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Custody Chains and Remoteness: Disconnecting Investors from Issuers

Eva Micheler

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Eva Micheler is Reader in Law at the Law Department and Research Associate at the Systemic Risk Centre, London School of Economics and Political Science

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Custody Chains and Remoteness - Disconnecting Investors from Issuers

Eva Micheler (LSE Law)

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1. Introduction

The article shows that the current market infrastructure systemically prevents investors, both shareholders and bondholders, from exercising their rights against issuers. Equity and debt securities are now normally held through a chain of custodians. These custodians are connected with each other through contract law. There also exists legislation determining the relationship between custodians and their clients.¹

It will be shown in the paper that custody chains have become independent from investors and issuers. Neither issuers nor investors are able to control the length of the chain or the content of the legal arrangements that governs the custody chain. Custodians are connected through a series of bilateral links that are independent of each other. This erodes the rights of investors. The paper will illustrate this by reference to the liability of custodians for their services and by reference to the ability of custodians to contract with sub-custodians on terms that are independent from the terms that they have entered into with their customers.

Custody chains affect securities markets at a very fundamental level. Securities are a bundle of rights that investor have against issuers. Market participants assume that these rights are enforceable against the issuer. There is always a risk that an issuer defaults and becomes unable to meet claims. Otherwise, however, the market is entitled to expect that its infrastructure will make it possible to enforce claims where an investor takes the view that the issuer does not comply with the terms of an issue.

If the enforcement of claims is significantly compromised this can affect the value of securities. Investors will only enforce claims if the cost of enforcement is outweighed by the benefits. If the market infrastructure is set up in way that makes enforcement systematically very expensive investors will refrain from enforcing claims and that has implication for the value of those claims. This can have systemic implications.

¹ [references]; also distinguish this from a direct and transparent holding system.

Custody chains not only affect securities values in the portfolios of investors. They also cause problems for issuers. They pose a significant hurdle preventing individual and institutional investors from exercising rights against issuers when they wish to do so and as a result deprive issuers of oversight from the shareholders.

This problem cannot be overcome by contract law, corporate law or property law. The thesis of this paper is that structural reform is required to reduce the number of intermediaries that operate between issuers and investors.

It is useful to determine the boundaries of the paper. There is an ongoing corporate governance debate relating to equity securities. That debate focusses on the question as to how much influence shareholders should have over the management of a company.² This paper does not contribute to this debate. The paper accepts that law assigns governance rights to shareholders. Policy choices have been made when the level of shareholder influence was determined. These choices will vary from time to time. In any event, however, the mechanism through which shares are held should not obstruct the exercise of rights that investors have been granted by the articles of association or by legislation.

In relation to equity securities, there also exists a debate on empty voting.³ Empty voting occurs when shareholders acquire voting rights without acquiring the economic interest associated with the votes. The corporate governance concern there is that a particular shareholder has more influence than economic interest. The concern is also that disclosure rules requiring investors to disclose their share in a company reflect the real level of influence exercised by shareholders. The paper does not contribute to this debate. The issue addressed by the paper is a situation where the holder of an economic interest who wishes to exercise this interest is prevented to do so by the market infrastructure through which securities are held.

There also exists a debate analysing the effect of intermediation and fragmentation in relation to investment decisions.⁴ It seems that those whose pension money is invested would benefit from a long term sustainable investment strategy. It is possible that intermediaries taking decisions for them have incentive structures that steer them away from pursuing strategies

² [references].

³ [references].

⁴ [references].

that best suit the requirements of ultimate beneficiaries. This is even more likely where decision making is fragmented and delegated to several levels of specialist investment providers. The impact of intermediation and fragmentation at the level of decision making is outside the scope of this article. The Law Commission is currently investigating the scope of fiduciary duties in this context.

A final disclaimer needs to be made. The paper does not, at this stage, attempt to analyse the economic reasons explaining why custody chains exist. It will be shown at a later stage that there exists economics literature analysing credit chains which can, to some extent, also help to explain custody chains.⁵

The paper begins by briefly defining custody chains. After that it will be shown how custody chains erode the ability of investors to remedy negligent services by custodians. Custody chains also undermine the contractual arrangements of ultimate investors and their immediate service providers.

The paper will also illustrate that and in what way custody chains obstruct the enforcement of investor rights. This can reduce the value of securities. This can also compromise the governance of issuers.

The paper will conclude that the problems associated with custody chains are very difficult to remedy by law. The recommendation is that a central, direct and transparent mechanism should be created that links investors with issuers. Policymakers should expect intense resistance from existing market participants trying to preserve the incumbent structure.

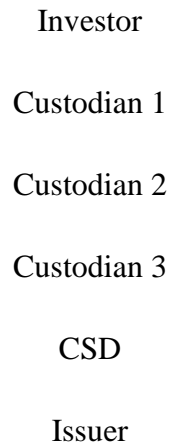
2. Custody Chains

In modern securities market shares and other securities are held indirectly through financial service providers who hold securities on behalf of clients. These service providers will be referred to as custodians in this paper.⁶ A custody chain is made up of one or more custodians. Connections are made through bilateral contracts. The ultimate investor has a contract with custodian 1. Custodian 1 has a contract with custodian 2. Custodian 2 has a

⁵ Eva Micheler and Jason Donaldson, 'Negotiability and Custody Chains' (forthcoming).

