be allowed to circulate where it is impaired or even cancelled by a set-off but this impairment is not visible to the transferee. Unless there is some mechanism for surrender of a debt instrument at the moment the defence were allowed, the risk would arise, so the defence would surely fail.
22. An 'insolvency' set-off (under rules 14.24 and 14.25 of the Insolvency (England and Wales) Rules 2016) requires mutuality. It is well understood that a claim by a trustee acting in his own right is not mutual with a claim against a beneficiary, or vice versa. What is less clear is whether insolvency set-off 'looks through' a trust. But in practice, the problem is likely to be very tough, since debt securities' intermediation chains are ordinarily very complex and cross-border. Debt securities are typically issued in the form of a global note, issued to a 'common depository' who holds the note for investors recorded on the books of the two ICSDs Euroclear (BE) and Clearstream (LU) who in turn hold their entitlements under the laws of their respective jurisdictions for other intermediaries, who may be custodians holding for investors or sub-custodians holding for yet other intermediaries. It is far from correct to imagine that each step in such a chain would be characterized as a bare trust allowing look-through by a debtor-investor. Furthermore, the 'negotiable instrument' (transferability) objection may also apply.
23. As to the position of a 'direct' holder of a debt instrument, a set-off under rule 14.24 or rule 14.25 may theoretically be available if the transfer objection can be overcome. However, in the case of public companies a direct holding structure would be unusual except in relation to instruments issued by banking entities, for which special insolvency rules apply.
24. Set-off restrictions are unlikely to impair the situation of a genuine investor who invests with a view to a return on its investment. Historically the policy of the law in insolvency has been to distinguish such an investor from an opportunistic debtor seeking a device to pay less on his/her debt. The law thus disallows set-off when a debtor acquires a claim (usually at a discount) against his/her creditor (the issuer) with a view of set-off (at par value) in the event of formal insolvency proceedings of the issuer. This is the policy behind rule 14.24(6) and rule 14.25(6). It would conflict with that policy if set-offs were made more widely available to bond investors, who would benefit from trades done in the period leading to insolvency to the detriment of the issuer's general body of creditors.

Good faith purchaser (CfE paras 2.71-2.80)

25. It is important for the success and liquidity of securities markets that transfers of securities occur without carrying invisible encumbrances in the form of equitable interests of former owners and people claiming through them. The following observations complement the discussion in para 2.73 of the Call for Evidence relating to good faith purchasers.
26. Effectiveness of transfer requires that a *bona fide* purchaser of securities has a defence against third party claims of which it was unaware. Although the basic rule of English law is that *nemo dat quod non habet* (a non-owner cannot transfer what he does not own), English law also provides that a

bona fide purchaser for value of a legal estate without notice acquires clean title against any challengers.

