Intermediated Securities

Call for Evidence

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Introduction

Despite the advantages of intermediation, it is a belief that the trade-off is reduced competition for securities and places unfair risk and cost onto the ultimate investor. The main positive positions of this response to this Call for Evidence[1] are: 1) everyone should be enabled to purchase the legal title in the shares, rather than the current position of being disabled; and 2) a specific legislative remedy needs to be considered for investors against intermediaries and possibly the company as issuer to improve the certainty of the law and reduce transaction costs in dealing with the practicalities of the intermediated securities chain. A tentative suggestion is also made to consider complete reform to, and carving out of, retail investor law with a specific statutory enactment.

It is anticipated that such proposals would not undermine the current system of intermediation but work in conjunction with it. The advantages of the intermediation system would still drive people to that system but would enable investors with a sufficient risk appetite to purchase or own the shares directly. A more competitive market would, hopefully, reduce the administrative costs involved in purchasing shares directly. A specific statutory remedy for ultimate investors who suffer loss or wrongdoing would not make corporate law "unworkable"[2] but would seek to provide a limited and defined solution, particularly where the FSCS or FCA provisions do not cover the loss. This would reduce any reliance on common law rules and equitable principles to fill gaps in protection and resolve such cases that may otherwise result in a haphazard development of the law and increase the transaction costs in intermediated securities for the benefit of all parties.

The main negative position of this response is that it does not consider that improving the way voting rights can be fed back to shareholders will have any positive impact on governance. Instead consideration should be given to the way intermediated securities are marketed, acquired, held, and disposed of as a way of improving the transparency and understanding of what is being, and has been, purchased and the risk investors face by doing so. This should have a knock on effect for the improvement of governance by enabling ultimate investors to determine where their money is invested.

I shall now take each question in turn.

Question 1

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, it is difficult. The example of *In the matter of Public Joint-Stock Company Commercial Bank "Privatbank"*[3] demonstrates the transaction costs involved in "enfranchising" the ultimate investor

[1] Hereinafter 'the Call'

[2] *Enviroco Ltd v Farstad Supply A/S* [2011] 2 BCLC 165 at [38]

[3] [2015] EWHC 3299 (Ch), [2015] 11 WLUK 345

that make it difficult and costly. However, from the outset I should note that that response to this question should not be taken as implying it should be easier.

Example of terms

The following two examples demonstrate the legal and practical limitations faced by investors in obtaining or exercising any voting rights: Freetrade Ltd and Wealthify Ltd. The legal difficulties can be seen in the example of Freetrade through the following condition in their agreement with the investor:

> The Custodian that holds Securities that you have acquired through our Services will have legal title to those Securities and will hold those Securities in its name – in other words, the Custodian's name will appear on all registers, etc. that show who the owner of those Securities is. However, you will be the beneficial owner of those Securities – in other words, as between you, us and the Custodian, you are the ultimate owner of those Securities.
>
> A person who holds Securities may from time to time be invited to cast votes in relation to the company whose Securities those are, attend meetings of those companies, subscribe for additional Securities and/or to take other actions, all on account of the fact that that person is a holder of those Securities. These are sometimes referred to as "corporate actions". The registered holder of those Securities will be informed of these corporate actions (i.e. the Custodian in this case). You hereby: (i) acknowledge and agree that we will have no duty to inform you of any corporate actions related to any Securities that are beneficially owned by you through our Services, even if we become aware thereof, (ii) irrevocably waive your right to exercise any corporate actions that may be exercised by the holder of the Securities that you beneficially own through our Service, and (iii) agree that the Custodian may in its discretion act on those corporate actions as it sees fit.[4]

The legal limitation here of obtaining voting rights is clear. There is no right for the ultimate investor to exercise such rights because they have contracted away any such ability.

Now take the example of Wealthify, which demonstrates practical and legal limitations. The terms and conditions of their Custodian Bank, Winterflood, provide:

> Clause 4.8: On request and in accordance with Applicable Law, we will arrange for you to attend shareholders', securities holders or unit holders' meetings in respect of your investments. We can also arrange for you to vote and receive any information issued to shareholders, securities holders or unit holders, but only upon the prior and timely receipt of an instruction by you, or by a Representative on your behalf, to do so.

While this, in theory, offers better ability as an investor to exercise governance rights, it contains several problems. First, the right to vote is buried in the terms and conditions. These rights are not, as far as I can see, otherwise advertised to the ultimate investor at the time of opening an account with the company. Second, the term stated in Winterflood's terms and conditions places the burden on the investor to exercise any voting rights. The investor has to discover which companies their money is invested in, when meetings are being held, and must cover the costs involved in exercising the vote. Providers can often lack transparency on where money is invested.[5] Ultimate investors may

[4] Freetrade Terms and Condition, 'Your Securities' available at <https://freetrade.io/terms-conditions> last accessed 04/11/2019

[5] See, for example, Friends of the Earth, 'What's your pension funding? How UK institutional investors finance the global land grab' <https://friendsoftheearth.uk/sites/default/files/downloads/whats-your-pension-funding-how-uk-institutional-investors-finance-global-land.pdf> last accessed 11/10/19, p 4 – reporting 4 out of the top 10 pension funds provided no public information on the companies that their funds invest in

simply not look where the money is invested.[6] Just like standard form contracts where it is irrational to read them in most instances, it becomes irrational or inefficient to exercise voting rights because of the effort required to exercise them.

Finally, a legal limitation to the exercise of voting rights is that while the ultimate investor is given the opportunity to vote, they are only entitled to exercise rights as if they were the member but does not confer enforceable rights of a member upon them. If there were any issues regarding the exercise of the vote, the investor would have to rely on the intermediary to enforce those rights.[7]

Solving the "problem": Corporate law and governance and the normative consensus

In regard to what can be done to "solve these problems", the question implies a normative position. It implies that difficulty in voting is a "problem" and implies a normative solution that granting shareholders and investors better access to voting rights is a good thing or a solution.

The Call itself highlights the advantages of intermediation and do not need to be reiterated here.[8] While the normative consensus of corporate law and governance is to maximise the wealth of the company, the literature is by no means settled on what a 'shareholder-centric model' of corporate law and governance should look like. The normative assumption in the question is that the end investor knows their self-interest best and should be granted better access to, or more, voting rights. But the normative position of corporate law and governance does not always correspond with the interests of investors. This has been true even of the first companies. The English East India Company shareholders were described as subscribing to no lofty principles, where their "expectations of a quick and handsome profit were tempered only by their acute anxiety to keep the expenses of eastern trade to a minimum".[9] People do not become more selfless as they are given more powers.[10] The opposite may very well be true. Powers may well be exercised selfishly and not for the collective value.[11] Since ultimate investors may well be retail investors, it is unlikely that feeding them voting rights would have any meaningful benefit. Despite a survey of retail investors saying 7 out of 10 would like to voice their concerns,[12] they are unlikely to exercise rights and, if they do, particularly for retail investors, it is unlikely to be on an informed basis that may undermine the corporate purpose.

Alternatively, intermediaries do have the knowledge and incentive to question and read the relevant documents relating to the companies. Dividing the labour up in this way may be a more efficient shareholder centric model than enfranchising the ultimate investor by law[13] or contract. Fund managers can bring much more information, understanding and experience to analyse corporate documentation, which a retail investor could or would not. They also have the incentive to maximise the fund and duties as trustee in doing so. However, the company also has interests that extend beyond the immediate interests of retail investors, such as sustainability, climate change, future profits, employee retention and so on, that are unlikely to be reflected by the interests of retail

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[6] See, for example, BBC Money Box podcast, 'Can my money help fight climate change' first aired 9th October 2019

[7] Companies Act 2006, s 145; see also, *Eckerle v Wickeder Westfalenstahl GmbH* [2013] 3 WLR 1316 at [26]

[8] Para 1.37

[9] J Keay, *The Honourable Company: A History Of The English East India Company* (Harper Collins Publishers, 1993) 25

[10] S Bainbridge, 'The Case for Limited Shareholder Voting Rights' (2006) 53 UCLA Law Review 601

[11] For a summary see, D Gibbs-Kneller and C Ogbonnaya, 'Empirical analysis of the statutory derivative claim: de facto application and the sine quibus non' (2019) 19(2) *Journal of Corporate Law Studies* 303, 305-308

[12] The Share Centre Customer Survey 2014

[13] i.e. through the implementation of the Shareholder Rights Directive II 2017/828/EU

investors but can be and are in the fund manager's. The incurable "narrowness of soul, which makes [people] prefer the present to the remote"[14] is applicable to retail investors as much as it is to anyone else. Enfranchising retail investors who do not have to consider the more remote issue relevant to the company might produce negative externalities.

Enforcement: The derivative claim

Even if one were to accept that governance would be improved if investors could exercise more rights, an additional problem in achieving that aim is enforcement. Currently the investor would have no enforcement rights by virtue of the Companies Act 2006, s 145(4). The investor has no recourse against the company *qua* member. Also, as the facts of *Eckerle* demonstrated, the conduct of the intermediary may bar the intermediary from pursuing the company to remedy any loss or wrongdoing on the investor's behalf. However, if retail investors were in some way enfranchised under the current rules, enforcement would still be difficult due to obstacles in current enforcement mechanisms, particularly the statutory derivative claim.