⁶ [Clarify term] at this stage of the paper the term also includes CSDs.

contract with Custodian 3. Custodian 3 has a contract with the CSD. The CSD is connected with the issuer.⁷



One important feature of custody chains is that the contracts are entered into bilaterally only. The investor is normally not a party to the contract between Custodian 1 and Custodian 2. The contract between Custodian 1 and Custodian 2 does not normally give direct rights to the investor.⁸ Each custodian enters into a bilateral relationship with his immediate client and another bilateral relationship with his immediate sub-custodians. The contract with the client is independent from the contract with the sub-custodian.

It will be shown below in the next two sections that this erodes the interest of the ultimate investor and compromises the enforcement of the rights by the ultimate investor.

3. Erosion of investor rights

a. Introduction

Standard arrangements enable custodians to employ sub-custodians. They also give them the freedom to appoint the sub-custodian. As a result ultimate investors have no control over which and how many sub-custodians acts at the levels further down the chain.

⁷ The relationship between a custodian and his immediate client can also be subject to legislation protecting the interest of the clients of custodians. The aim of these rules is to ring-fence securities that are held by custodians for clients with a view to preventing the creditors of the custodian concerned from ceasing them. They do not limit the ability of a custodian to employ a sub-custodian.

⁸ Euroclear's terms explicitly state that, 'No customer or other entity or individual for which you may be acting will, in that capacity, have or be entitled to assert any rights, claims or remedies against us.' (Terms and Conditions governing the use of Euroclear (July 2013) article 18 second paragraph).

Examples of this can be found in the general terms of Euroclear and Clearstream Banking Luxembourg. Euroclear is under its terms allowed 'to hold securities' with 'any subcustodian ... directly or indirectly through such a subcustodian, with any Other Settlement System ...'.⁹ Any 'Other Settlement System with which securities are held may, in turn, redeposit or hold securities with one or more subcustodians or Depositories with the requirement of our [Euroclear's] approval'.¹⁰ Clearstream's terms are very similar. CBL 'may hold securities at any other place or deposit them with other depositories, in Luxembourg and abroad, including banks, custodians and sub-custodians, or other clearing systems ... CBL may permit any such entity, in turn, to redeposit or hold securities with one or more other entities used by it without the prior approval by CBL'.¹¹

In addition to having no control over who the service providers are that act between them and the issuer, ultimate investors also have no influence over the terms upon which securities are held at the levels further down.

It will be shown in the following subsection that this can lead to dilution of contractual terms from the perspective of the ultimate investor. The subsection contains two examples. From the perspective of ultimate investors custody chains can lead to a reduction of liability for negligent services. Custody chains can also result in exposing the ultimate investor to risk that was not explicitly envisaged by the contract between the him and his immediate custodian.

b. Custody chains reduce liability for custody services

One example of how custody chains erode investor rights is the liability of custodians for providing services negligently.

Each custodian is liable for its own negligence. This includes liability for employees and other individuals that work within the custodian's own organisation. This liability can be

⁹ Terms and Conditions governing the use of Euroclear (July 2013) article 4(b)(i).

¹⁰ Terms and Conditions governing the use of Euroclear (July 2013) article 4(b)(ii); see also article 11(a)i: 'We may, from time to time, appoint banks or legal entities (other than Euroclear Bank) as additional depositories for securities held in the Euroclear System.'

¹¹ CBL General Terms and Conditions, article 15; see also article 47.

modified by contract.¹² But the law imposes limits on the extent to which liability can be excluded by contract.¹³

Outsourcing custody to a sub-custodian can, however, reduce liability to an extent that goes beyond what is permitted by the applicable law. This is because a custodian is not liable for the acts or omissions of the staff of a sub-custodian in the same way as it is liable for its own staff.

Euroclear is 'not liable for the acts or omissions of (or the bankruptcy or insolvency of) any Depository or subcustodian or any Other Settlement System ...'.¹⁴ CBL also excludes liability for the 'acts or omissions of (or the bankruptcy or insolvency of) any of CBL's depositories, sub-depositories, custodians, sub-custodians or of any other clearance system ...'.¹⁵ Moreover CBL is not liable for 'the failure to perform for any reason of, or the incorrect performance of, any financial institution used by or properly instructed by CBL to carry out payment instructions'.¹⁶

This is reasonable. A custodian has no control over the level of services delivered by individuals outside its own organisation and is therefore entitled to reject liability if a loss occurs as a result of their negligence.¹⁷

From the perspective of the custodian delegation has the effect of reducing liability. By outsourcing the holding of assets a custodian can transform liability from a liability for its own mistakes to a more remote and less likely liability for not having properly identified or

¹² The Terms and Conditions governing the use of Euroclear, for example, state that Euroclear is liable for 'negligence or wilful misconduct on ... [its] part'. The liability 'for indirect losses such as, but not limited to, loss of business or loss of profit or for unforeseeable losses' is limited to 'gross negligence or wilful misconduct on ... [its] part' (Article 12(a)). Under its terms, CBL is liable for its own negligence or wilful misconduct (CBL General Terms and Conditions, article 48). It is not liable for 'indirect or unforeseeable loss, claim, liability, expense or other damages unless such action or omission constitutes gross negligence or wilful misconduct on the part of CBL'. (CBL General Terms and Conditions, article 48, 3rd sentence.) CBL is not liable for events beyond its 'reasonable control' (CBL General Terms and Conditions, article 48, 4th sentence.).
¹³ [insert references].