27. The requirement for a 'legal estate' is more difficult, but of crucial importance. In relation to shares, the preponderance of academic and judicial commentary favours the notion that a registered shareholder has a legal estate (see Micheler, *Property in Securities, a comparative study* (Cambridge University Press, 2007), section 2.3; *J Sainsbury plc v O'Connor (Inspector of Taxes)* [1991] 1 WLR 963; *Akers v Samba Financial Group* [2017] UKSC 6). Conversely, unless the transferee is directly registered on the register of members of the issuer, the transferee could not claim to have the 'legal estate'. As far as an indirect investor who acquires shares is concerned, its custodian will have the legal estate, and the *bona fide* purchaser defence is not available.
28. In relation to debt securities, the usual pattern for issue and holding of the securities is for the global note to be in custody with a common depository, who alone can claim to have the 'legal estate'. So for debt securities, no acquirer will be able to avail itself of the *bona fide* purchaser defence.
29. Where the *bona fide* purchaser defence is not available, the *nemo dat* rule will apply, and as between competing transferees with equitable interests the first in time will prevail. (Cf. *Cave v Cave* (1880) 15 Ch.D. 639). Professor Smith (*Property Law*, 9th edition (Pearson, 2017), p. 230) gives examples where the first-in-time priority rule could be upset, saying that these are 'unusual'.
30. However, it does not appear that title defects cause practical problems in relation to freely transferable securities which are typically the subject of intermediated holding patterns. A vast number of transactions occurs and is settled daily without difficulty. Accordingly, the apparent inference from the analysis of the *bona fide* purchaser rule, that the rights of a *bona fide* purchaser are weak because she/he does not have the 'legal estate', needs to be assessed more critically, and in the context of the actual settlement environment. Transfers following a transaction on a trading venue will be settled by a transfer at the CSD (in the UK, EUI) level, a process which is discussed in more detail below. To make out a claim, it is necessary for a claimant to show that the property held by the purchaser is the thing which the claimant had. That 'thing' was in fact a chose in action against an intermediary – which, as argued in paragraph 16 above, is distinct from the underlying security – and thus not the same 'thing' as that which the purchaser has. Even if this objection could be overcome, tracing a right to the 'securities' through net settlement processes, omnibus accounts which are subject to frequent inward and outward flows, subsequent transactions after reaching the hands of the purchaser and so forth will all confuse the trail. Without a clear path, the proprietary claim will likely fail.
31. From a strictly legal standpoint, a number of difficulties will stand in the way of a claimant seeking to challenge a *bona fide* purchaser even if the purchaser does not have the legal estate:
    - If the claimant represented to the purchaser that there is no claim, or implicitly authorized the disputed transaction, the purchaser should succeed.
    - Where the purchaser is a subsequent transferee (P2) and acquired the securities from an intermediate purchaser (P1) who had the legal estate and no notice, P2 should obtain a clean title, even if P2 acquired with notice of the claimant's claim.
    - If the purchaser subsequently obtains the legal estate, and had no notice of the claim at the time of purchase, it seems that the purchaser will take free of the claim (see *McCarthy & Stone v Julian S. Hodge* [1971] 1 WLR 1547, citing *Barnes v Barnes* [1894] 1 Ch 25). A bona fide custody client may thus be able to upgrade its defence by instructing its custodian to register shares directly in the client's name.
    - In a case involving foreign securities, the claimant's equitable interest may never have attached to the securities, or the purchaser may have a more complete defence to the claim, under the law of the place where the purchaser's entitlement falls to be decided. In these cases English

law may still purport to have reach, but it will be in exercise of *in personam* jurisdiction, and the purchaser may not be subject to the jurisdiction of an English court.

32. On the other side of the debate, the position of a bona fide purchaser even with the legal estate may be at risk, because the concept of 'notice' under English law is somewhat slippery. The doctrine of constructive notice treats facts which would have come to the purchaser's knowledge 'if such inquiries … had been made as ought reasonably to have been made' as ones of which the purchaser has notice even though the purchaser had no actual knowledge (see section 199, Law of Property Act 1925). Thus questions of market practice, which will be a determinant of what ought reasonably to be done, are entwined in the legal analysis.

Transfers of equitable interests (CfE paras 2.77-2.80)

33. A preliminary comment to be made in relation to transfers of securities is that a transfer in an intermediated environment will rarely, if ever, constitute an 'assignment'. A transfer out of custody would not involve an 'assignment' by an indirect investor: the beneficial interest held at the custodian is not being transferred, so there is no assignment of the item of property enjoyed by the transferor-investor. Rather, an outright transfer process is one of direction to the trustee for a disposition of the property held on trust. Thus, various legal formalities which could apply to 'assignments' will not be relevant to transfers of intermediated securities.
34. Notwithstanding that comment, a transfer of an interest in securities from a custody account will constitute a 'disposition of an equitable interest' in property. Section 53(1)(c) of the Law of Property Act 1925 states that 'a disposition of an equitable interest … must be in writing signed by the person disposing of the same …'. Because transactions which do not comply with the section are void, it has given many headaches to academic lawyers considering the problem (Cf. Macfarlane and Stevens, *Interests in securities – Practical Problems and Conceptual Solutions*, chapter 2 in Gullifer and Payne, eds., *Intermediated securities: legal problems and practical issues* (Hart Publishing, 2010)).
35. However, modern law is tolerant when it comes to what constitutes writing and signature. A custodian's or broker's electronic communications methodology for transmission of instructions would usually comply with the statutory requirements for 'writing' and 'signature' (see Law Society Practice Note, *Execution of a document using an electronic signature*, 21 July 2016). It may be that section 53(1)(c) is more of a bugbear than an actual problem.
36. As observed in para 2.78 of the Call for Evidence, for transfers via CREST, section 785 of the Companies Act 2006 disapplies the need for a written instrument to a transfer of an equitable interest in securities. While it is technically possible for a share transfer to settle across the books of an upper-tier intermediary without going through CREST, whether that happens depends on the operational arrangements for generating settlement instructions. Transactions emanating from organised trading venues may result in automatically generated settlement instructions directed to CREST; in such cases active intervention by the settlement agent (custodian) would be needed to divert the settlement away from CREST so that it can occur on the intermediary's books. The extent to which lower-tier settlement occurs will become more evident with the introduction of reporting obligations on 'internalised settlement' under article 9 of the CSD Regulation (see also regulation 2(2)(za) of the Central Securities Depositories Regulations 2014).
37. Other solutions which may assist in combating section 53(1)(c) in residual cases are: for financial collateral arrangements, section 53(1)(c) is expressly disapplied; and more generally, there is a slim possibility that the concept of 'disposition' does not apply to an indirect interest in shares (cf. *Akers v Samba Financial Group* [2017] UKSC 6 in interpreting section 127 of the Insolvency Act 1986).

