

Conference Report

Intermediated Securities and Investor Rights

LSE 24 March 2014

On 24 March 2014, Dr. Eva Micheler organised a conference entitled 'Intermediated Securities and Investor Rights'. The event was funded by the Law and Financial Markets Project and the Systemic Risk Centre. The aim of the conference was to determine whether the law is able to ensure that securities continue to be negotiable. The main question was whether it is possible to conclude that holding and lending chains have become too complex and inter-connected that investors are systemically compromised in their ability to exercise rights against the issuers.

The event was oversubscribed and attended by regulators, practitioners as well as academics. The contributions made by participants showed that the event raised questions of fundamental importance to the current debate on stewardship, investor rights, corporate governance and also on systemic risk in financial markets. It added a new perspective on both the discussion on intermediated securities and the discussion on stewardship and corporate governance.

The conference consisted of three sessions.

1. Setting the Scene
2. The Ability of Private Law to Facilitate the Enforcement of Investor Rights
3. The Ability of Regulation to Facilitate the Enforcement of Investor Rights.

Session one was chaired by **Professor David Kershaw** and began with a presentation by **Professor John Kay** (LSE, Oxford) who referred to Ronald Coase and Edith Penrose and posed the question whether a corporation is a true substantive reality, or a mere legal fiction, created by the law.

He illustrated the different perspectives on the company by referring to the situation of Imperial Chemical Industries (ICI) that moved from a Penrosian type of business to a Coasian business. In other words, ICI moved from having a conception of the company as a social institution to a commercial organization prioritizing shareholders returns.

He also questioned what is meant by being an owner of shares in a company. Is it possible to conclude that, in fact, the directors of the company own the company more than the shareholders do? He also raised the question whether it can be said that shareholders are the owners of their shares because the different aspects of share ownership of one particular share are increasingly exercised by different persons or entities.

David Hertzell (Law Commissioner for England and Wales) continued proceedings by discussing the Law Commission's project on Fiduciary Duties and Investment Intermediaries, which arose out of the Kay review into short termism into UK equity markets. Approaching the question whether short termism was driving bad management decisions from a pension and pension perspective, David Hertzell pointed to the role of fiduciary duties. Traditional trusts are based on individuals providing for their relations. In the context of pensions the beneficiaries' own money goes into the scheme. What are the consequences of these commercial differences?

David Hertzell stressed that the trustee must put the financial interest of the beneficiaries first. But the law does not prevent a trustee from taking into account environmental, social, and governance (ESG) factors. The Law Commission's view was that currently, the law reflects an appropriate understanding of beneficiaries' best interest and that not the law, but rather the market was the main cause of short termism. Herding practices and the fact that most pension funds are small and the trustees have limited time resources and expertise clearly indicate the limits of what the law can achieve. Moreover, a change in the law could have unintended effects.

Nevertheless, there remains a high degree of uncertainty which led to an overly narrow interpretation of fiduciary duties and in this respect better guidance is required. In this respect, the consultees agreed that trustees could, and should, take ESG consideration into account, next to short term financial returns.

Regarding fiduciary duties and their role in investment chains, David Hertzell pointed out that courts are reluctant to extend duties of care and go behind regulation or contracts. In addition, he pointed out that they are an uncertain tool to change behavior but revision of certain FCA rules could be considered as to target specific concerns. The more appropriate view might be to review the regulation of investment consultants.

The first session was closed by a presentation on the effect of custody chains on the investor rights delivered by **Dr Eva Micheler** (LSE).¹ Investors and the intermediaries which form part of the chain are connected by bilateral contracts. There is an independent contract between investor and custodian one, and another independent contract between custodian one and custodian two. This means that the investor has no rights under any other contract except the one with his direct counterparty. This structure dilutes the rights of investors. There is no limitation on the number of custodians neither is there any control over the terms of the contract. Whenever bilateral arrangements terms are established that are efficient as between the two parties. This does not necessarily create an outcome that is efficient for the investor or for the issuer. Custody chains can have the effect of eroding the rights of investors and can make it very difficult to enforce rights against issuers. Micheler's view is that investors and issuers would benefit from having a transparent system that directly connects investors with issuers.