If we presuppose ultimate investors can enforce rights, any enforcement action is likely to relate to the conduct of directors.[15] Therefore, the mechanism they would have to utilise would be the statutory derivative procedure set out in the Companies Act 2006, Part 11.[16] The problem with relying on this procedure, as two recent papers show,[17] is that *de facto* implementation of that statutory procedure by the judiciary imposes legal and practical obstacles to a point where only the most obvious cases are successful. Given that shareholders struggle to overcome these obstacles, the research acknowledges that individuals not traditionally caught by the derivative procedure are even less likely to be successful, i.e. beneficial interest holders.[18]

To summarise these obstacles, the court imposes what one of the papers identifies as the "*sine quibus non*"[19] for the courts to grant a shareholder permission to continue to sue derivatively. Those conditions are: 1) the claim must be in the interest of the company, which is synonymous with the claim's legal merits reaching a high threshold; and 2) there is no principle that could be invoked to dismiss the claim, which are generalised as the claimant must be the "proper person"[20] to enforce the company's rights. Since an ultimate investor does not, or may not, have access to the relevant corporate information, demonstrating any potential wrongdoing has sufficient legal merit to meet the conditions imposed by the court is going to be very difficult.[21] Even with access to the

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[14] D Hume, Enquiry concerning the Principles of Morals, ed P H Nidditch (OUP 3rd ed, 1988) 252-56

[15] At least in relation to more serious matters affecting corporate value, rather than more trivial residual matters relating to things such as the recognition of individual votes

[16] Or possibly under the old equitable procedure, see, *Re Fort Gilkicker Ltd* [2013] EWHC 348 – where the old procedure survived for double derivative claims. Retail investors are not party to the company constitution, so would have no rights by virtue of Companies Act 2006, s 33, unless the statute was amended to extend the meaning of member, which seems unlikely to happen

[17] D Gibbs-Kneller and D Gindis, 'De jure Convergence, de facto Divergence: A comparison of factual implementation of shareholder derivative suit enforcement in the United States and the United Kingdom' (2019) 19(6) *European Business Law Review* 909-330 *forthcoming*; D Gibbs-Kneller and C Ogbonnaya, 'Empirical analysis of the statutory derivative claim: de facto application and the sine quibus non' (2019) 19(2) *Journal of Corporate Law Studies* 303

[18] D Gibbs-Kneller and C Ogbonnaya, 'Empirical analysis of the statutory derivative claim: de facto application and the sine quibus non' (2019) 19(2) *Journal of Corporate Law Studies* 303, 329-31

[19] Essential conditions

[20] D Gibbs-Kneller and C Ogbonnaya, 'Empirical analysis of the statutory derivative claim: de facto application and the sine quibus non' (2019) 19(2) *Journal of Corporate Law Studies* 303, 310

[21] For rules relating to shareholder access to corporate information see, The Companies (Model Articles) Regulations 2008 No 3229, Sch I, Art. 50 (Ltd); Sch III, Art. 83 (plc) – Except as provided by law or authorised by

information they may lack the expertise to appraise the information received. This point highlights the problem with the normative assumption in the question posed by the Call. Most retail investors simply lack the expertise to know how to exercise or remedy their rights. By comparison, the intermediary, however, does, or can have, the incentive and obligation to maximise the value of the fund and is, perhaps, best placed to exercise rights and remedies, in what is a sensible and efficient division of (beneficial) ownership and control of shares.

Even if the investor could overcome the first condition of the court, it is unlikely that the company could not establish a principle to have the claim dismissed under the second condition. One example of a principle that could be invoked by the company against an ultimate investor is an absence of wrongdoer control. In the absence of wrongdoer control, the proper person to litigate would be the members of the company. While this is no longer a bar to a claim, as was the position under the previous equitable procedure,[22] this *sine qua non* requires there to be no reason to dismiss a claim. Roth J noted 'a claim that lies in a company can be pursued only by the company' and an absence of wrongdoer control means the company may not be deprived of its rights of enforcement.[23]

It is unlikely those with a beneficial interest could overcome this condition. Courts have generally set their face against developing exceptions to who can enforce the company's rights. In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* the court stated that they should not be:

> Pioneering a method of controlling companies in the public interest without involving regulation by a statutory body … voluntary regulation of companies is a matter for the City. The compulsory regulation of companies is a matter for Parliament.[24]

Mozley v Alston noted being liberal may open the floodgates 'as many different bills might be filed as there were shareholders in a company, all praying different things'.[25] The courts, generally, are also reluctant to interfere with matters of internal management. Disputes normally arise out of business matters, which courts are less apt at dealing with than business persons, *Carlen v Drury* '[t]his court is not to be required on every occasion to take the management of every playhouse and brewhouse in the Kingdom'.[26] Therefore, anyone outside the scope of the equitable procedure is still likely to be prevented from accessing permission to sue under the statutory procedure.

Another principle that may be utilised is independent views. Independent directors and members' views may be solicited at any time. It is unlikely those views would support litigation and a claim would be dismissed.[27] Faced with these risks, a beneficial interest holder is unlikely to pursue derivative proceedings due to the risk of cost liability under English rule.[28] Existing and recent

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the directors or an ordinary resolution of the company, no person is entitled to inspect any of the company's accounting or other records or documents merely by virtue of being a member/shareholder; Civil Procedure Rules 31.16, 31.6

[22] Those claims heard under the exception to *Foss v Harbottle* (1843) Hare 461; and Civil Procedure Rules 19.9

[23] *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [11], [21]; [2012] BCC 797; see also, *Bridge v Daley* [2015] EWHC 2121 (Ch) at [55]–[57], [68]; *cf Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [16], [49]

[24] [1982] Ch. 204, 224

[25] (1847) 1 Ph 790, 799; 41 ER 833, 837

[26] (1812) 1 Ves & Bea 154, 157; 35 ER 61, 62

[27] See, for example, *Bridge v Daley* [2015] EWHC 2121 at [56]; *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [75], [83]; D Gibbs-Kneller and D Gindis, 'De jure Convergence, de facto Divergence: A comparison of factual implementation of shareholder derivative suit enforcement in the United States and the United Kingdom' (2019) 19(6) *European Business Law Review* 909-330 *forthcoming*

[28] Civil Procedure Rules, 44.3(2)(a); see also *Wallis v Duke of Portland* 3 Ves. Jun. 494 *per* Lord Loughborough regarding justifications for such a rule; *cf. Martell v Consett Iron Co Ltd* [1955] Ch 363, 399-400

reforms to civil litigation funding are also very unlikely to reduce that risk and incentivise derivative litigation.[29]

Reframing the "problem" to improve governance

The question could be reframed to consider how intermediaries may be empowered to better represent the interests of individual investors, as opposed to taking collective decisions. However, in regard to improving the investor's position and indirectly the governance of companies, focus should be given instead to making it easier for them to know where their money is invested. This will enable them to instruct the intermediary to move it should it be invested in a company that the ultimate investor does not want it to be. This should not only include moving money in a fund to another company, but moving the whole investment out of the fund to another fund platform.

Shareholders, legal and beneficial, are likely to follow the 'path of least resistance'.[30] For beneficial shareholders, that path is voting with their money, not their hand in general meeting or trying to enforce rights, as the above shows. Compulsory and regulatory measures need to be considered that enable shareholders to dispose of their investment from firms where they no longer wish to invest in.[31] For example, periodic disclosure of investment holdings to ultimate investors. Currently, there is too much emphasis on, and too many obstacles in front of, the ultimate investor to discover where funds are invested. Albeit the market is producing platforms, such as Fund Eco Market and Ethical Investment Association, which enable ultimate investors to make investment decisions that align to their interests. But even these still place the burden on the investor and do not provide periodic disclosure on investments once the securities have been acquired.

Placing even more burden on them, that question 1 seems to be implying, by giving them better access to voting rights is unlikely to have the intended consequence of improved governance. While the decision of where to invest does and should require some decision making to be made by the ultimate investor, there needs to be more initial and periodic transparency on where that money is going to enable the ultimate investor to make decisions. This needs to be coupled with a suitably regulatory system on labelling of funds with appropriate kite marks to avoid obscuring where money is invested. There are many different options out there for the ultimate investor, such as ethical, impact, climate and sustainable funds, and green or blue bonds but these labels do not necessarily reflect the reasonable expectations of ultimate investors. While the industry has produced some level of certification of these funds, such as green bonds, their meaning may not be fully transparent. For example, China has issued green bonds to finance coal powered power stations.[32] No reasonable investor would expect a green bond to have been invested in such a way. Another example from ShareAction is that while Fund Managers may advertise certain credentials, such as on climate action, there are several instances where they block positive climate votes.[33]

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[29] See, D Gibbs-Kneller and D Gindis, 'De jure Convergence, de facto Divergence: A comparison of factual implementation of shareholder derivative suit enforcement in the United States and the United Kingdom' (2019) 19(6) *European Business Law Review* 909-330 *forthcoming*

[30] M Gelter, 'Why Do Shareholder Derivative Suits Remain Rare in Continental Europe' (2012) 37 *Brooklyn Journal of International Law* 843, 870

[31] This may be coupled with the statutory remedy proposed in question 8 below and considered further in question 25

[32] Reuters, 'China coal-fired power plant issues green bonds' 04/08/17 <https://uk.reuters.com/article/china-power-financing-idUKL4N1KP3RQ> last accessed 11/10/19

[33] ShareAction, US investors are too cosy with companies on climate crisis, miles behind Europe, 4th Nov 2019 <https://shareaction.org/us-investors-are-too-cosy-with-companies-on-climate-crisis-miles-behind-europe/> last accessed 05/11/2019

Question 2

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?

See above. Again, there is a normative implication in this question that passing back of direct rights will have a positive effect on the governance of the company. That is by no means certain if those rights are not exercised to achieve the corporate purpose. What does need to be done is enabling investors to purchase the legal title to shares, discussed below, and the facility to move investments, as discussed above and in question 25.

Question 3

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?