¹⁴ Terms and Conditions governing the use of Euroclear (July 2013) 12(d).

¹⁵ Euroclear Terms and Conditions 12 (d) ###; CBL General Terms and Conditions, article 48, sentence 5

¹⁶ CBL General Terms and Conditions, article 48, sentence 5.

¹⁷ To be analysed: Are there systemic reasons to be cautious about liability of one intermediary for mistakes of others?

instructed a sub-custodian.¹⁸ This incentivises custodians to employ sub-custodians and prolongs chains.

From the perspective of the ultimate investor delegation significantly modifies the standard to which their immediate service provider is liable to them. He only has a claim against the custodian that he is directly connected to if that custodian was itself negligent.

If the ultimate investor suffers a loss because an intermediary other than his immediate custodian has acted negligently and if that negligence justifies a claim for breach of contract, he cannot sue that custodian directly.

It is possible that a custodian has an obligation to act for his client to claim against his sub-custodian. But that obligation is unlikely to be onerous.

If a customer suffers a loss 'as a result of any act or omission of, or the bankruptcy or insolvency of, any Depository or subcustodian or any Other Settlement System' Euroclear 'will take such steps in order to effect a recovery as ... *[it] deem[s] appropriate under all circumstances*'.¹⁹ Again Clearstream has very similar terms. If a customer 'suffers any loss or liability as the result of any act or omission of ... CBL's depositories, sub-depositories, custodians, sub-custodians or of any other clearance system ... CBL shall take such steps in order to effect a recovery as it *shall reasonably deem appropriate under all the circumstances*'.²⁰

The cost of such an intervention is borne by the customer. Euroclear and CBL only agree to bear the cost if they are themselves liable by virtue of their 'own negligence or wilful misconduct' (Euroclear) or 'own gross negligence or wilful misconduct' (Clearstream).²¹

Both custodians take a reasonable approach. They would be ill-advised to promise that they will enforce all claims at the request of its customers. The terms 'reasonably deem appropriate' give them discretion to decide whether or not to recover loss on behalf of

¹⁸ Article 17(1) MiFID Implementing Directive requires 'investment firms' to exercise all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of financial instruments. In particular it is important that the third party is subject to regulation and supervision (article 17(2) and (3) MiFID); [insert analysis of how far these reach and how they have been implemented].

¹⁹ Terms and Conditions governing the use of Euroclear (July 2013) article 12(d) second paragraph (author's emphasis).

²⁰ CBL General Terms and Conditions, article 48, paragraph 3 (author's emphasis); Euroclear term 12 (d).

²¹ Terms and Conditions governing the use of Euroclear (July 2013) article 12(d); CBL General Terms and Conditions, article 48, paragraph 3.

customers. The wording chosen by them gives them a wide scope within which they can act. This is understandable and limits the potential for time-consuming and costly arguments on what steps they should take. The result, however, is that the ability of the ultimate investor to claim for the negligent provision of custody services is significantly reduced by the fact that his securities are held in a custody chain.

The problem with custody chains is that the ultimate investor may have an incentive to enforce a claim, but can only do so if the immediate custodian was negligent. That custodian or a custodian further down the chain may have a contractual remedy, but does not necessarily have the incentive to enforce his claim.

Bilateral links enable custodians to reduce potential liability for their services. This dilutes the rights of ultimate investors. This also creates an incentive for custodians to employ sub-custodians. That prolongs chains and causes the number of custodians involved in the chain to increase. Matters are made worse by the fact that the more organisations are involved the more likely it is for mistakes to occur. Adding further members to the chain increases the likelihood of mistakes to happen and at the same time makes remedying these mistakes more complicated and more costly.

c. Erosion of contractual terms

We have already seen that both Euroclear and Clearstream have significant flexibility to outsource custody to other custodians. They also have the ability to identify the sub-custodian. It will now be shown in this sub-section that they also have wide discretion as to the terms on which they can delegate custody services to other providers. From the perspective of the ultimate investor this may lead to a undermining of terms giving sub-custodians greater freedom in relation to assets than the ultimate investor has explicitly granted to his immediate custodian.

Euroclear is able to subcontract 'upon such terms and conditions as may be customary for such subcustodian or Other Settlement System (or upon such other terms and conditions as may be approved by ... [it]'.²² CBL may subcontract 'upon such terms as may be customary

²² Terms and Conditions governing the use of Euroclear (July 2013) article 4(b)(1)(z); see also article 11(a)(i) and (ii): 'We may, from time to time appoint ... additional depositories ... [and] determine the terms and conditions upon which any [d]epository shall act'.

for deposits with such entities, or upon such other terms and conditions as may be approved by CBL'.²³

The wording suggests that Euroclear and CBL can accept 'customary' terms but also other terms, provided that they 'approve' them. There is no explicit limitation on their discretion. In particular there is no reference in the contract that they are bound by the limitations of the arrangement that they themselves have made with the customer.²⁴ This provides both custodians with extensive discretion in relation to what kind of arrangements they make with their sub-custodians.

The ability of custodians to sub-contract upon terms that are determined by them undermines the contractual arrangement between the ultimate investor and its immediate service provider. By giving a custodian wide discretion to sub-contract an investor is taken to have accepted terms that affect him without necessarily being aware that his position has changed as a result of this.

