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The Quoted Companies Alliance is the independent membership organisation that champions the interests of small to mid-size quoted companies.

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Tuesday 5 November 2019

Dear Commercial and Common Law team,

**[Intermediated Securities: Call for evidence]**

We welcome the opportunity to respond to your consultation on intermediated securities.

The Quoted Companies Alliance has examined the proposals and advised on this response from the viewpoint of small and mid-size quoted companies.

We welcome your work to identify the issues in the current system of intermediation and highlight potential options for reform. The current system of intermediation has made the trading process considerably quicker and easier, as well as reducing some costs and burdens for certain parties. However, we believe that the current system significantly restricts an issuer's ability to constructively engage with its ultimate investors, as well as the system obstructing an ultimate investor's ability to engage with the company it has invested in.

Issuers and ultimate investors often have to go through lengthy and complex processes to engage with one another, which frequently results in the breakdown of that engagement altogether. This has significant implications for corporate governance and stewardship, and can also provoke legal complications.

We firmly believe that ultimate investors should have the right to request that their details are recorded in the share register and that intermediaries should not have the ability to exclude this right. This provides companies with the opportunity to communicate with its ultimate investors and should permit ultimate investors to vote directly on important matters.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

A handwritten signature in blue ink, appearing to be "D2L".

Tim Ward  
Chief Executive

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

If so:

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

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

Yes – we do consider that it is difficult for the ultimate investor to exercise their voting rights. We believe that this is due to the intermediated securities chain, which acts as a barrier to ultimate investors exercising their voting rights. The complexity of intermediation is such that ultimate investors find that they are often unable to exercise their voting rights, or have to go through highly cumbersome processes to do so.

Whilst some intermediaries recognise and acknowledge that voting or shareholder rights are not their property, it is their responsibility to pass down these rights to the ultimate investor. However, the complexity of the intermediated chain has historically resulted in a significantly high level of error, a lack of reliability and validity and issues with identification and timeframes being met.

It remains highly important for the small and mid-size companies we represent to have their shareholders constructively engage with them. This affords them the means to acquire their feedback on potentially contentious issues. The inability to exercise their voting rights is especially troublesome as these votes are often regarding important matters such as how the company operates and on corporate governance issues. Not only this, but we are also aware that ultimate investors can encounter difficulties in terms of being permitted access to information from the issuer due to the intermediated system.

**Q2 Are there particular systems or models of holding intermediated securities which could better facilitate the passing back of direct rights for ultimate investors? If so, what are the current obstacles to the use of such systems?**

Yes – there are different types and systems of intermediated securities holding systems, which better facilitate the passing back of rights for ultimate investors. Typically, intermediated holding systems exist in two forms. First of all, there are transparent systems, whereby investors and issuers are directly connected and intermediaries have a more dormant role; and, second, tiered, non-transparent systems, whereby there is no direct connection between issuers and investors, but the connection can be facilitated by the intermediary. It is the latter system where ultimate investors are most frequently impeded from gaining access to their rights. This includes: the right to receive income on securities through interest on bonds or dividends on shares; the exercise of voting rights attached to shares; and the provision of information from issuer to ultimate investor. In such systems, there is often a discrepancy between the entity legally entitled to exercise rights and the entity economically entitled to exercise rights. As a result of this, an information gap exists where the issuer does not have the knowledge of who the holder of economic entitlements is.

As such, we note three obstacles that prevent or impede the passing back of direct rights to the ultimate investor. They are issues of identification, transparency and on the definitional scope of certain directives.

Companies are often unable to identify their shareholders because companies and intermediaries have not stored personal data relating to the shareholders. This is a prerequisite for engagement and communication, and thus essential in facilitating the passing back of rights to the ultimate investor. Quoted companies should

have the right to identify their shareholders, where, upon being requested, intermediaries should pass over the information regarding the identity of the shareholder without any delay whatsoever. In addition to this, there is a lack of transparency around the intermediated chain that acts as a significant obstacle to the passing back of rights to ultimate investors. This issue is exacerbated in intermediated securities chains that operate in a cross-border context, whereby different legal systems are in place and interact with different tiers of the chain. The recently revised EU Shareholder Rights Directive II had aimed to ameliorate these issues through the identification of shareholders. However, there are still definitional complications as the Directive still allows for the shareholder/ultimate investor to be defined as the legal person that is recognised as a shareholder under the applicable law. Thus, one may still define a shareholder on the basis of legal criterion.