While I have not exercised votes through my investments held by intermediaries before, I would probably be more inclined to vote on matters clearly relating to the share value. For example, I would more likely vote on matters regarding takeovers and re-registering from public to private, but accounting and audit matters less likely. Remuneration would fall somewhere in the middle.

I have exercised my vote through a building society before. I voted in favour of all except one resolution. Those I voted in favour of I did so because I lacked time and information to assess the resolutions. I did vote against an independent director's reappointment however, since they had been on the board for more than 10 years. The resolution still passed overwhelmingly.

Question 4

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?

No comment

Question 5

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?

I would agree that this appears to be a problem. As the example of Wealthify above shows, the practical burdens make it difficult to exercise a vote. In light of the Commission's point about record dates, this seems to compound the issue.

Question 6

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

If so:

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

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

No additional comment. See points about enforcement and CA 2006, s 145(4) above.

Question 7

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?

I thought that this was a specific example of the more general problem of intermediaries representing a variety of interests in any given resolution. As such, schemes of arrangement have the potential to cause "problems" as much as any other decision involving a headcount of shareholders. If the proxy/intermediary can only vote once when representing 20,000 people's interests that causes problems for the investor and the proxy as intermediary. However, one could imagine the practical difficulties of an alternative system that enabled the intermediary to be counted 20,000 times in the headcount. However, members do have a statutory right to demand a poll.[34] The Act provides that any article that excludes the right to demand a poll is void. How a poll vote may be demanded is left to the Articles.[35] The chair is also under a duty to demand a poll when

[34] Companies Act 2006, s 321

[35] The Companies (Model Articles) Regulations 2008/3229, Art 44 (ltd); Art 36 (plc)

they have a real sense that a poll would produce a different result.[36] Since a proxy as intermediary can exercise their 20,000 votes, assuming that they hold 20,000 shares, in a poll any which way they choose or are instructed to do so,[37] a solution may already be available.

Question 8

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?

To quote from the Consultation:

> Under the no look through *principle*, the ultimate investor may *only* bring an action against its immediate intermediary. The ultimate investor *does not* have the right to enforce the terms of the securities, or bring an action for breach of trust, against any higher-tier intermediary in the chain, including the company. For example, if a company defaults on its obligations to its shareholders, the ultimate investor will not be able to sue the company directly. Nor will the ultimate investor's immediate intermediary be liable to the ultimate investor for the company's default. (my emphasis added)

Some inaccuracies in this statement are at apt to mislead and obscure reality. The "no look through" principle is cited by Richards LJ.[38] A principle is a generalisation about how something works with few exceptions.[39] However, while it is trite law that a person to a contract cannot sue or be sued upon it, it is not the case that the ultimate investor may *only* bring an action against an *immediate* intermediary. Nor is it true that the intermediary will not be liable to the ultimate investor for the company's default. It depends on the circumstances. Take four short examples to demonstrate this.

First is a statutory example. The quote above obscures the fact that an issuer of securities, i.e. the company, can have direct liability to the beneficial interest holder under existing specific statutory provisions.[40] Next, the relationship between investor-fund manager-Custodian can be an express trust properly constituted.[41] Some terms and conditions of fund providers expressly acknowledge this.[42] But a trust may also exist ad hoc, if the circumstances do disclose that one exists. Clearly the Custodian holds the pooled interest for the ultimate investors' benefit. If it is a trust then the

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[36] *Second Consolidated Trust v Ceylon Amalgamated Estates* [1943] 2 All E.R. 567

[37] Companies Act 2006, s 322

[38] *Secure Capital v Credit Suisse* [2017] EWCA Civ 1486; [2017] 2 CLC 428 at [10] – "the system operates on the basis of a "no look through" principle, whereby each party has rights only against their own counterparty."; see also, *Secure Capital v Credit Suisse* [2015] EWHC 388 (Comm) at [58]

[39] P Atiyah, The Rise and Fall of Freedom of Contract, (OUP, 1979) 346

[40] See, for example, Financial Services and Markets Act 2000, s 90A and Schedule 10A, Parts 2 and 3, Paras 3, 8; discussed in more detail below

[41] *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 (Ch) at [226]

[42] The Share Centre Terms of Business, Clause 5.10 available at <https://www.share.com/globalassets/assets/downloads/tsc_tob.pdf> last accessed 04/11/2019; Freetrade's Ltd claim in their terms and conditions, that their agreement does not create a "trust between us", would not preclude a trust existing between the Custodian and investor

investor does have recourse against the Custodian where there is a breach of trust i.e. a higher-tier intermediary. Another example is it is well established in the Companies Act 2006, s 170 and common law[43] that directors owe their duties to the company but that does not preclude owing duties to others. Finally, take negligence and *Chandler v Cape Industries Plc*.[44] While the doctrine of corporate personality precluded a subsidiary's employees suing the parent company in contract, it did not preclude them suing, successfully so, in the tort of negligence. The parent company assumed a duty of care to the employees on the basis of the test in *Caparo Industries v Dickman*.[45] Indeed, Richards LJ acknowledges that while the "no look through" "principle" barred a claim in contract he was not suggesting it would bar a claim in tort.[46] The claim that there is a "no look through" principle that amounts to an "ultimate investor…only" being able to bring an action against an "immediate intermediary" is akin to saying an end consumer could not sue a manufacturer for a snail in one's drink. That is clearly not the law.

The intermediated relationships frequently involve commitments that may fail to satisfy the formal requirements for contractual enforceability, whether it is privity or otherwise. For example, statements in prospectus, disclosures required by Transparency rules, or estimated or predicted returns on investments are not enforceable through contract by an ultimate investor. However, in the law of obligations, *sensu lato*, outside of contract law,[47] formal requirements such as privity do not preclude actions against third parties in relation to those commitments. Tort, trusts, property, bailments, unjust enrichment, fiduciary duties, for example, are guided by their own norms and imperatives. They are all theoretically available to the ultimate investor to sue someone further up the intermediary chain, including the company as issuer and its directors. Existing authorities seem to focus on the issuer's liability under the terms of the securities issue, which appears to be the source of some of this obscurity.[48]

To avoid doubt, we should call the "no look through" principle privity of contract. As a species of that doctrine, only a member has enforceable rights *qua* member. Privity of contract is certainly not a principle of the law of obligations generally. Thus the short answer to question 8 is no. Privity of contract is not a problem. Problems have arisen because the law developed and was largely designed for certificated securities between two parties, which is no longer the case. The practical realities of the intermediated securities chain[49] means third parties are the reality and the restriction of any rights of ultimate investors stems from having to rely on disparate and uncertain areas of law without unifying principles that make it difficult for even a lawyer to know what rights an investor has against third parties and vice versa. These rights will only provide intermittent protection, particularly as protection will depend on a case to case basis determined by the circumstances and what was agreed. For example, a reasonable investor will not doubt find it strange that a fund provider regulated by, and advertises itself as covered by, the FCA and covered by the FSCS only

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[43] *Peskin v Anderson* [2001] 1 BCLC 372
[44] [2012] EWCA Civ 525
[45] [1990] 2 AC 605; For discussion see, D Gibbs, 'Chandler v Cape – Company Law: Corporate Groups' (2013) 24(1) *International Company and Commercial Law Review* N5-7
[46] *Secure Capital v Credit Suisse* [2017] EWCA Civ 1486; [2017] 2 CLC 428 at [56] and at [57] emphasising 'in contract'; see also R Elias, 'Legal Aspects of Collateral Swaps' (2001) *Journal of International Financial Markets* 232, 243
[47] *Cf.* Contracts (Rights Third Parties) Act 1999
[48] See, for example, *Secure Capital v Credit Suisse* [2015] EWHC 388 (Comm) at [58] and the articles cited therein; Law Commission, Intermediated Securities: Call for Evidence, para 2.36; Law Commission, Fiduciary Duties of Investment Intermediaries, (Law Com No 350, 2014) para 11.115
[49] See, for example, *Secure Capital v Credit Suisse* [2015] EWHC 388 (Comm) at [59]; Law Commission, Fiduciary Duties of Investment Intermediaries, (Law Com No 350, 2014) paras 11.120-32

covers some investments offered by that fund provider and not others. But this is also a problem for intermediaries who may not know the scope of their obligations to investors to properly assess their potential liability. Without a full empirical study, intuition and anecdotal observations suggest that litigation on fairly similar points is fairly frequent in this area.[50] This cannot be conducive of an efficient market.

These problems for investors and intermediaries alike in enforcing non-contractual rights in the intermediated chain can be demonstrated through two examples: negligence and third party reliance on contractual terms. The solution to this problem is a statutory remedy.

Negligence

For the example of negligence, establishing negligence to the relevant legal standard where there is loss in the intermediated securities may be difficult. For example, establishing the intermediaries in *Eckerle* had been negligent may prove impossible since there is no standard to judge the intermediary against to say they fell below what was reasonably expected of them and the burden is on the investor to establish the relevant causal requirement between act and loss.[51] Further, it is unlikely the courts would seek to establish any such standard short of clear incompetence,[52] particularly as a multitude of factors can affect corporate value, which a judge is unlikely to assess.[53] A meritorious action may be stymied by procedural demands that place an unrealistic demand on ultimate investors because of either information asymmetry or financial naïveté. For example, corporate documentation is not generally provided to the ultimate investor, or they may only have a right to request it. Discovery of negligent conduct may be practically difficult.