Matters are made worse by the fact that lower levels of service are normally associated with lower cost. Subcontracting to a sub-custodian that offers a better price may be in the interest of the custodian instruction the sub-custodian, but can dilute the rights of the ultimate investor.

d. Conclusions

This section has shown that custody chains reduce the ability of ultimate investor to remedy the negligent provision of services by custodians and also undermine the terms of the contract that was entered into between the ultimate investor and his immediate service providers. The next section will explain that custody chains obstruct the enforcement of claims by investors against issuers.

²³ CBL General Terms and Conditions, article 15.

²⁴ Regulation in some cases provides for limitations (See e.g. Article 19 MiFID Implementing Directive according to which 'investment firms' must not enter into arrangements for securities financing transactions in relation to client assets unless the client has given express consent. This also applies when assets are held in omnibus accounts with a third party.) but necessarily lags behind.

4. Obstructing enforcement

a. Introduction

In most cases there is no need for an investor to take an issuer to court. Issuers have reputational incentives to fulfil obligations. But there are cases where investors nevertheless decide to embark on litigation. This would occur for example when the investor has cause to allege that he was inadequately informed about the risk involved in the instrument and decides to claim for a remedy against the issuer for misrepresentation or fraud. This would also occur when the investor concludes that the issuer does not comply with the terms of issue. There may, for example, be disagreement as to the exact instances and terms of payment under the underlying instruments.

To claim against the issuer the investor will have to show that he owns the securities or is at least entitled to enforce them to have standing in court.

The investor has at most five options to prove this. He can instruct the custodians to enforce the right on his behalf, request delivery of paper certificates if the securities are issued in paper form, collapse the chains of trusts or arrange for an assignment to become the legal owner. He can also show that under the law of the place where the securities are held he is considered the owner. It will be shown below that each of these five options is very costly and cumbersome. Custody chains can prevent investors from being able to enforce claims and that can have systemic implications for the value of assets.

b. Enforcement by custodians

It is possible for the investor to ask his direct custodian to pass a request to next custodian and then further down the chain from one custodian to another requesting the custodian directly connected with the issuer to enforce the rights on behalf of the ultimate investor. This, however, is not a realistic option. It would involve cumbersome communications through a chain of intermediaries.

Moreover, the custodian directly connected with the issuer is unlikely to be interested in getting involved in litigation on behalf of customers. Euroclear, for example states in his terms that it makes 'no investigation with respect to and ... [is] not liable for ... the acts or

omissions of ... any issuer'.²⁵ CBL states in its terms that it has 'no obligation to take any action with respect to any rights, options or warrants ... except to the extent that CBL has been explicitly instructed by the Customer, and has, in writing, agreed to take such action, or as otherwise provided in the Governing Documents.'²⁶

c. Delivery of paper certificates

A better option for the ultimate investor is to collapse the chain and become the immediate owner of the securities. This is however a option that is only available in limited circumstances. Requesting delivery of paper documents is only possible if the securities have been issued in paper form and if the terms of the issue allow for the delivery of individual certificates or if the instrument is a bespoke product where the investor holds all the units of one issue.²⁷ Even then custodians can exclude a right to physical delivery in their terms.²⁸

The denominations of individual paper certificates can also be a problem. CBL, for example, may decline to execute, or execute only in part, a request to physically deliver certificates representing fungible securities if CBL does not have certificates in the appropriate denominations available. If CBL does not have available certificates in the appropriate denominations, CBL undertakes, at the Customer's request and expense, to obtain certificates in the appropriate denominations.²⁹

In circumstances where the physical delivery of paper documents is possible the process of doing so is not straightforward. All custodians have an incentive for reputational reasons to assist investors in enforcing rights. They also, however, need to have in place and follow adequate procedures to ensure that the assets they look after are only accessed by individuals with authority to do so. To avoid breaching duties to other clients they need to ascertain the entitlement of a particular individual before helping them.

²⁵ Terms and Conditions governing the use of Euroclear (July 2013) article 12(e).

²⁶ CBL General Terms and Conditions, article 18.

²⁷ The Operating Procedures of the Euroclear System (February 2014) 3.4.3 explicitly point out that if an issue is represented by a global certificate and this is not permitted by the governing documentation of the execute instructions for physical delivery.

²⁸ For an example of this see the Special Terms – Brokerage (Besondere Bedingungen – Brokerage) of Postbank, section 18 available from https://www.postbank.de/privatkunden/depot_eroeffnen.html (as of 6 February 2014).

²⁹ CBL General Terms and Conditions, article 11.

The cost of and the risk associated with physical delivery falls on the customer. Euroclear, for example, arranges for delivery by post, armoured car or courier.³⁰ The customer bears the risk of such physical delivery once the certificates are deposited in the mail, armoured car or courier service.³¹ But Euroclear may continue to insure the securities at this time.³² The expenses associated with the physical delivery are charged to the customer.³³ Under CBL terms physical delivery is effected at the expense and risk of the customer requesting the delivery.³⁴ CBL reserves the right to determine the appropriate method of physical delivery of certificates, and the extent and the writer of any insurance coverage for such delivery.³⁵ The cost of insurance coverage is borne by the customer.³⁶

It is understandable that custodians pass the expenses of procuring paper certificates on to their customers. If there are a number of intermediaries cost will arise at each level. Each custodian in the chain will have to apply resources to contact the custodian above him in the chain and arrange for a delivery to the ultimate investor. This adds to the cost of enforcement and may not deliver the desired effect if a custodian further down the chain has excluded delivery.

d. Collapsing subtrusts

If securities are held on trust by a custodian and depending on the terms of the arrangement it may be possible for the investor to collapse the trust and request a transfer of the assets held by the custodian to him. That, however, also requires the investor to approach one custodian after the other along the chain. At each level terms will have to be examined to determine if the arrangement can be collapsed at the request of the investor.