Professor Charles W Mooney, Jr (Penn Law, Philadelphia) chaired the second session of the day on "The Ability of Private Law to Facilitate the Enforcement of Investor Rights". The panelists were mainly comprised of experts from academia including Matthias Lehman, Phillip Paech, Elena Zaccaria, Sarah Paterson and DR. Karin Wallin-Norman.

The session began with **Professor Matthias Lehmann** (Martin Luther University, Halle-Wittenberg) presenting an analysis of the benefits and drawbacks of the UNIDROIT Convention on Intermediated Securities. The convention uses neutral language because of the differences in national jurisdictions with regard to property law and rights in securities. Neutral language also avoids the risk that terms are being confounded with national concepts. Another benefit is that this approach facilitates consensus among the potential signatory states precisely because there is a high degree of flexibility. The functional approach also entails some drawbacks. It has been criticized as being too broad.

¹ The paper on which this presentation is based is available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2413025.

Phillip Paech (LSE) followed with a talk on netting and the enforcement of investor rights. Having introduced the concept and explaining the different types of netting, Dr. Paech discussed the practical effect of clearing, namely ‘collapsing’ multi-party obligations. He distinguished three different legal typologies of clearing. The first case can be referred to as ‘multi-party clearing’. The clearing house does not assume any rights or obligations. There is a mere cross-assignment of rights between the individual members. The clearing house acts as a CCP yet the underlying exposures remain unchanged. In a second scenario parties start to move some of their exposures (e.g. the delivery obligation/payment obligation) to the clearing house. In other words, the clearing house partly interposes itself between the parties. This situation can be referred to as ‘central clearing of isolated rights’. The final variation of clearing is the true CCP clearing situation. The clearing house fully interposes itself between parties and becomes buyer to every seller and a seller to every buyer. Each transaction between clearing members is taken on by the CCP.

The question arises whether the investor-issuer relationship is disrupted by these forms of netting. In the case of multi-party clearing, the legal relationships are administered by the system but the clearing house does not take a position in them. The fact that the original legal relationships are not assumed by the clearing house means that they remain where they were in the beginning. The situation is, however, different in the case of ‘central clearing of isolated rights’ and true CCP clearing. In these cases the central entity takes a legal position and becomes (partially or fully) engaged in the legal contracts. Does this mean that, albeit even for a short time, it becomes the legal owner of the securities itself? If this is the case, the CCP can have an influence on corporate rights.

The next presentation was given by **Elena Zaccaria** (LSE) and focused on the role of omnibus accounts and investors rights. In many countries, including the UK, intermediaries usually hold securities in a global or omnibus account rather than creating separate accounts. An omnibus account has the advantage of simplifying management of clients’ securities, they reduce costs and further reduce operational risk.

Regardless of these benefits, Zaccaria drew attention to some drawbacks related to omnibus accounts. In particular, they reduce the level of transparency in the indirect holding system. The interest of the investor in his/her securities is only shown in the books of his/her direct intermediary and cannot be tracked higher up the custody chain.

Responding to this concern, the FCA decided to undertake a fundamental review of the client money and custody asset regime. A variety of other regulatory initiatives to improve client asset protection have been taken in the meantime. The European Commission appears not to be too concerned about the matter since its working programme for 2014 does not include the proposal for securities law legislation. Nevertheless, certain conditions on pooling have already been introduced into other Directives and Regulations (e.g. EMIR, AIFMD, CSDR proposal). The intention is to enhance individual segregation by making the customer aware of the risks inherent to an omnibus account.