Third party reliance on contractual terms

Now take third party reliance on contractual terms. The investment chain is established by an initial contract between the ultimate investor and the first intermediary.[54] That contract may well empower, as the Freetrade example showed, a Custodian to act for the benefit of the investor. However, variants to this might involve the option for the investors to exercise the rights in the company or be exercised by the custodian as the default, as per the example in Wealthify, or contractually enfranchise the investors expressly. But to what extent are those terms in the initial investment contract relevant to the scope of the obligations owed between the removed intermediary, such as the custodian, and the investor? There is limited authority on this point in an intermediated securities context. Existing private law obligations such as bailments, tort, and fiduciary duties yield different results.[55] This means the rights of the parties in this intermediated chain may well hinge on the nature of the complaint and the particular circumstances of the relationship relevant to what was initially agreed that leads to uncertain and intermittent protection for the investor.

[50] For example, in preparing this response jurisdiction, issuer liability under the FSMA 2000, and contractual liability issues have appeared frequently enough since CREST went live and more so in recent years

[51] D Nolan and J Davies, Torts and Equitable Wrongs, in A Burrows (ed), *English Private Law* (OUP 3rd ed, 2013) 17.61-65

[52] As relevant cases on the Companies Act 2006, s 174 demonstrate. See, for example, *Dovey v Cory* [1901] AC 477

[53] See, for example, *Bridge v Daley* [2015] EWHC 2121 at [40]-[45]

[54] Law Commission, Fiduciary Duties of Investment Intermediaries, (Law Com No 350, 2014) para 11.113 also describes the chain as a series of trusts

[55] Another area that could have been considered below is agency law. However, such a matter vis-à-vis third party liability has been highlighted previously elsewhere and is not repeated here: See, The White Paper (Financial Services in the United Kingdom: A new framework for investor protection, 1985, Cmnd 9432) para 10.6; and the Gower Report (Review of Investor Protection, 1984, Cmnd 9125) para 8.50

Bailment on terms

Consider first bailment on terms. The relationship in the intermediated chain is similar to this type of legal relationship, which involves physical property bailed by one party to another who subsequently sub-bails to another down a chain. Bailment is unlikely to directly apply to dematerialised shares as there is nothing to physically possess.[56] In dematerialised securities the interest not the note or certificate is traded.[57] But the way in which sub-bailees and bailors may enforce the terms of the original bailment against one another is illustrative of how third parties can rely on contractual terms they are not party to.

Bailment on terms is primarily illustrated in shipping cases, such as *The Pioneer Container*.[58] This is where the owner has passed the goods to the carrier under a bailment who subsequently contracts under sub-bailment. Sub-bailment allows the sub-bailee to rely on terms of that sub-bailment against the owner. The owner and claimant had consented to a sub-bailment by the carrier 'on any terms'. Here the claimants were bound by a jurisdiction clause to sub-bailees despite no contractual relationship existing between them. In *Morris v CW Martin & Sons Ltd*[59] Lord Denning explained that a bailment on terms required the owner to have consented, either expressly or implicitly, "to the bailee making a sub-bailment containing those conditions". Therefore if the owner does not consent, then a sub-bailee cannot rely on the terms in the contract.[60] Whether an owner consents is a matter of construction of contract. The use of the phrase 'on any terms' evidenced that they had.

The difficulty with reliance on third party terms by sub-bailees is it has never been normatively explained in modern terms why bailments are capable of being a functional equivalent to an exception to the doctrine of privity. Academic opinion offers little insight on the matter and judges seemingly accept Lord Denning's obiter statement and Lord Goff's non-binding decision as correct on the basis it has not been doubted by other authorities.[61]

If one were to develop the law of third party rights in the intermediated chain by analogy to bailment on terms based on the similarities observed in each type of relationship, all they would need to demonstrate to incorporate the terms of the initial contract as binding between investor and third party is that the investor consented to the relevant terms the intermediary acted upon according to orthodox rules of contractual construction. They would, therefore, be bound to each other in regard to the respective obligations between investor and first intermediary. Whether the investor or third party can rely on the terms of the initial contract under a bailment claim, depends on the individual circumstances of the agreement. However, in the intermediated chain agreements appear to frequently exclude third party reliance on the contractual terms.[62]

Tort

Now consider how tort, particularly the duty of care, deals with third party reliance on terms. This can be sub-divided into two issues. The first is how the terms of the contract between an investor

[56] See, Palmer, Palmer on Bailment, 3rd ed Ch 30; Where there are certificated shares there is authority for bailment to apply, *MCC Proceeds Inc v Lehman Brothers International (Europe)* [1998] 4 All ER 675; *BBMB Finance Hong Kong Ltd v Eda Holdings Ltd* [1990] WLR 409
[57] See, for example, *Secure Capital v Credit Suisse* [2017] EWCA Civ 1486; [2017] 2 CLC 428 at [9]
[58] [1994] 2 AC 324, PC
[59] [1966] 1 QB 716, 729
[60] *The Pioneer Container* [1994] 2 AC 324, 341, PC
[61] *Singer Co (UK) Ltd v Tees and Hartlepool Port Authority* [1988] 2 Lloyd's Rep. 164, 168
[62] See, for example, *Secure Capital v Credit Suisse* [2017] EWCA Civ 1486; [2017] 2 CLC 428 at [51]; *Secure Capital v Credit Suisse* [2015] EWHC 388 (Comm) at [58]; Freetrade's Terms and Conditions; and The Share Centre, Terms of Business, Clause 12.7

and intermediary may scope the duty of care owed by a third party intermediary to the investor. The second is how exclusion clauses in that contract may be relied upon by the third party.

Scope of the duty

Starting with the scope of the duty, if a duty is owed, it is uncertain how the terms of the initial contract may scope the duty. Carver, in the context of carriage contracts, argues that "the terms of the contract of carriage may then be relevant in determining the extent of the duty (if any) owed by the carrier to the cargo-owner: e.g. the carrier is unlikely to owe any duty to heat the cargo if the contract is one to carry the goods in a ship without heating facilities". However, Carver cites authority concerned with implied contracts, not negligence.[63] Furthermore, the defendant was not the third party but an original contractor who had agreed what they undertook responsibility for. Seemingly, the terms of the contract act in some nebulous way in determining what the third party has assumed responsibility for, which may or may not be conclusively set out in a contract. This may vary from case to case in intermediated relationships. For example, some intermediaries do look to enfranchise their investors with the respective voting rights, while examples such as Freetrade demonstrate that others do not. Therefore, in the Freetrade example the intermediary may have a wider duty of care to investors than those where the investors are enfranchised.

Thus the way a duty of care is scoped may lead to different outcomes in similar cases. Investors may place money in a platform in the same sort of fund, yet one investor may be owed a wider scope of care than the other based on the technical language of the contract agreed. A recent development in tort regarding vicarious liability may add to this uncertainty regarding tort liability. Here the Supreme Court held that if the facts disclose that an individual takes on activities that are integral to a business whereby the "commission of the wrongful act is a risk created by the defendant by assigning those activities to the individual in question",[64] the business may be vicariously liable for the torts committed by the individual. Thus, an investor may be able to look to the first intermediary for the torts of a higher-tiered intermediary only if the circumstances permit it. That, as mentioned, may vary from case to case.

Exclusions Clauses

Now consider exclusion clauses. Unlike bailments, a third party is not contractual bound in the initial contract on terms that exclude or limit liability for negligence due to absence of privity. Instead to rely on exclusions or limitations to the duty of care, the doctrine of notice or any relevant statutory provisions must be utilised. *Smith v Bush* held that a contract between a purchaser and mortgagee that excluded the mortgagee and valuer's liability for negligence, could be relied upon by the valuer by virtue of notice and the Unfair Contract Terms Act 1977, ss 1(1)(b), 2(1) but was still liable on the specific facts of the case.[65] That is to say that a party may rely on an exclusion of liability for negligence under their duty of care provided any complainant had notice of such an exclusion. The ability of a third party to rely on or be subject to a notice of exclusion in a contract is also part of common law.[66]

Effective notice is not just contractual construction. Notice includes constructive notice.[67] Construction of terms as notices excluding liability also depends on the nature of the relationship i.e.

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[63] G Treitel and F Reynolds, *Carver on Bills of Lading* (Sweet and Maxwell 4td ed, 2017) 5.133; Citing *Mitsui & Co Ltd v Novorossiysk Shipping Co (The Gudermes)* [1993] 1 Lloyd's Rep. 311 at 326

[64] *Cox v Ministry of Justice* [2016] UKSC 10, [2016] AC 660 at [24], [30]

[65] [1990] 1 AC 831, HL

[66] *Davies v Parry* (1988) 20 HLR 452, 466; *Hedley Bryne & Co Ltd v Heller & Partners Ltd* [1964] AC 465

[67] For some recent discussion in case law on the doctrine of notice see, for example, *Barclays Bank Plc v O'Brien* [1994] 1 AC 180 (HL); and *Royal Bank of Scotland Plc v Etridge (No 2)* [2001] UKHL 44, [2002] 2 AC 773

commercial or consumer. In this context, the law may differentiate between retail and institutional investors for the purposes of interpreting exclusion clauses. *Taberna Europe CDO II Plc v Selskabet af 1 September 2008 A/S (formerly Roskilde Bank A/S) (In Bankruptcy)*[68] confirms that while the *contra proferentem* rule is unlikely to apply between commercial parties i.e. institutional investors, thus orthodox construction to its interpretation does, but it may well do so for consumer, i.e. retail investors. In effect, the potential liability in negligence of an intermediary in the chain may well depend on who the complainant is. Therefore, exclusion of liability for negligence is possible if such an effective notice is construed according to the rules of construction to have done so.