**Q3 Do you consider that the type of vote affects the extent to which ultimate investors can exercise voting rights? If so, do you have examples, or specific evidence, of this issue?**

No – we do not consider that the type of vote affects the extent to which ultimate investors can exercise voting rights. Rather, we believe that all type of votes, whether at an annual general meeting (AGM), during a takeover or on bonus or rights issues, are difficult to exercise due to the chain of intermediaries. This is because it will be the intermediary's name on the register and they have the status of being the legal shareholder. As such, the ultimate investor has no such right or ability to vote at company meetings, attend meetings, requisition resolutions or even receive information from the company, such as a notice of meetings or annual reports.

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

If so:

**(1) What is the impact of this?**

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

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

Yes – we do consider that it is difficult for ultimate investors to obtain confirmation that their votes have been received. Failure to receive vote confirmation has considerable implications for governance. The ultimate investor is unable to have any certainty that their vote has been cast or whether a vote has been placed in accordance with their instructions.

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

If so:

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

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

Yes – the rules and practical arrangements relating to the timing of voting does affect the ability of ultimate investors to vote. As the consultation highlights, there are both practical and legal concerns in relation to the timing of voting. This situation is magnified when the information must be passed down through the chain of intermediaries.

From the perspective of small and mid-size quoted companies, it is especially difficult to provide information to shareholders in an intermediated security chain about an upcoming vote in a timely and efficient manner as these companies have smaller capacities and less resources to be able to locate shareholders and then distribute information accordingly.

**Q6 Do you consider that there are aspects of proxy voting which may affect the rights of ultimate investors in the context of an intermediated securities chain?**

If so:

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

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

Yes – there are aspects of proxy voting that affect the rights of ultimate investors in the context of an intermediated chain. Purely by virtue of a proxy's inherent nature as being a person or organisation to represent someone else, means that there is an additional element within the intermediated chain. This serves to add to the complexity of the chain, and creates further issues relating to transparency and voting confirmation.

Voting confirmation, for instance, is an extremely important mechanism that is often made considerably more difficult in an intermediated securities chain. These difficulties are then exacerbated when a proxy agent or proxy adviser comes into the equation. Under such circumstances, it is difficult, and, often impossible, for an ultimate investor to determine categorically that a vote has been received and cast. This failure within the voting chain has the potential to result in different voting outcomes, which makes it especially difficult for public companies to operate in accordance with their shareholders preferences.

In order to solve these problems, the opacity in the ownership chain needs to be overcome. This will consequently make the voting chain less opaque and more transparent and ensure that the rights of ultimate investors are respected.

**Q7 Do you consider that the headcount test in section 899 of the Companies Act 2006 has the potential to cause problems in the context of intermediated securities? In what way?**

If so:

**(1) Do you have examples, or specific evidence, of problems arising out of the application of section 899 of the Companies Act 2006 to intermediated securities?**

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

Yes – we do consider that the headcount in section 899 of the Companies Act 2006 has the potential to cause problems in the context of intermediated securities. Firstly, as section 899 pertains that a scheme of arrangement is between a company and its creditors or members, this means that ultimate investors are

unable to exercise their rights as they are not the legal owners of the shares. Secondly, and as highlighted in the consultation, the legal owner of the share – the creditor or the member – are only considered to be one member, despite a situation arising in which the intermediary may hold a substantial amount of shares on behalf of many ultimate investors. As a result, this not only means that the voting power of the ultimate investor is greatly diluted, but also that there may be opposing views between ultimate investors connected by the same intermediary, meaning that views are not accurately represented.

**Q8 Do you consider that, in practice, the no look through principle may restrict the rights of ultimate investors who wish to bring an action against an issuing company or intermediary?**

If so:

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

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

We consider that the no look through principle does not necessarily restrict the rights of the ultimate investors who wish to bring an action against an issuing company or intermediary. Rather, we see that the no look through principle makes the process of ultimate investors bringing action against an issuing company more complex. That is, the ultimate investor still has the power to claim against their immediate intermediary, encouraging them to claim against the next intermediary/company, or use their commercial position to apply pressure to their intermediary to take action. Whilst this process may not be as straightforward or as direct as a challenge to the company, the ultimate investor still has the capacity to encourage the relevant intermediary to assert the rights associated with their shareholdings on their behalf.

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

We consider that there are significant benefits to the no look through principle. For instance, the no look through principles promotes certainty and consistency in securities markets. This is so as the principle reduces the likelihood of disruption, thereby increasing settlement efficiency through decreasing settlement volumes in the post trade infrastructure.

The no look through system also protects issuers by reducing the risk of their exposure to multiple direct claims.

