Commercial and Common Law Team
Law Commission
1st Floor, Tower, 52 Queen's Anne Gate
London, SW1H 9AG

29th November 2019

Dear Madam or Sir,

Re: Intermediated Securities

The Association for Financial Markets in Europe (AFME) and UK Finance are pleased to offer a contribution to the work of the Commission with respect to intermediated securities.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation. Our members are large and small, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. Our members' customers are individuals, corporates, charities, clubs, associations and government bodies, served domestically and cross-border. These customers access a wide range of financial and advisory products and services, essential to their day-to-day activities.

We have been closely involved in efforts to overcome the legal inefficiencies with respect to intermediated securities that are commonly known as the Giovannini Barriers. Through the AFME Post-Trade Division Legal Committee, a number of submissions have been made, over the years, to the European institutions examining these questions, and members of AFME have been invited by the European Commission to participate in its work to develop reform proposals.

The role of English law has been a component part of the analyses carried out by AFME. We feel able to offer some general comments, therefore, with respect to it, as well as to offer material from our review of the legislation of other European countries that might prove helpful. Rather than addressing the points in the Call for Evidence, we would like to offer the materials that we have concerning the relevant issues and extend an offer to discuss the technical aspects of securities intermediation with the Commission.

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Previous Work

AFME White Paper
In the AFME White Paper, A Roadmap for Integrated, Safe and Efficient Post Trade Services in Europe (May 2018), we set out the following vision for the legal environment in Europe:

> • Securities laws in Europe are harmonised to an extent that reduces / eliminates operationally relevant legal uncertainties, including an insolvency framework that comprises financial markets intermediaries (even when acting as indirect participants of a settlement system), enforceable close-out netting and internationally harmonised conflict of law rules.
> • The Europe-wide acceptance and recognition of the nominee concept (i.e. assets that are held on behalf of clients are not proprietary assets of an intermediary) and omnibus accounts, as well as an internationally compatible conflict of laws regime for both securities and claims, are part of the securities law reform.
> • On access rights, there is a removal of all legal and regulatory obstacles at all levels of the post trading system that currently prevent end investors from being able to access the services they need as well as intermediaries from providing those services.

This remains a target for the post-trade environment in Europe. Our hope is that the new relationship of the UK and the EU will, so far as possible, realise these features of a fair and efficient legal environment for post-trade services.

European Post Trade Forum
Organised under the sponsorship of the European Commission, the European Post Trade Forum consisted of a number of experts who analysed the position for the remaining Giovannini barriers. The two areas that the Forum members agreed should be addressed were Legal Barrier 1 (good faith acquisition in TTCAs/repos) and Legal Barrier 2 (clients' ownership rights and allocation of shortfalls). As you will see from EPTF Report (May 2017)[1], the issues for attention by the UK were generally with respect to operational barriers and not these Legal Barriers.

English Law Considerations
The lack of issues identified for the UK by the EPTF follows from the high level of flexibility and certainty in English law with respect to ownership of securities and the services provided by intermediaries. Indeed, in our review of issues connected with securities law reform, over the years, we have never identified a concern that English law will not recognise the interests of investors. The equitable jurisdiction of the courts of England is sufficient to address any potential issues that arise because of the practical alienation of investors from their property through intermediation, provided that the relevant securities are in the UK or sufficiently under the control of a person who is subject to the jurisdiction of the UK courts.

The reality is that almost all of the questions around intermediated securities arise in cases of insolvency. It is to the insolvency rules, therefore, that we must turn in order to test whether and how intermediated securities may be restored to the control of an investor.

Here, again, we do not see that English and Welsh insolvency law is defective. What is more problematic is the actual machinery of insolvency. The appointment of insolvency practitioners

[1] https://ec.europa.eu/info/sites/info/files/170515-eptf-report_en.pdf

to gather the assets of a firm and to distribute it in accordance with legal and equitable requirements is where the greatest worries lie. The concern is not that the end result will not be equitable; rather, that the time that it takes insolvency practitioners to gather and process the required information is an issue for investors. The barriers to acting as owners, in these situations, are primarily administrative and practical, rather than juridical.

That said, we suggest that it would be desirable for the law to set out the principles that are meant to be given effect to.