There is also the Contracts (Rights of Third Parties) Act 1999. If the initial contract excludes liability for the benefit of an intermediary, satisfying the requirements of the Act, the third party may rely on that term. This creates an additional layer of protection for the third party intermediary, who seemingly may be able to rely on a term under this Act, or a notice under the UCTA 1977. Subject to any differences between terms and notices, they appear to be functional equivalents in terms of outcome subject to CRTPA 1999, s 7(2) and the UCTA 1977, s 2(2). The former provides that a third party cannot invoke the latter to contest the validity of the term on grounds of reasonableness. Thus should an intermediary seek to claim the benefit of an exclusion clause as third party, they could avoid it being scrutinised on grounds of reasonableness. However, if the third party relies on the term as a notice in respect to their own duty of care, the UCTA 1977 remains operational and is subject to a test of reasonableness.

As such, liability in tort of a third party may rest on the specific terms of the contract that determine its scope, whether there was sufficient notice regarding exclusions, the status of the relevant contracting parties, and which legislation is being applied. Looking at some fund's terms and conditions, it would seem that since they expressly excluded third party reliance on the terms, an intermediary removed up the chain would be unable to rely on any exclusions to liability. While the agreements of Freetrade and The Share Centre do not exclude liability for negligence, they do exclude other types of liability. While that would preclude the immediate intermediary being liable, it does not mean that the investor could not look to the higher tiered intermediary for any potential liability arising from tort.

Fiduciary Duties

Finally, consider how a complaint based on fiduciary duties applies different principles in regards to third party reliance on terms than bailments and torts and how individual claims of fiduciary duty breach may yield different results.

Previously, it has not been clearly explained how a contract determines fiduciary duties. A recent paper explains this interaction is a two-stage process.[69] While the role of contract demonstrates that protection for ultimate investors will be intermittent, one key benefit of recognising this two-stage process is that if the third party can rely on the terms, it will make it easier to know when one is in a fiduciary relationship in the investment chain and the scope of those duties. Failure to recognise this process so far has led to some errors in the law, both in reasoning and in outcomes.

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[68] [2016] EWCA Civ 1262 at [21]-[26]; [2017] Q.B. 633

[69] D Gibbs-Kneller and D Whayman, 'How contractual terms determine fiduciary duties: a two-stage process' (2019) 70(2) *Northern Ireland Legal Quarterly* 241; See also, D Gibbs-Kneller and D Whayman, 'How contractual terms determine fiduciary duties: a two-stage process' Blog post <https://nilq.qub.ac.uk/index.php/nilq/announcement/view/18> last accessed 04/11/2019 – where the below text on this section has been taken and adapted from

To summarise this two-stage process: The conventional wisdom, that the 2014 Consultation appears to proceed upon, is that the duty of loyalty is determined in a single-stage process. One starts with a blank slate, and then positively implies the duty of loyalty if the nature of the engagement – defined by the terms of the contract – demands it.

Most judgments proceed on the basis that, in ad hoc cases, the terms of the contract are important in some rather nebulous way. The classic exposition is in *Hospital Products Ltd v United States Surgical Corporation*, which illustrates this:

> [I]t is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them. The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction.[70]

This passage has been quoted in the stage two cases of *Northampton Regional Livestock Centre Company Ltd v Cowling*,[71] *Hilton v Barker Booth & Eastwood*[72] and *Global Container Lines Ltd v Bonyad Shipping Co (No 1)*[73] and the stage one cases of *Ranson v Customer Systems plc*[74] and *Fujitsu Services Ltd v IBM United Kingdom Ltd*.[75] *Ranson* was cited with approval by Lord Neuberger MR in the stage two case of *Rossetti Marketing Ltd v Diamond Sofa Co Ltd*.[76] Further vague statements can be seen, such as '[t]he precise scope of [the duty of loyalty] must be moulded according to the nature of the relationship'[77] and the defendant's 'capacity to make decisions . . . is inconsistent [with the existence of a general fiduciary relationship]'.[78]

However, the correct analysis, it is argued, is a two-stage process. In a first stage, the duty of loyalty is raised in a multi-factorial enquiry that considers the nature of the engagement, just as the conventional wisdom dictates. In this stage, it is a balancing exercise and no single factor is conclusive. However, there is then a second stage, which uses the contractual doctrines of interpretation and implication. This stage is akin to the non-contractual process of authorisation of what would otherwise be a breach of fiduciary duty. This second stage can only reduce, not enlarge, the scope of the duty of loyalty. It is sharply logical and ordered. If the conditions in the authorising terms are met, the duty of loyalty is reduced accordingly. There is no balancing and weighing in the second stage.

The central normative argument to support the case for a two-stage process, in brief, is as follows. We consider, from first principles, how the underlying nature of the duty of loyalty drives the law into a particular structure. It is the only way to resolve the fiduciary duty's internal tension between controlling the fiduciary's self-interest and the principal's autonomy to authorise, when fully informed, what would otherwise be a self-interested act. At the first-stage, the protective nature of the duty of loyalty positively demands a multifactorial approach because a sharply logical approach

[70] (1984) 156 CLR 41 (HCA) 97

[71] [2014] EWHC 30 (QB) [180] this point not raised on appeal: [2015] EWCA Civ 651, [2016] PNLR 5. The issue was disclosure, a stage two issue

[72] [2005] UKHL 8, [2005] 1 WLR 567 [30]. The issue was whether there was an implied term meaning disclosure was not required

[73] [1998] 1 Lloyd's Rep 528 (QB) 546

[74] [2012] EWCA Civ 841, [2012] IRLR 769 [26]

[75] [2014] EWHC 752 (TCC), [2014] 1 CLC 353 [123]

[76] [2012] EWCA Civ 1021 [21]

[77] *New Zealand Netherlands Society 'Oranje' Inc v Kuys* [1973] 1 WLR 1126 (PC) 1130

[78] (1984) 156 CLR 41 (HCA) 98

is too susceptible to evasion. The trade-off is that this stage must be relatively uncertain. Conversely, once the duty of loyalty has been raised, there must be a relatively certain, sharply logical second phase to authorise what would otherwise be a breach of fiduciary duty. This is so that a fiduciary is not caught out and subject to swingeing liability where fully-informed authorisation has been obtained. This is the *quid pro quo* for the relatively uncertain first stage. It also means that the contractual doctrines are appropriate in the second stage, although they are still subject to overriding fiduciary principles. Exactly how is explored in the article and discussed below.

What this two-stage process means for investment intermediaries and even the company and its directors is that first, even if they are not in an immediate relationship with the end investor this should not preclude a fiduciary relationship being established. Quite rightly, the more remote the relationship the harder it will be to establishing fiduciary duties are owed to the ultimate investor. However, the relationship, as defined by the terms of the contract, might reveal an express trust or an assumption of responsibility undertaken by an intermediary or the company to the ultimate investor. As Lord Templeman explained in the context of house valuations, that while a mortgagee does not assume responsibility to the purchaser for the valuation, the valuer does assume responsibility to both mortgagee and purchaser by agreeing to carry out a valuation for mortgage purposes knowing that the valuation fee has been paid by the purchaser in order to decide whether or not to enter into a contract to purchase the house.[79] Thus, the same principle applies here. As the Freetrade example above shows, the Custodian entitled to vote does so on behalf of the ultimate investor. It is an express trust properly constituted. Regardless there is an assumption of responsibility. Therefore, if the intermediary assumes responsibility to a point where fiduciary duties arise, the intermediary is potentially liable to the investor despite the “no look through” principle. However, given the fact specific nature of this potential liability as a stage-one issue, the ultimate investor may not be consistently able to establish there is a fiduciary relationship, either against different intermediaries or the same ones in different contracts, if the terms of the individual contracts indicate that it should not.

Next is to consider how those terms might scope the duty owed at stage-two. The difficulty here is that which has already been established. The fiduciary intermediary is not privy to the contract. There is no authority on whether terms of that contract that scope that fiduciary duty would have to be repeated in the trust deed with the intermediary or whether consent in the initial contract is enough. For example, suppose the initial contract between investor and fund manager permits the custodian to take a 1% commission. Therefore, that would not be a breach of fiduciary duty to take that commission. However, if that term is not repeated in the trust deed would the intermediary be able to scope their fiduciary duty with reference to that term?[80] Based on the “no look through” principle and case law applying it, the answer would seem to be no. But the authorities do not really engage with this point regarding any fiduciary relationship between ultimate investor and removed intermediary. Their focus is on privity in regards to direct actions by an ultimate investor against issuer.[81] If one does exist between investor and removed intermediary, the courts will be placed on the horns of a dilemma between the autonomy of the investor who authorised the commission and

[79] *Smith v Bush* [1990] 1 AC 831, 847 HL

[80] For example, The Share Centre Custodian Agreement, Clause 5.11 reads as follows – “TSC may retain any commissions received from a third party arising from transactions carried out for you and the amount of such commission and the identity of the third party will be available upon request. In addition, TSC may pay a share of the fees or commissions charged to you with third parties and the amount paid to the third party and its identity will be available upon request”

[81] See, for example, Law Commission, Fiduciary Duties of Investment Intermediaries, (Law Com No 350, 2014) paras 11.113-15

the strict rules of privity. This is where analogy with bailment on terms could be utilised and autonomy could and perhaps should prevail as a matter of practicality and reducing transaction costs.

Assuming that the terms of the contract do scope any fiduciary duty of an investment intermediary removed up the chain, those terms need to be consistent with fiduciary principles, as opposed to orthodox interpretation of contractual terms. Thus, unlike in bailments or tort, third party reliance on terms would be subject to overriding fiduciary principles specific to the nature of the fiduciary relationship.