**Q10 Do you consider that the regulatory regime alone is sufficient to address the risks and consequences of an insolvency in a chain of investment intermediaries?**

Yes. Following the financial crisis, the regulatory regime was appropriately and sufficiently amended to address the risks and consequences of an insolvency in a chain of investment intermediaries.

**Q11 Do you consider that there is merit in our reviewing the consequences of insolvency in an intermediated securities chain from a legal, as opposed to regulatory, perspective?**

We have no comments.

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

If so:

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

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

Yes – the insolvency of an intermediary in an intermediated securities chain does have the potential to cause problems. Despite ultimate investor's having their assets ring-fenced, there is the potential that a shortfall will exist, whereby the intermediary does not have the sufficient securities to pay back to the ultimate investor. This problem is particularly pronounced as a result of the intermediated securities chain, as it is more difficult for the ultimate investor to attempt to recover the assets.

**Q13 Do you consider that there is uncertainty about how assets would be distributed in the event of an intermediary's insolvency? If so, how could this uncertainty be resolved?**

Yes – we agree with the issues as outlined within the consultation document, that there is uncertainty about how assets would be distributed in the event of an intermediary's insolvency.

**Q14 Do you consider that there is a need for better education of ultimate investors about the risks of an intermediary's insolvency, and a better awareness about the application of the Financial Services Compensation Scheme? What could be done to reduce the exposure of ultimate investors in the event of an intermediary's insolvency?**

Yes – there is a need for greater education of ultimate investors about the risks of an intermediary's insolvency, and in particular, amongst retail ultimate investors.

**Q15 Do you consider that the application of a right to set off has the potential to cause problems in the context of an intermediated securities chain?**

If so:

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

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

Yes – we do consider that the application of a right to set off has the potential to cause problems in the context of an intermediated securities chain. This is due to uncertainty over how and in what capacity the right to set off applies to an intermediated securities chain. In order to overcome this, greater clarity is needed.

**Q16 Do you consider that the disparity in the way that purchasers of directly held securities and intermediated securities are protected by law has the potential to cause problems?**

If so:

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

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

Yes – the disparity between the way that purchasers of directly held securities and intermediated securities are protected by law has the potential to cause problems. This is because those who purchase intermediated securities are exposed to a number of risks, especially as those who hold securities through an intermediated chain are deprived of the sorts of protections available to those that hold shares directly.

For instance, by agreeing to outsource the custody of an asset to an intermediary, the ultimate investor bears the risk of potential negligence or fraud by the intermediary and will not necessarily be afforded the right to claim against them. This is exacerbated when the intermediary of the ultimate investor out-sources custody to additional intermediaries.

**Q17 Do you consider that the application of section 53(1)(c) of the Law of Property Act 1925 has the potential to cause problems in the context of an intermediated securities chain?**

If so:

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

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

We have no comments.

**Q18 Do you consider that distributed ledger technology has the potential to facilitate the exercise of shareholders' rights and, if so, in what way? What are the obstacles to adoption of this technology? Are there any other jurisdictions we should look to as examples?**

Yes – we do believe that distributed ledger technology, such as blockchain, has the potential to help facilitate the exercise of shareholders' rights. There are two main problems that exist in an intermediated security chain regarding the exercise of shareholder rights. These are: (1) the complex system of intermediaries that creates a lack of transparency and trust between ultimate investors and issuers in the exercise of shareholder rights and sharing information; and (2) the different means through which an ultimate investor can engage with companies that creates inequalities and disadvantages between different types of ultimate investor.

The first issue is resolved as the data stored in a blockchain is immutable and verifiable, meaning that trust between the issuer and the ultimate investor can more easily be established. Through distributed ledger technology, ultimate investors are also able to receive voting confirmation and verify that their vote has been included. This serves to significantly reduce the complexity of the intermediated system and enhances transparency and trust.

Different types of ultimate investors engage with companies in different ways. For example, large institutional ultimate investors may engage with companies through private meetings with companies, whereas smaller ultimate investors may only have the opportunity to engage with the company at its AGM. The adoption of distributed ledger technology helps to ameliorate these inequalities and harmonise systems of engagement through the offering of common digital discussion platforms.

**Q19 We welcome consultees' views on, and any evidence of, ways in which technology in general might be able to solve problems in the context of an intermediated securities chain.**

We have no comments.

**Q20 Has the market started to prepare for the dematerialisation that would be required under CSDR? If so, what steps have been taken and by whom?**

We have no comments.