Again it is possible for this option to become blocked by contractual terms. Custodians may be happy to disclose the identity of their immediate sub-custodian to their customers. Euroclear, for example, provides clients with 'notice of the appointment or termination of any Depository or Other Settlement System'.³⁷ But they only provide information about the

³⁰ Terms and Conditions governing the use of Euroclear (July 2013) article 12(g) and The Operating Procedures of the Euroclear System (February 2014) 5.2.4.3(c).

³¹ The Operating Procedures of the Euroclear System (February 2014) 5.2.4.3(d).

³² The Operating Procedures of the Euroclear System (February 2014) 5.2.4.3(d).

³³ The Operating Procedures of the Euroclear System (February 2014) 2.13.3.

³⁴ CBL General Terms and Conditions, article 14.

³⁵ CBL General Terms and Conditions, article 14.

³⁶ CBL General Terms and Conditions, article 14.

³⁷ Terms and Conditions governing the use of Euroclear (July 2013) article 11(d).

identity of their immediate sub-custodian and they are only able to give such information to own their customers and cannot share information with the ultimate investor without the consent of their clients.³⁸

Moreover, while it is important to receive information about the identity of the sub-custodian, Euroclear and CBL's terms do not give their customers the right to receive information about the terms upon which securities are held at the level further down the chain. They also do not promise to investigate the identity of sub-custodians further down the chain. In addition to that standard terms do not necessarily give a right to the customer enabling them to step into the arrangement that the custodian has with a sub-custodian.

e. Assignment

Perhaps the most realistic option is for the investor to request an assignment of the rights of his custodian and its sub-custodians to him. This involves a chain of assignments starting with the custodian immediately connected to the investor and then proceeding from one custodian to the next along the chain. Like a request for delivery of paper certificates or the collapse of a trust arrangement, assignments will have to be processed at every level. The investor in this scenario is dependent on the willingness of each of the custodians to engage in negotiations about the assignment. Each custodian will have views on what terms they are able to accept. Time is required and legal advice will be involved for the terms of the assignment to be drawn up. If the chain spans across jurisdictions the terms will have to be considered against the background of the law of those jurisdictions and that is likely to increase legal fees.

f. Claiming as an intermediated owner

If the securities are held in a jurisdiction where the ultimate investor is considered to be the owner notwithstanding the custody chain, the investor may be able to sue the issuer without having to collapse the chain.³⁹

This however may still require the owner to provide evidence that connects him to the issuer. He has to determine the identity of all custodians between him and the issuer. He has to supply proof from each custodian that shows that a chain exists leading to the conclusion that

³⁸ See eg CBL General Terms and Conditions, article 40.

³⁹ [references].

they are holding the securities that he is trying to enforce for their respective immediate customers and ultimately for him.⁴⁰ The investor has to approach each custodian in turn and, except for his immediate custodian, indirectly.

Further complications arise if the issuer is located in the UK or in any other jurisdiction that does not apply a look through approach or if there is a jurisdiction clause appointing the courts of such a jurisdiction. To be able to sue the investor needs to plead that the securities are held in a foreign jurisdiction and that under the law of that jurisdiction he is considered to be the owner of the securities and entitled to enforce them. The investor has to show that, notwithstanding the fact that his name only appears in the statements issued by his immediate custodian the foreign law considers him to be the owner of the securities.

In English law the content of foreign law is a question of fact which the investor needs to plead and prove by presenting expert evidence. An investor who wants to claim as an owner under foreign law has to identify and pay for that expert. To succeed the investor has to persuade an English court of notions of ownership that are very different from English law. Moreover it is possible that the issuer also supplies expert evidence on foreign law supporting the conclusion that in the circumstances of the case the investor would not be considered an owner under the foreign law. This creates uncertainty.

Putting together evidence from all custodians that are positioned between the issuer and the investor and proving foreign law takes time and costs money. The cost increases with the length of the chain.

g. Conclusions

Custody chains make the enforcement of claims against issuers time consuming and costly. Delay can be a problem against the background of limitation periods. Cost can render claims unenforceable and in consequence affect the value of the claim. This is because a claim will only be enforced if the cost of the likely recovery outweighs the cost of enforcement. If enforcement costs reach a level that renders the enforcement of claims uneconomical in most cases securities become effectively unenforceable. This affects the value of the securities concerned. Because this would affect all securities held in a particular market this can have

⁴⁰ CBL General Terms and Conditions, article 15.

systemic implications. These thoughts will not be further elaborated in the context of this paper.⁴¹

The conclusion here is that custody chains significantly increase the cost of enforcing claims. They make the enforcement of claims uneconomical in circumstances where enforcement could take place if the securities were held directly. This reduces the value of the securities concerned. There will always be claims that are so small that cost of enforcement does not justify the return. But custody chains significantly exacerbate the problem. An investor who believes to have a legitimate claim for a significant amount of money may find himself unable to realise the value of the asset as a result of the market infrastructure and in circumstances where he had no control over the length of the custody chain and the terms governing the arrangement.