This second stage and the application of fiduciary principles helps resolves the internal tension between the autonomy of the beneficiary and their vulnerable position to opportunism from the fiduciary. The fiduciary's ability to act is circumscribed by what the ultimate investor permitted. Autonomy negates the protective function of the fiduciary duty but only where the autonomy is exercised on a fully disclosed basis.[82] Otherwise the vulnerable position of the ultimate investor is exposed to opportunism from the intermediary. The same principle applies where there is ambiguity in the interpretation of what was permitted. Such terms will be interpreted *contra proferentem*. This respects the ultimate investor's autonomy and protects them from opportunism when new or unforeseen situations arise. It would be impossible to start with a finely tuned duty that covers future events.

Therefore, if one were to take an example of a contractual term that permits a 1% commission, this would not be a breach of fiduciary duty for taking that commission. The autonomy principle negates the protective function of the fiduciary duty. Now suppose the intermediary-Custodian is entitled to vote for the benefit of an ultimate investor, such a term permits just that and no more. Unless it can be implied,[83] the term does not expressly authorise the intermediary to vote with a conflict of interest. The risk of opportunism in permitting them to do so is too great. Such a term is then interpreted *contra proferentem* to protect the beneficiary from opportunism inherent in such ambiguity.

But yet again, the problem for ultimate investors is what the contractual terms permit vary from case to case. Therefore, some investors may be protected while others are not. Uncertainty in contractual terms may also be difficult to reconcile. The fact this two-stage process is yet to be formally recognised by the courts adds another layer of difficulty.

As such individual cases on each of these private law obligations may yield different results from case to case, but also different results may be reached depending on the nature of the complaint when third parties seek to rely on those terms. If it is one of bailment, all that needs to be established is consent to the terms and a third party can rely on them. If the complaint is in tort, the doctrine of notice and contra proferentem may determine the extent of third party reliance on terms but privity will exclude third party reliance on other exclusions in the contract. But if it is a complaint about a fiduciary duty, it is uncertain if the third party can even rely on the initial contract and if they can, unlike bailments and tort, the interpretation of those terms is subject to overriding principles to reflect the normative function of fiduciary law.

[82] D Gibbs-Kneller and D Whayman, 'How contractual terms determine fiduciary duties: a two-stage process' (2019) 70(2) *Northern Ireland Legal Quarterly* 241, 254-55

[83] D Gibbs-Kneller and D Whayman, 'How contractual terms determine fiduciary duties: a two-stage process' (2019) 70(2) *Northern Ireland Legal Quarterly* 241, 248-53

Intermediated Securities

The above has been a discussion in abstract and largely hypothesising about how a court may treat third party non-contractual claims in the intermediated securities chain, particularly in relation to tort claims and third party reliance on terms. It shows that attempts to do so may yield different results. There is limited case law on third party reliance on terms in cases specifically related to the intermediated chain. This is likely due to it being a relatively recent phenomenon. However, some authorities give some limited insight into how they may be approached. They largely reinforce the point already made: investors are intermittently protected based on the nature of the complaint, circumstance and what was agreed.

With exclusion clauses, intermediaries should be able to rely on them against the initial investor on the basis of UCTA 1977 notice requirements.[84] Beyond exclusion clauses, the CRTPA 1999 may also determine the obligations of the intermediary if they satisfy the requirements of the Act. However, as mentioned, most contracts explicitly exclude third party reliance on such terms and would, therefore, be inapplicable.

Jurisdiction clauses can also be problematic, as *Profit Investment Sim SpA v Ossi*[85] shows. Formal requirements of consent in writing for jurisdiction clauses may preclude an intermediary relying on such clauses. The case confirms that for a third party to succeed to the rights of a jurisdiction clause, it would have to be done in accordance with national law. Since there is no privity between the parties, there can be no succession. Therefore, an intermediary could not rely on a jurisdiction clause in the initial contract as much as an investor could not rely on a jurisdiction clause in the securities issue.

Anderson v Sense Network Ltd[86] highlights how contractual terms in one contract in the intermediary chain may restrict protection offered by regulatory measures. Therefore demonstrating how investors are subject to intermittent protection. In this case, Midas, which became the respondent's, Sense Network Ltd (SN), Appointed Representative (AR) under an agreement in 2007[87] to advise clients on investments and arrange deals. As AR, SN was principal to Midas for the purposes of responsibility for regulatory compliance.[88] Put another way, SN was an authorised person accepting responsibility for the AR's regulatory compliance for which they would be exempt. Midas had hid a fraudulent Ponzi scheme from its principal, which investors also invested in. The investors argued that the scheme operated by Midas was business for which the principal had responsibility under the FSMA 2000, s 39(3)[89] and a collective investment scheme for the purposes of FSMA 2000, s 235 for which the principal is vicariously liable.

However, the Court of Appeal held that a principal's responsibility under the FCA Handbook and section 39 dependent not only on a generic list of categories of business for which they were authorised. The liability SN took responsibility for was only in relation to "acts or omissions of the AR

[84] *Taberna Europe CDO II Plc v Selskabet af 1 September 2008 A/S (formerly Roskilde Bank A/S) (In Bankruptcy)* [2016] EWCA Civ 1262; [2017] Q.B. 633; *IFE Fund S.A. v Goldman Sachs International* [2007] 1 Lloyd's Rep 264

[85] Case C-366/13 [2016] 1 WLR 3832; see also *Secure Capital v Credit Suisse* [2017] EWCA Civ 1486; [2017] 2 CLC 428

[86] [2019] EWCA Civ 1395

[87] Replaced in 2013

[88] e.g. FCA Handbook Supervision Manual Ch.12 (SUP 12); FSMA 2000; FMSA 2000 (Regulated Activities) Order 2001 (SI 2001/544)

[89] FSMA 2000, s 39(3) – The principal of an appointed representative is responsible, to the same extent as if he had expressly permitted it, for anything done or omitted by the representative in carrying on the business for which he has accepted responsibility.

"in carrying on the business for which [the authorised person] has accepted responsibility for"".[90] Section 39 acted in conjunction with the AR agreement, which enabled principals to limit the scope of the type of business they accepted responsibility for. Since the express clause limited the principal's responsibility to that outlined in cl 3.1 of the AR agreement, Midas' advice to the appellant investors to invest in a fraudulent scheme fell outside the business for which the principal had accepted responsibility for.[91] The court continued that the principal was not vicariously liable. They were not carrying out activities assigned to them by the principal as part of its business and for its benefit.[92]

The court held "an authorised person cannot accept responsibility for a business which it does not have authorisation from the FCA".[93] A sensible conclusion as a matter of law. In doing so it highlights the problem of third parties in the intermediated chain. The investor, as third party, is engaging with Midas through SN. Yet SN's responsibility to the investors for the conduct of Midas is circumscribed through a private agreement between SN and Midas. While the authorised person, SN, is required to disclose "information as to the services which he holds himself out as able to provide", there is no applicable provision for appointed representatives to enable the investor to identify the activities that the AR is permitted to carry on.[94] Placing the burden on the investor to discover this is cumbersome. Even if the AR did have to disclose those activities, it is unlikely a retail investor would actually look before investing, particularly as some providers can be regulated and covered by the FCA and FSCS, even if particular investments are not, such as "execution-only" transactions,[95] making it incredibly confusing for investors.

What these examples appear to disclose is that the investor is at the mercy of circumstance as to whether their losses will be legally protected. There appears to be a lack of coherent principles in the regulation and private law obligations and it is both parties suffering from the uncertainty: The investor, who is shouldering the risk of loss; and the issuer and intermediary who are unsure of their liability.

Summary and Statutory Exception

To summarise, the "no look through" principle is not a principle at all. The "no look through" principle is actually privity of contract (only parties to the contract can sue) and statutory interpretation (a member is the one on the register). Focus on this façade ignores a deeper level issue. That is, as the market has developed, the ultimate investor is forced to rely on disparate areas of law that are dependent on circumstances in the absence of specific legal provisions. Even when there is regulation some of the protection is still heavily dictated to by contract. This may well lead, or has lead, to a haphazard development of the law, encourage litigation to exploit uncertainties, increase transaction costs, and result in unjust lacuna in law whereby some investors are protected but others are not. Indeed there have been 4 cases in 4 years regarding the liability of an authorised person under FSMA 2000, s 39 yielding different outcomes for the investors.[96] Also the ultimate investors in *Public Joint-Stock Company Commercial Bank "Privatbank"* were "enfranchised" but the

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[90] [2019] EWCA Civ 1395 at [35]
[91] [2019] EWCA Civ 1395 at [29]-[35] and [55]-[57]
[92] [2019] EWCA Civ 1395 at [64]-[65]
[93] [2019] EWCA Civ 1395 at [37]
[94] See FSMA 2000, s 347(1), (2)(a), (j); and [44]-[45]
[95] FCA Handbook, Advising on Investments, Art 53; See also, FCA Conduct of Business Sourcebook Arts 9-10
[96] [2019] EWCA Civ 1395; *R v Financial Ombudsman (on the application of Tenetconnect Services Ltd* [2018] EWHC 459 (Admin); *Ovcharenko v InvestUK Ltd* [2017] EWHC 2114 (QB); *Personal Touch Financial Services Ltd v SimplySure Ltd* [2016] EWCA Civ 461

ultimate investors in *Eckerle v Wickeder Westfalenstahl GmbH* and *Secure Capital SA v Credit Suisse AG* were not.[97]

Since the difficulty or problem lies not in the "no look through principle" but potential solutions being potential varied and unpredictable, a solution may well be to develop a specific statutory remedy for ultimate investors to pursue loss or wrongdoing by intermediaries and/or the company and its directors. This may well be specific to retail investors who are in a more vulnerable position. Some ideas on what that remedy may look like can be drawn from existing legislation that cuts through intermediated relationships.