**Q21 Are there approaches in relation to dematerialisation in the context of CSDR which could be applied to the ultimate investors in an intermediated chain to provide ultimate investors with the same or similar rights as direct shareholders?**

We have no comments.

**Q22 Are there concerns about imposing dematerialisation on long-time shareholders currently holding paper certificates, when they may not be confident users of technology?**

Yes – there are concerns relating to imposing dematerialisation on long-time shareholders who currently hold paper certificates. This not only excludes individuals that may not have access to, or be confident in, technology, but has also created concerns over whether those who currently hold paper share certificates will be able to remain direct shareholders with access to all shareholder rights after dematerialisation.

**Q23 We welcome comments from consultees as to whether there are aspects of the law of the devolved jurisdictions which we should be aware of given the work we propose in relation to intermediated securities.**

We have no comments.

**Q24 What other jurisdictions should we consider and why?**

We have no comments.

**Q25 We welcome suggestions from consultees as to other issues which arise in practice which should be included in our scoping study. For each issue, we would be grateful for the following information:**

**(1) A summary of the problem.**

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

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

We have no comments.

**Q26 What are the benefits – financial or otherwise – of the current system of intermediation? What are the costs or disadvantages – are there any problems beyond those we have highlighted above?**

We have the following points to raise regarding the benefits and costs/disadvantages of the current system of intermediation:

#### **Benefits**

- An intermediated and dematerialised securities chain has made trading significantly quicker, as well as making the process considerably easier.

- The operation of pooled nominee accounts can be more cost effective for brokers and helps to keep their costs down due to fewer administration/transaction costs.
- Collectively held securities can allow for simpler voting processes as the account provider is responsible for processing the instructions and entitlements, which may reduce the burden on the issuer.
- The current system of intermediation reduces the burden for issuers as they do not have to deal directly with a large number of investors as the burden is shifted to an intermediary who will hold shares for numerous ultimate investors.

### **Costs/disadvantages**

- An information shortfall exists due to the poor level of engagement between the ultimate investor and the issuing company.
- The processes of intermediation – whereby ultimate investors become detached from direct ownership in their shares – has increased the overall costs for the ultimate investor as a result of the costs of custody and administration being passed from the broker, or other intermediary, to the ultimate investor.
- Ultimate investors are dependent on their intermediary to facilitate access to their share/voting rights, which is sometimes difficult, if not impossible, to achieve. In an intermediated securities chain, ultimate investors do not automatically receive their shareholder rights as they do not appear on the company share register and, as such, are not visible to the issuing company.
- There are disadvantages within the current system of intermediation regarding delay. That is, the time it takes an ultimate investor at the end of the chain of intermediaries to receive communications from a company on potential corporate actions may be so long that it causes ultimate investors to miss out on votes or not have time to consider them properly.
- Where an intermediary holds securities for many investors in a pooled account, some may wish to vote in favour of a particular matter and some may wish to vote against, creating a situation of conflicting votes.

### **Q27 What could be the benefits – financial or otherwise – of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain?**

We see the following benefits of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain:

- Ensuring the availability of rights provides a channel for communication between shareholders, the board and management on important issues, such as company resolutions, the election of directors and a host of other governance issues.
- Ensuring the availability of rights for ultimate investors will help to override the opacity of current intermediated securities chains to make them more transparent and open.
- In ensuring the availability of rights, an ultimate investor should have their contact details and the number of shares that they are interested in included within the share register and be permitted the ability to vote directly. This means that ultimate investors will no longer have to go through overly cumbersome processes to access their votes; the timing and efficiency of votes taking place will improve greatly; and ultimate investors will be able to accurately and reliably table and receive confirmation of their vote.

- Ensuring the availability of rights for ultimate investors serves to encourage stewardship activities.

**Q28 What could be the costs – financial or otherwise – of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain?**

We see the following costs of ensuring the availability of rights and remedies to the ultimate investor in an intermediated securities chain:

- There are both legal and practical implications of ensuring the availability of rights to the ultimate investor in an intermediated securities chain.
- **Practical:**
  - In terms of the practical implications, ensuring the rights of investors could result in the practical advantages of intermediation being dissolved, which includes greater transferability of shares and administrative convenience.
  - As well as the above, ensuring the availability of rights will be a considerable practical undertaking in establishing frameworks and structures to facilitate the availability of rights to the ultimate investor.
- **Legal:**
  - As the name on the register of the issuer in the intermediated securities chain is the intermediary, it is they who have the legal entitlement to vote. As such, changes will have to take place in order to facilitate the entitlement to vote being passed down to the ultimate investor.