5. Enforcement and asset values

The enforcement problem has recently been illustrated by a case that came before the UK High Court.⁴² In that case investors had the value of their assets reduced because the custody chain prevented them from claiming against the issuer.

To be sure this did not happen because the investor concluded that enforcement was uneconomical. This happened because, despite arrangements in the issuer's articles, the custody chain prevented the ultimate investor from exercising rights under the Companies Act. The case illustrates a number of points that arise in relation to custody chains.⁴³ At this point in the paper it helps to show that the inability to enforce a shareholder right destroys value.

The case concerned a public limited company incorporated in England (DNick Holding plc). It was managed and operated from Germany. Its shares were only listed for trading in Germany. The directors of the company decided to cancel the German listing and to convert the company from a public limited company to a private limited company. They called an extraordinary shareholder meeting where a resolution was passed approving the re-registration of the company as a private company . This was opposed by three minority

⁴¹ Eva Micheler and Jason Donaldson, 'Negotiability and Custody Chains' (forthcoming).

⁴² *Eckerle v Wickeder Westfalenstahl GmbH* which was decided by the High Court on 23 January 2013 [2013] EWHC 68 (Ch).

⁴³ See [].

shareholders. They tried to rely on Companies Act 2006, s 98. According to this section 'the holders of not less in the aggregated than 5% in nominal value of the company's issued share capital' may apply to court for a cancellation of the resolution. On the hearing the court may make an order cancelling or confirming the resolution. It may also make an order that an arrangement may be made to the satisfaction of the court for the purchase of the interests of dissentient members.

The problem for the three minority shareholders was that shares in listed companies are worth more than shares in private companies. The lack of a ready market in which minority shares can be sold in reduces the number of willing buyers. The value of their shares was reduced as a result of the delisting. Normally this problem would be addressed by take-over rules. It appears that the shareholders in *Eckerle*, however, were not protected by the UK or the German takeover rules. The minority shareholders therefore relied on CA 2006, s 98. They wanted to be bought out. To benefit from that section they had to show that they were 'holders' of at least 5% of the share capital. They held 7.2% of the shares or at least they thought they did.

The problem was that the investors' names were not on the shareholder register. On the register of shareholders were entered Dr Platt holding one share and the Bank of New York Depository (Nominees) Ltd holding 5,671,317 shares. BNY held the shares on trust for Clearstream AG. Clearstream AG kept accounts of Clearstream Interests which related to the beneficial interest they held in the shares owned by BNY. Clearstream account holders are not individuals but banks or other financial institutions. The facts of the case do not reveal how many intermediaries acted between Clearstream and the ultimate investors, but it is clear that there would have been at least one, it is possible that there were more than one.

Justice Norris then found that the claimants were not literally speaking the holders of 7.2% of the shares, they were only holders of 'the ultimate economic interests in underlying securities amounting to a specified percentage of shares held by BNY on trust for Clearstream account holders whose customers the claimants are'. This was not good enough for them to be able to exercise rights under Companies Act 2006, s 98.

Taking advantage of the provisions on indirect investors contained in the Companies Act 2006 DNick Holdings Plc had tried to address the problem. The articles made provisions enabling a member to nominate another person or persons as entitled to enjoy or exercise all or any specified rights of the member in relation to the company (CA 2006, section 145).

Article 79.2 of DNick's articles provided that 'each person who is a CI [Clearstream Interest] holder' could either direct the registered holder of the share how to exercise the vote attaching to the relevant underlying share or to appoint a proxy to do so. It appears that the ultimate investors attempted to persuade the judge that they were able to rely on this provision, arguing that they were holders of Clearstream Interests.⁴⁴

They failed because DNick's articles defined the term 'CI Holder' as the holder of 'an interest in the shares in the capital of the Company traded and settled through Clearstream.' They were identified on 'the electronic register of CI Holders . . . maintained by Clearstream.' The judge found that '[t]he only interests traded and settled through Clearstream are the interests of Clearstream account holders. Only banks and financial institutions which are Clearstream account holders, and between whom those trades are conducted and settled on the exchange, and whose trades are recorded on the electronic register, fit this description.'⁴⁵

Eckerle demonstrates that custody chains obstruct the enforcement of claims. It also demonstrates that this affects the value of securities. The shares lost value because they were removed from the public market. Because of the custody chain the normal remedy to prevent an investor from suffering that loss of value was not available to the investors who held the economic interest in the shares and thus suffered the loss.

Another important point follows from *Eckerle*. The effect of custody chains on investor rights is not fully understood by market participants or it would seem by the regulators. This is illustrated by the fact that DNick Plc's shares were listed with a UK securities number on the German stock exchange. The German listing authorities must have been under the impression that UK shares were listed. This is remarkable because it was impossible for DNick Plc's shares to be listed. These shares were owned by Dr Platt and the nominee company. Clearstream only held a beneficial interest, but was not a shareholder. It can be assumed that the German investors also thought that they held UK shares only to find out that English law would not recognize them as shareholders.

⁴⁴ *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), para 14(h).

⁴⁵ *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), para 14(h).

6. Custody chains and corporate governance

Custody chains obstruct the enforcement of claims and can cause assets to lose value. This affects ultimate investors. In addition to that custody chains also have implications for the governance of issuers. Custody chains can make it impossible for shareholder to vote and deprive issuers of oversight by their investors. Given that more than half of the investors in UK companies are located outside the country, voting arrangements across border matter as much as domestic arrangements.