One example is the Consumer Protection Act 1987. It solved the problem of end-consumers having to sue manufacturers in the tort of negligence for harm caused by defective goods by cutting out the requirement of tort causation and preventing exclusions by creating specific statutory liability. The statute provides that manufacturers are strictly liable for harm caused by defective goods.[98]

Another example can be drawn from existing statutory provisions on securities. This is FSMA 2000, particularly ss 39, 90, and 90A. For section 90, liability for deceit or misrepresentation or negligence could not normally extend to the secondary market for the purchase of shares because of the requirement that "the maker of the statement be aware of the transaction to which it relates".[99] The problems are cut through by that legislation by requiring compensation to be paid to anyone acquiring securities to which the particulars apply where the loss is a result of an untrue or misleading statement relating to those particulars or an omission of information required in the particulars by that legislation.

With section 39, this overcomes the problems inherent in agency law, since the authorised person is liable for the acts of the Appointed Representative "to the same extent as if he had expressly permitted it". Thus, it overcomes issues regarding express, implied, and apparent authority for determining the principal's liability for acts of the agent at common law.

Section 90A is a particularly important example for ultimate investors. It establishes that, in accordance with Schedule 10A, an issuer will be liable to pay compensation to persons who have suffered loss as a result of misleading statements or dishonest omissions in certain published information relating to securities or a dishonest delay in publishing information. Schedule 10A, Part 2, para 3(1) provides:

> An issuer of securities to which this Schedule applies is liable to pay compensation to a person who—
>
> (a) acquires, continues to hold or disposes of the securities in reliance on published information to which this Schedule applies, and
>
> (b) suffers loss in respect of the securities as a result of—
>
> (i) any untrue or misleading statement in that published information, or
>
> (ii) the omission from that published information of any matter required to be included in it.

[97] [2017] EWCA Civ 1486, [2017] 10 WLUK 154
[98] Consumer Protection Act 1987, s 2
[99] D Kershaw, Company Law in Context (OUP 2nd ed, 2012) Web Ch B, 15

The interpretation of someone who is consider to be "a person who acquires, continues to hold or disposes of securities" is set out in Schedule 10A, Part 3, para 8(3), (4) as:

> References in this Schedule to the acquisition or disposal of securities include—
>
> (a) acquisition or disposal of any interest in securities, or
>
> (b) contracting to acquire or dispose of securities or of any interest in securities, except where what is acquired or disposed of (or contracted to be acquired or disposed of) is a depositary receipt, derivative instrument or other financial instrument representing securities.
>
> (4) References to continuing to hold securities have a corresponding meaning.

In a recent case the court held that the issuer of securities, held through an intermediated chain in dematerialised form through a CREST account, was liable to those who had never acquired the legal interest in the shares.[100] The critical word is contained in the Act is in Schedule 10A, Part 3, s 8(3) which extends the meaning of acquisition, disposal, or holding to *any* interest, not just legal interest. Tesco's claims that the claimants had no "interest" in securities nor had the "acquired", "disposed", or "held" securities failed for that reason.[101]

It is possible that this last example offers some degree of protection for retail investors already, on top of what FCA and FSCS already provides. It might be that it could extend further for retail investors. Given the nature of intermediation and the lack of transparency in the market,[102] it may be difficult for an investor to know if they have actually acquired, disposed of, or held securities as a result misleading statements or dishonest omissions. Even if they are aware of the securities they hold, demonstrating a causal link between loss and act may be difficult. A modest amendment for retail investors to reduce their risk may be to impose strict liability for misleading statements and dishonest omissions.

What exactly that statutory provision should be is beyond the scope of this response but above has highlighted potential problems regarding Appointed Representatives and the lack of regulation regarding authorised persons offering unregulated activities. However, it should look to provide a simple legislative response to wrongdoing in the investment chain, particularly to fill the gaps in protection and cut through problems left by private common law solutions and existing legislative and regulatory provisions. For example, where a company has not gone insolvent but loss has been suffered, where the risk profile of a fund changes, instances of fraud or negligence as the *Anderson* litigation demonstrated, or instances of misleading or dishonest activity, as in *SL Claimants*.

Such a proposal should benefit investors by protecting them from loss and reduce the unfair risk placed on them.[103] They currently invest their money but have no rights *qua* "member" in the companies invested in and, as set out above, establishing liability on private law or regulatory grounds can be uncertain and intermittent. However, a statutory proposal can also benefit intermediaries and companies. The benefits should include, first the reduction in transaction costs. Having to 'enfranchise' ultimate investors, draft contracts that seek to protect intermediaries from liability in the law of obligations, or defend such cases based on uncertainties increases the cost of

[100] *The "SL Claimants" v Tesco plc* [2019] EWHC 2858 (Ch)
[101] *The "SL Claimants" v Tesco plc* [2019] EWHC 2858 (Ch) at [36], [82]-[93], [120]-[123]
[102] Including difficulties in tracing, see, Law Commission, Fiduciary Duties of Investment Intermediaries, (Law Com No 350, 2014) para 11.128-30
[103] With regard to the unfair risk, see the Call paras 1.38, 2.35

transacting.[104] A legislative rule can cut through that to simplify and/or clarify the matter for all concerned. For example, investors in Woodford Investment Management brought via the financial platform Hargreaves Lansdown, perhaps on the advice of a financial advisor. The complainant could go to the financial advisor and then the ombudsman if the complaint is not resolved. Any claim against Hargreaves Lansdown their liability depends on whether the investor relied upon them for advice. They would have notices saying this is not advice on things such as their top 10 buys. However, many people do take it as advice to make decisions. Ascertaining who did and did not rely on that information as advice will require detailed assessment of facts in individual cases leaving some investors protected and others not. Complaining against Woodford Investment Management would be difficult if it acted within the scope of the fund. For one there is no contract between Woodford Investment Management and the investor where they purchased via a financial platform. Also, even if the investor argued that what happened went beyond what they reasonably expected, that is not a ground for suit unless it falls outside what was legally permissible. Second, any fear that statutory liability will increase litigation faced by intermediaries or the company should be unfounded. The existence of other remedies, such as the FSCS, will limit intermediary exposure to any increase in litigation. It should only be those instances where those remedies do not apply should any legislation be utilised by ultimate investors.[105] Thus, corporate law is unlikely to become "unworkable". Finally, by reducing the risk to the ultimate investor it should increase trust and transparency in the system and encourage investment. Lack of transparency is one of the main reasons people choose not to invest. Improvements via statute to the intermediary chain should free up capital in the system.

The final point to make is that a statutory solution may be limited to retail investors. Experienced institutional investors may well be able to internalise such costs and take the appropriate risks with insurance. A retail investor is rarely able to do so or think to do so. The law is complex and does not appear to be fit for purpose for retail investors. Wholesale revision on the law relating to retail investors might be necessary. That should at least focus on transparency of information with the emphasis placed on the intermediary to do so, the right to move investments from companies and funds, the right to buy legal title to shares, and direct remedial rights against intermediaries and the company and its directors.

Question 9

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

It seems unnecessary to reiterate in detail the benefits of privity of contract.

Question 10

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?

For answers to QQ10-14 see question 14 below.

[104] See, for example, *Anderson v Sense Network Ltd* [2019] EWCA Civ 1395, which spent 13 days in the High Court and 2 days in the Court of Appeal
[105] See, for example, <https://www.fscs.org.uk/what-we-cover/investments/>

Question 11

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?

Question 12

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?

Question 13

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?

Question 14

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?

Notably the FSCS covers most loss in the event of insolvency. The proposal above for a statutory remedy may include situations where an intermediary or a company has gone insolvent, if the circumstances that brought about insolvency resulted in loss or wrongdoing covered by any statutory regime. This should aim to protect those few investors who fall outside the FSCS limits whereby they can recover any additional loss subject to specific rules on distribution of assets in insolvency. Thus, it may be necessary for any statutory remedy to prescribe how it operates in the context of insolvency.

I do not think better education is needed per se, but better transparency of the remedies currently available and also better regulation on when firms can advertise such protection offered by the FSCS. London Capital and Finance plc, for example, were authorised by the FCA and protected by the FSCS but not all the investments they provided were covered, leaving 11,605 investors £236m investment unprotected.

Most intermediaries will only advertise that they are covered by the FSCS. Stating that it is capped at £85,000 should increase awareness of what is covered. Also, when investing, anyone providing a product covered by the FCA and FSCS should receive information about the protection offered from the product provider, much like the requirement on banks to do so when opening a bank account. If this is already a requirement it is not universally being done, since personal experience from two funds I invest in have not provided any information of the sort.

Also, in cases such as London Capital and Finance, they should be required to make it clear what they are authorised to do by the FCA and what is covered on each individual investment. Alternatively, the FSCS should provide compensation in the event of any intermediary's insolvency where they are regulated by the FCA, regardless of whether the particular investment is covered i.e. execution-only services. The complex nature of the regulatory regime makes it unfair, at least for retail investors, to suffer the loss from an intermediary's insolvency due to an oddity in the regulation that goes against the reasonable expectations of the investor.

Question 15

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?

No comment

Question 16

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 intermediary is best placed to assess the quality of that title and the end investor should have suitable recourse against the intermediary for that error. The Freetrade example mentioned above demonstrates that the intermediary may well be in breach of express terms if they fail to provide the relevant interest in the securities to the investor because they state the investor is the "ultimate owner". Without such express terms in the agreement or lack of privity, investors should not have to rely on tort law to remedy any issue that should arise with defective title. I would initially support the idea of strict liability for an intermediary purchasing securities with defective title for a beneficiary.

Question 17

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?

In the context of a person's estate when they die intestate, securities held by that person can be given by the lawyer to a stock broker to sell, rather than the executor or trustee instructing the lawyer to do so.