Technological developments, Dematerialisation, Devolution, Other Jurisdictions

38. No comments are offered on these parts of the Call for Evidence.

Other issues – Geneva Securities Convention

39. Paragraphs 2.108-2.110 of the Call for Evidence invite submission of additional issues for consideration. For a long time the agenda for law reform in relation to intermediated securities has been debated at international level, culminating in the Unidroit Convention on Substantive Rules for Intermediated Securities 2009 (the Geneva Securities Convention).
40. The Geneva Securities Convention would constitute book entries on the books of an intermediary as definitive records of title. English law does not accord any legal *in rem* status to the credit entries to a custody account, yet the difficulties and potential difficulties with English law identified in the Call for Evidence would not obviously be solved by adopting the Geneva Securities Convention rule.
41. In English law, even without the Geneva Securities Convention rule, the account and book-entries are nevertheless of considerable importance, while avoiding some of the anomalies of the Convention:
    - The account has evidential importance. In any case where there is a dispute about the custodian's activity, or the size of the investor's holding, or there is a shortfall, the entries on the account will carry very substantial weight. If the custodian fails, and there is a question whether a particular asset is beneficially owned by the custodian for itself, or held on trust for clients, the books and records of the custodian will ordinarily be decisive (for an example, see Lehman Brothers/Pricewaterhouse Coopers statement at https://www.pwc.co.uk/services/business-recovery/administrations/lehman/lehman-faqs-trust-property-client-assets.html).
    - Book entries need to be treated with care: not all entries are equal, and not all entries are records of ownership, even in securities accounts. For example, custodians who have properly lent out their clients' securities, or taken security interests in collateral held elsewhere will need to keep records of those matters; these ought not to be treated as 'credit entries' indicating ownership entitlements.
    - An advantage of the English law approach is that it is not legally necessary for an investor to establish that there is an account entry in its favour in order to enjoy the rights attached to the securities. Conversely, even an entry which is intended to reflect an ownership entitlement ought not to be regarded as definitive. For example, as previously discussed, reconciliation errors may occur, settlements may fail, automatic debit at the higher tier (as happens with exchange-traded transaction settlement) may lead to timing mismatch as book entries at one tier do not keep pace in real time with entries at another.
    - In the event of error in the account, it is not possible for the entries on the account to constitute the 'creation' of securities if the custodian does not itself actually hold such securities either at EUI or via another intermediary. Correction of an error is an administrative matter with no status *in rem* (as opposed to evidential consequences which may be important if there is a dispute or a shortfall).
42. The following supplementary remarks about the Geneva Securities Convention might be added:
    - Articles 11 and 12 (Acquisition and disposition methods). A 'control agreement', even in the context of the Financial Collateral Arrangements (No.2) Regulations 2003, is probably insufficient to give rise to an effective collateral arrangement in English law (see *Re Lehman Brothers International Europe (in administration)* [2012] EWHC 2997 (Ch)). There may be merit in revisiting certain areas of difficulty in the application of the Financial Collateral Directive, which is troublesome in the UK as it is across EU Member States – see EPTF Barrier 8.
    - Articles 18-20 (Acquisition and priority of claims). The Convention does not explain satisfactorily how the problem of securities creation would be addressed if a bona fide acquirer has obtained inviolable title under article 18 while a bona fide prior owner retains title by reference to a

different set of account entries; in its present condition, English law would not tolerate such a situation.

- Article 22 (Upper tier attachment). If a custodian is an upper tier intermediary, it is not possible under English law for securities held by the custodian in a properly segregated client account to be attached for the satisfaction of the custodian's own debts. No new English law rule is needed to deal with this problem, if indeed it exists as a real issue.

The respondent welcomes the attention of the Law Commission to these questions and is grateful for the opportunity to express these comments. The identity of the respondent and the content of the response are not confidential.

Sir John Dermot Turing
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