Empirical evidence was accepted by the Company Law Review Steering Group showing that as a result of the logistics involved in processing voting instructions votes do not reach issuers.⁴⁶ At the time the hope was expressed that 'practical advances in the use of electronic technology would very soon make it feasible, at low cost, for the intermediary who is the registered holder to collect diverse instructions from beneficial owners, reflect them accurately in proxy voting instructions passed to the company registrar, and obtain and pass back to the beneficial owners confirmation that the votes had been recorded'.⁴⁷

Notwithstanding the available technology, passing along voting rights through a chain is not straightforward.⁴⁸ Custodians normally outsource the processing of voting instructions to proxy advisors.⁴⁹ These providers need to process these instructions and normally set deadlines that are 7-10 days before the meeting.⁵⁰ If an investor sells shares after that deadline but before the deadline for sending votes to the issuer, it is possible that the seller's instructions cannot be cancelled in time and that the buyers instructions have nevertheless reached the issuer. In these circumstances the company will receive more votes than shares. The company does not have access to the records of the proxy advisors or the custodian and is therefore unable to determine which votes to accept. If there is doubt as to whether a vote

⁴⁶ Company Law Review Final Report I, para. 6.25. See also Review of the impediments to voting UK shares, Report by Paul Myners to the Shareholder Voting Working Group, July 2007 pp. 1-4 and Report of the Committee of Inquiry into UK Vote Execution, on behalf of the National Association of Pension Funds, July 1999 para 1.7; see also Dirk Zetzsche, 'Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive' (2008) 8(2) JCLS 289 at 327.

⁴⁷ Company Law Review Final Report I, para. 7.3.

⁴⁸ See also Dirk Zetzsche, 'Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive' (2008) 8(2) JCLS 289 at 333 and Kahan and Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 University of Pennsylvania Law Review 1201.

⁴⁹ Manifest, Safe Custody and Shareholder Rights, The Impact of Pooled Accounts, A Manifest Discussion Paper (August 2007) 3.

⁵⁰ Custodians sometimes also block shares in order to be able to process voting instructions (European Commission Directorate General Internal Market and Services, Summary of the Informal Discussion Concerning the Initiative on Shareholders Engagement (March 2013) 6).

was validly cast the company will disregard the votes concerned.⁵¹ Problems are exacerbated by omnibus accounts. The service providers concerned need to determine what proportion has abstained or has voted for or against on every resolution. If the shares are held through more than one custodian this process has to be repeated at every level. If shares are sold during that period voting instructions need to be withdrawn and re-issued. There is a view that in these circumstances accurate reconciliation of holdings is almost impossible.⁵² If an issuer receives more voting instructions for an omnibus account than shares held in the name on the register, there is a risk that all votes cast in relation to that registered name will be disregarded. If the name registered on the shareholder register relates to an omnibus account this can, apparently, lead to the registrar having to disregard the votes for as much as 10% of the shares on the register.⁵³

Shares that are subject to lending arrangements need to be recalled for investors to be able to exercise voting rights.⁵⁴ This discourages investors who have explicitly consented to lending arrangements from exercising voting rights. The most recent survey by the National Association of Pension Funds shows that 96% of the respondents vote on shares, but only 44% recall shares that are subject to lending arrangements.⁵⁵ The fact that the ultimate investor may be unaware of lending also has implications for the exercise of governance rights. It may lead to the issuer disregarding their votes because the securities were not be recalled in time.⁵⁶

The problem that indirect investors may be unable to exercise voting rights was discussed by the Company Law Review Steering Group, which prepared the Companies Act 2006. The Group noted that institutional investors were holding a significant proportion of the equity of listed companies. The understanding at the time was that this could help to overcome the problem of apathetic individual shareholders who hold very small shares each and therefore

⁵¹ Manifest, Safe Custody and Shareholder Rights, The Impact of Pooled Accounts, A Manifest Discussion Paper (August 2007) 3.

⁵² Manifest, Safe Custody and Shareholder Rights, The Impact of Pooled Accounts, A Manifest Discussion Paper (August 2007) 4; Michiel van Esch (Robeco), 'Audit shows flaws in the proxy-voting process' 29 October 2012 available from <http://www.robeco.com/en/professionals/insights/sustainability-investing/insights/2012/audit-shows-flaws-in-the-proxy.jsp>.

⁵³ Manifest, Safe Custody and Shareholder Rights, The Impact of Pooled Accounts, A Manifest Discussion Paper (August 2007) 4; see also Michiel van Esch (Robeco), 'Audit shows flaws in the proxy-voting process' 29 October 2012 available from <http://www.robeco.com/en/professionals/insights/sustainability-investing/insights/2012/audit-shows-flaws-in-the-proxy.jsp>.

⁵⁴ [Euroclear Operating Procedures].

⁵⁵ NAPF Engagement Survey 2013: Pension Funds' Engagement with Companies (November 2013) 28 and 30.