While the problems of the 1925 Act are highlighted, there is an absence of explanation in the Call for why there is, or perhaps was, a need for writing in the disposition of an equitable interest. The 2014 Consultation refers to it as an "anachronism".[106] Therefore, just because the 1925 Act, s 53(1)(c) does not reflect modern practice of settling computerised securities and creates problems it does not mean the justification is redundant or there is new justification in the modern context i.e. investors knowing when funds are transferred, which may be relevant to them personally for reasons such as knowing where money is invested.

Equally, one might say that the complaint that the law does not reflect the modern settlement practice is untrue. The electronic settlement process applies to the legal title, which the 1925 Act does not apply to.

Question 18

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?

It has become too difficult to purchase legal title to securities. They are meant to be freely transferable but are effectively only freely transferable amongst selected institutions. As the consultations acknowledges, CREST membership amongst individuals is now below 10,000. Securities are a significant source of wealth, yet, if only 5,400 individuals have direct access to that wealth, the majority are cut off from potentially significant redistributive benefits from investing.[107] While the advantages of intermediation are made clear and drive this model of securities 'ownership',[108] it should not be at the expense of closing the market off to other forms for the investor to hold securities. If an individual is willing to take the risk of owning shares personally, they

[106] Law Commission, Fiduciary Duties of Investment Intermediaries, (Law Com No 350, 2014) para 11.122
[107] See, for example, M Nau, 'Economic Elites, Investments, and Income Inequality' (2013) 92(2*) Social Forces* 437 – demonstrating that investment income is a contributor to growing inequality; F Alvaredo et al, 'The Top 1 Percent in International and Historical Perspective' (2013) 27(3) *Journal of Economic Perspectives* 3 – where private wealth (including inheritance and capital income) relative to national income in Europe has observed a "spectacular" U-shaped curve; A Atkinson and T Piketty, *Top Incomes over the 20th Century*, (Oxford, 2000) 109-111 – showing a decline in investment income at the end of the 20th Century but still consisting of around 10% of total gross income
[108] The Call, Para 1.37

should be enabled and not disabled from entering the market. The perception is that the law, by immobilising securities, has enabled intermediaries to corner a market and make entry for individuals very difficult.

As such, I would support any technology that allows legal title to be held by the investor and not the intermediary for reasons stated above regarding transferable shares, property and wealth distribution. I do doubt whether it will result in intermediaries not being needed, as the Call considers,[109] but more likely fewer being necessary. The efficiencies in intermediation should still drive that model of investing. Expertise on where to invest, how to vote and so on is still valuable and what drives the current shape of the market and is likely to persist even with DLT.

It may also improve governance with regard to greater representation from those from different backgrounds, discussed in question 27.

Question 19

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

No comment

Question 20

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?

No comment

Question 21

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?

No comment

Question 22

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

I think it is best to phase out paper-based certificates. As long term paper based shares pass through people's estates, this may be the best time to move them across to electronic records.

Perhaps a modest amendment to the Law of Property Act 1925 will facilitate this, whereby paper share certificates passed under an estate must be settled using the electronic register.

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[109] The Call, para 2.83

Question 23

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.

No comment

Question 24

What other jurisdictions should we consider and why?

No comment

Question 25

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.

A recent podcast has highlighted the problems, particularly women, face in investing.[110] One particular concern is the use of jargon. One issue I wish to raise in this context is how these products are being described by the fund provider when purchased by an investor. I shall use the examples of Freetrade and The Share Centre to demonstrate this.

What is described or advertised by these providers is not what is being purchased by the investor. In the example of Freetrade if an investor looks at the Freetrade website or app the investor is invited to "purchase stock" in well-known companies. The Share Centre also recently sent around an e-mail communication. The e-mail uses phrases such as "owning shares…[is] about owning a part of the business" and "when you invest in a company, you become one of its owners and earn the right to have a say in how it runs its business".

Both examples demonstrate that the investor is being told what they are purchasing is a share of a business. A share in a business includes some form of participation rights and not just an "interest" measured by a "sum of money".[111] Shares are also described as personal property.[112] These descriptions of a share do not correspond with what is actually being purchased in these examples. The terms of both Freetrade, described above in question 1, and The Share Centre[113] make it clear

[110] BBC Radio 4, Money Box: How do I start investing? Podcast. First aired 18th September 2019
[111] See, *Borland's Trustee v Steel Bros & Co Ltd* [1901] 1 Ch 279, 288
[112] Companies Act 2006, s 541
[113] The Share Centre's Terms of Business, Clause 5.10

that the investor is not purchasing the legal title. Indeed, The Share Centre's terms of business identify that investments are pooled in a nominee account with no separate certification to evidence legal ownership and may not, therefore, be identifiable. Likewise, despite, Freetrade claiming the investor will be purchasing stock, the terms provide that the Custodian may use a single account with all the customers' funds deposited into it.

It is trite law that personal property be identifiable. Therefore, the purchase is not a share purchase. Likewise, the absence of legal ownership, means the investors have no respective rights as members against the company. The Freetrade example makes that clear, and while The Share Centre does enfranchise its investors, that investor still has no respective enforcement rights against the company, meaning they are not considered the member in legal terms, they are, at best, a proxy. The Share Centre is also unable to enfranchise investors on a headcount vote, and the terms of business make express provision that the nominee reserves the right to not offer the entitlement to the investor.[114]

These terms make it clear you are not purchasing a share. You receive a beneficial interest only, which does not make the investor the "owner". The contractual rights an investor has are against the intermediary, not the company. While it is not a share it is not a bond either, since there is no entitlement to a debt.[115] At best it is a bad bond, where all the risk is assumed by the investor with no guarantee of return and no right in governance. A similar point is made by Salter QC.[116]

I also asked friends and family what they thought they were buying when they invested in shares. While not an academic or representative study, the common answer amongst the 10 people who responded was a "share in the company". Some thought they "owned" the share, while most expected to or expected to have rights against the company. Two respondents simply did not know if they owned the shares or not. The respondents reveal a lack of understanding about what is being purchased when investing in shares. Some better language in marketing may well clear this up. Currently, it is an investment without a name and investors do not get what they should reasonably expect.

The simple solution to this is better regulation, whether self or mandatory, that commits to clear and transparent information on what is being purchased. This should be important for fund platforms and other intermediaries. While the platforms often stipulate they are providing "execution-only" services, leaving the investor outside of the FCA's regulatory rules on regulated activity[117] and suitability of investments, the way they describe their products may bring them within those rules. If they are inaccurately describing to the potential investor what will be purchased through the platform, i.e. that they will being purchasing a share in a company, it could become a "regulated activity" that amounts to giving "advice" on "buying" shares if the investor purchases on the strength of that information reasonably believing it gives them rights in and against those companies the fund invests in.

[114] The Share Centre's Terms of Business, Clause 8.6
[115] *Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1, 23
[116] The Call, para 2.35
[117] FCA Handbook, Advising on Investments, Art 53; See also, FCA Conduct of Business Sourcebook Arts 9-10

Question 26

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?

I believe I have touched on these elsewhere, i.e. expertise of intermediaries and the incentives and obligations to maximise the value of the investment.

There are problems relating to enforcement of rights, potential issues with wealth distribution, investor incentive problems with voting rights, problems with incoherent legal development of end investors suing those up the chain based on private law obligations. Transparency is also a problem.

Question 27

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?

Whether passing the rights and remedies to the ultimate investor would improve trust, it is a potential benefit. Ensuring they have clear remedies that cover loss, or even going as far as to overhaul the law relating to retail investors entirely, would be better than simply passing existing rights and remedies to investors.

The benefit of trust is not one that can be measured but should not be underestimated. While I cannot find the source, I recently read how few people invest their money but would do so if they could trust the system. BBC Radio 4's 'Money Box' also recently aired a show on investing that covered some issues individuals had when it came to investing.[118] These included the risk of the money "shrinking" or disappearing and not knowing where their money is. It was illuminating regarding the common issues people face when deciding whether to invest and when they do. Trust has to play a big part in that reducing that risk. Intermediated securities can seem daunting to newcomers and novices particularly, as the Money Box podcast identifies, when they are faced with significant jargon that is "opaque". If people are unsure about what they are buying and what will happen to their investment or witness events where money is lost with no legal recourse when it appears just that there should be, people will not trust the system and will not be willing to take the risk. Examples such as London Capital and Finance Plc and Woodford Investment Management will be ringing in most potential retail investor's ears today. This is compounded by the point above about the potential for inaccurate description in what investors purchase. This can tie up capital in the economy unnecessarily and hinder a potential source of wealth redistribution.

The industry is also male dominated. A recent podcast reports that only 10% of women felt the industry met their needs.[119] If control, i.e. legal title and/or the right to move investments from companies and funds, is handed over to the individual, that reality may change, similar to what social media has done in allowing more voices to be heard. Handing control over to the individual may promote diversity and reduce problems associated with group-think, whether internally in the organisation or what it does externally.

[118] BBC Radio 4, Money Box: How do I start investing? Podcast. First aired 18th September 2019

[119] BBC Radio 4, Money Box: How do I start investing? Podcast. First aired 18th September 2019

Question 28

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?

Some of this has already been touched on. Particularly, rights and remedies may be exercised less frequently resulting in less scrutiny of corporate actions, or if they are exercised they may not be done so to promote the success of the company, whether intentionally or otherwise.

Passing rights and remedies could also increase the cost of intermediated securities to a point where fewer people invest. Measures should be considered whereby intermediaries are incentivised to internalise the cost if the market does not naturally drive competition to lower those costs. Also the statutory remedy proposed may well reduce transaction costs to off-set potential increased costs in passing existing rights and remedies to investors for reasons set out earlier.

END