English Law – Custodians

As the Law Commission notes, while the English courts have characterised the custody relationship as a "series of trusts and sub-trusts," an area of law that has not been well explored in England, in the absence of reported cases, is the role and function of a custodian as trustee in this context. In particular, the distinction needs to be clearly made between a trustee for the purposes of the Trustee Act 1925 and a custodian as a species of securities intermediary.

There is no doubt that a custodian has fiduciary obligations which can only be described in England by using the rules of equity. A custodian in England may hold legal title for certain securities, but it is understood via both case law and a contractual and commercial understanding, that it does so only for the benefit of its principal. This can be described as a bare trust, because the custodian does not and is not expected to undertake the obligations of a trustee under the Trustee Act 1925, such as taking out insurance for the protection of the subject property.

This is entirely consistent with the rules of commercial agency. In practice, a custodian of securities is an agent for a principal (the investor, a trustee or another intermediary in a chain ultimately leading to the investor or beneficiary). Their duties with respect to securities are established through contract and commercial practice, rather than through trust law.
The custody contract regulates the rights and obligations of the principal and the agent. Because the principal cannot exercise its rights with respect to the relevant securities directly, given the division of ownership between legal and equitable interests, it must pay the agent for such services as the agent is willing to perform. It is a fallacy that there is something in the nature of securities law that prevents the principal from acting as the owner of the securities in all respects – they can do so, or approximate it, if they have appointed an agent that is willing to provide such services.

We note that there is little by way of academic material on this subject. We urge caution, therefore, in readings of books with titles such as *The Law of Global Custody*. Some of the theses contained in these books are untested and are controversial among practitioners.

Instead, we would encourage the Commission to look at examples of the contracts that are used by custodians (which are readily available online) to understand the commercial reality of the business of securities intermediation. These are not dissimilar between the main custodians, in their substance, although the extent to which any particular service might be provided may differ. The contracts reflect commercial practice as it has been settled between custodians and securities owners over the past four decades.

Controversies

One of the controversies on the law of intermediated securities concerns what is called the custodian's lien. It is common to find, in a review of the contracts of the global custodians, that a right is claimed to retain securities to the extent that there are financial obligations to the custodian or members of its group. Attached to the right of retention is a right of sale and set-off, in order that, as a last resort, the custodian may realise the assets it is holding for its principal to the extent of the principal's related debts to the custodian.

The controversy arises because it is suggested – for example, in the book, The Law of Global Custody – that it is not possible to have a lien over dematerialised securities. Because they cannot be physically held, as they were in the days of paper certificates, the argument is that they cannot be retained.

This question is significant, because the custodian's lien supports the credit afforded to investors by custodians. As the legal holder of securities for investors, custodians bear significant risks, including taxes, settlement risks, and the risks of claims by third parties concerning ownership of securities or rights flowing from them. The mechanics of fixed and floating charges are generally not suitable to secure such credit, since they require registration or positive acts to maintain them. The ancient custodian's lien provides the custodian with the ability to take full control of the assets registered in their name or the name of their agents, should the investor default in its obligations towards the custodian or expose it to risks that would otherwise be unsecured.

If it is correct that the custodian's lien is impossible, because the securities concerned have been converted from paper into book entries in company registers, then investors are exposing custodians to significant and material risks on an unsecured basis; and this would arise only because modern technology has eliminated the need for physical shares to be handled.

We would suggest that the academic hostility to the custodian's lien overlooks the possibility of constructive possession. There is no reason why a court could not rule that a custodian has constructive possession of dematerialised or immobilised securities. In our view, the only reason one has not done so, to this point, is that there have not been cases before the courts that would squarely address the point.

This question is very relevant to the nature and form of securities intermediation. The interests of the intermediary include the ability to treat securities within their possession or control as security for the credit they provide and the risks that they are exposed to. Those risks properly belong to the ultimate investor or beneficiary, but they are borne by the intermediary as a result of the services they provide. When considering the ways that investors are able to act as owners, it needs to be kept in mind that this is relevant not only to the exercise of rights; it is also very relevant to the discharge of responsibilities.

Next Steps

AFME and UK Finance members include securities intermediaries from the investment banking, brokerage and custodian services sectors. We would be very happy to meet with the Commission, perhaps together with other trade associations representing those sectors, in order to elaborate the securities law reform issues that we have been addressing and which arise in the context of the current Call for Evidence. We trust that our combined experience will prove helpful to the work of the Commission and look forward to hearing from you.

Yours Sincerely,

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Principal, Capital Markets & Wholesale Policy

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