Looking at the issue from a debt perspective, **Sarah Paterson** (LSE) followed up with by presenting a paper on 'Custody Chains and Corporate Rescue'.² There exist significant problems regarding the communication between bondholders and issuers in the context of corporate restructurings. The entity holding the bond often does not hold the ultimate interest in the bond. There are significant

² The paper is available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2406346.

differences between the approach adopted in the UK, where trustees act on behalf of bondholders, and the approach adopted in the US, where negotiations involve ultimate investors. To facilitate involvement of ultimate investors in the UK issuers have in the past exchanged global notes for definitive bonds. It is also possible to use what has been referred to as a 'contingent creditor analysis' allowing ultimate bondholders to participate in corporate restructurings.

The final presentation of the second session was given by **Dr. Karin Wallin-Norman** (Linköping University). The Nordic countries have a functional approach towards ownership. Under Swedish company law listed companies issue shares in dematerialized form. They have a 'share book' and an 'account register'. Both are kept by the Swedish CSD. The share book contains the names of owners and custodians and the number of shares they hold. Registration in the share book has, however, no proprietary effect. The account register contains the same information as the share book and also contains information about rights such as pledges and certain restrictions and the time of acquisition and disposal. Entries in the account register do have proprietary effect.

In addition, there is a 'general meeting share book' which contains the names of those entitled to vote. Custodians are not entitled to vote. Those who are entered as owners into the 'general meeting share book' are those who have acquired shares with proprietary effect. Dividends are paid to custodians who distribute them among their clients.

On a concluding note Dr Wallin-Norman ended by saying that in the modern sophisticated global securities market we have to move from the old, Roman, perspective and allow new thinking, even if this may feel very alien and counterintuitive.

After the coffee break, Professor **Rüdiger Veil** (Bucerius Law School), chaired the final panel discussion on the ability of regulation to facilitate the enforcement of investor rights.

Klaus Löber (Bank for International Settlements) opened the session by providing a global regulatory perspective on systemic risk and investor rights. He started by pointing out that none of the global regulatory standards are legally binding. Nevertheless, there is a high degree of de facto implementation. The main aim of these global standards are to contain systemic risk. Financial markets and intermediaries operate on a global level. It is important that national laws taken together create a consistent global framework

Next, **Dr Pablo Iglesias-Rodriguez** (VU University Amsterdam) gave a presentation on the Regulation on CCPS and the enforcement of investor rights. He pointed out that after novation the CCP assumes all the legal rights and obligations of its members.

Before the global financial crisis of 2007 regulation was essentially provided by the market infrastructure itself. After the crisis, the EU adopted EMIR which contains provisions on segregation and portability. Those have potential impact on the ability of clients to enforce their rights. Segregation refers to the separation between the assets of a clearing member and the assets and positions of the client of that clearing member. Portability refers to the fact that in the event of default of one of the clearing members, CCPs are required to initiate the transfer of the assets and positions of the defaulting member's clients, registered in the segregated accounts and omnibus accounts, to another clearing member (the designated clearing member).

Dr Matteo Solinas (University of Glasgow) spoke about the regulation of Central Securities Depositories and the enforcement of investor rights. The European legislative process on this topic is soon to become final. The draft European regulation introduces a number of rules that allow horizontal competition between CSDs, making it possible that they are a participant in another settlement system. Dr Solinas analysed the current draft regulation.

The final session was closed by an analysis of the Target2Securities (T2S) project and investor rights, given by **Pierre Beck** (Banque central du Luxembourg). Currently the system is highly fragmented and CSDs have to set up links between each other. The management of this structure is very cumbersome.

The T2S system creates an infrastructure for CSDs allowing them to better connect with each other. There is no obligation for the CSD to adhere to the project.

Beck indicated some benefits from using the T2S system. It promotes the smooth functioning of the payment system while at the same time contributing to the EU integrated market. Moreover, the Euro system is neutral towards its stakeholders and does not pursue an economic interest. There is the opportunity to use state of the art technology. Users will have the benefit of reduced settlement fees for domestic and cross-border transactions. It further offers the potential of collateral and liquidity management. T2S will be a significant contribution to the market for clearing and settlement. The cost of capital will be further reduced and the T2S system should reduce settlement risk under cross-border transactions. Investors can more easily diversify their portfolios and issuer can reach more easily the investors.