⁵⁶ [reference]

do not have an incentive to exercise governance rights. Institutional investors do not hold significant stakes either, but the hope was that the 'semi-concentration of shareholdings amongst institutions does create the possibility of a small coalition of institutional shareholders being able to exercise significant influence at the company level'.⁵⁷ The CLR also observed that this possibility does not automatically translate into reality and that investor engagement was suboptimal. The CLR found that institutional investor many not have sufficient incentives to exercise governance rights and made suggestions how this could be overcome.⁵⁸

In addition to problems with incentives, the CLR also found that the 'virtually universal practice in the United Kingdom of requiring shares to be registered ... does not resolve the problem of identifying the person with the true interest in the shares'.⁵⁹ This is because 'there is no need to register the share in the name of the person who has the financial interest in it'.⁶⁰ The CLR observed that 'the growth of such specialist institutions as custodians, depositories and broker nominees, each of which play a key role in the efficient holding, transfer and recording of shares, but whose involvement as intermediaries has led to a growing separation between the legal ownership of the shares (the "name on the register") and the "real" or beneficial owner'.⁶¹ Paul Davies and Jonathan Rickford pointed out that in addition to institutional investors acting for individuals custodians are 'yet another party' operating in this area.⁶² Custodians have their name on the register but do not benefit from the financial interest and therefore have no incentive to exercise voting rights.

⁵⁷ Paul Davies and Jonathan Rickford, *An Introduction to the New UK Companies Act: Part II* (2008) 5(3) *European Company and Financial Law Review* 239-279 at 240-241.

⁵⁸ Paul Davies and Jonathan Rickford, *An Introduction to the New UK Companies Act: Part II* (2008) 5(3) *European Company and Financial Law Review* 239-279 at 242. The CLR suggested rules that are now contained in CA 2006, s 1277-1280 and that enable the Secretary of State to require institutional investors to make disclosure in relation to how they exercise voting rights. This power has not yet been exercised. Instead the UK Stewardship Code, which operates on a comply or explain basis, attempts to encourage institutional investors to engage more actively with companies.

⁵⁹ Paul Davies and Jonathan Rickford, *An Introduction to the New UK Companies Act: Part II* (2008) 5(3) *European Company and Financial Law Review* 239-279 at 243

⁶⁰ Paul Davies and Jonathan Rickford, *An Introduction to the New UK Companies Act: Part II* (2008) 5(3) *European Company and Financial Law Review* 239-279 at 243.

⁶¹ CLR, Final Report 7.1.

⁶² Paul Davies and Jonathan Rickford, *An Introduction to the New UK Companies Act: Part II* (2008) 5(3) *European Company and Financial Law Review* 239-279 at 243.

To make it easier for those 'who have the central financial interest in the shares' to vote, the CLR recommended modifications to the Companies Act.⁶³ The original proposal, which contained the possibility for the Secretary of State to require a transfer of governance rights to indirect investors, was rejected by Parliament.⁶⁴ The rules that were adopted after further consultation allow companies to make arrangements in their articles 'enabling a member to nominate another person as entitled to enjoy or exercise ... rights of the member in relation to the company'.⁶⁵

Compared to the situation before the Companies Act 2006 where companies were prohibited from entering any trust on the share register, the reform has made a significant difference.⁶⁶ The disadvantage of this approach that was adopted, however, is that it puts the onus on the issuer. This has cost implications.⁶⁷

It also suffers from the further problem that it is impossible to identify in advance who the ultimate holder of securities will be. Issuers have no control over the length of the chain. The length of the chain is also subject to change as shares are bought and sold and pass through the portfolios of different investors who will all be associated with their own holding structures. Moreover, the number and identity of the intermediaries concerned is also subject to change. Custodians are able to move securities between sub-custodians and sub-custodians can delegate the holding of securities to other sub-custodians.

Neither investors or issuers have control over the number of intermediaries that operate between them. Through the process of delegation by contract custody chains are shaped by custodians and their respective bilateral business interests. Custody chains form independently of the interests of both investors or issuers. They make it difficult for issuers to identify the holders of the economic interest in their securities. They make it difficult for the holder of the economic interest to exercise control rights and thereby deprive the issuer of the level of governance that is foreseen in the articles of association or the legislation. It

⁶³ Paul Davies and Jonathan Rickford, *An Introduction to the New UK Companies Act: Part II* (2008) 5(3) *European Company and Financial Law Review* 239-279 at 242-243.

⁶⁴ Paul Davies and Jonathan Rickford, *An Introduction to the New UK Companies Act: Part II* (2008) 5(3) *European Company and Financial Law Review* 239-279 at 243-244

⁶⁵ CA 2006, s 145.

⁶⁶ CA 1985, s 360.

⁶⁷ RC Nolan, 'Indirect Investors: A Greater Say in the Company?' [2003] *JCLS* 73 at 86-87 points out that the cost for enfranchising indirect investors should not be put on the issuer. He writes that this is not justified in circumstances where the investor chooses the intermediary. It has been shown in this paper that like the issuer the ultimate investor does not have control over the length of the custody chain and also does not control arrangements at the levels of the sub-custodian.

seems like the market infrastructure that should serve ultimate investors and issuers has taken on a life of its own that compromises the interests of those whom it should serve.

7. Limitations of the law

Custody chains have separated investors from their assets. It will be shown below that this is very difficult for the law to overcome.

a. Contract law

Contract law is part of the problem. Rather than connecting investors with issuers the bilateral contracts that are entered into by custodians dilute the interest of the investor concerned and reduce the value of the assets.

It is possible to adopt legislation limiting the ability of custodians to use certain terms in their contracts.⁶⁸ The problem with that is that custodians will always stay ahead of the legislator and find ways of contracting around the limitations imposed by the legislation. Moreover, legislation is limited by jurisdictional boundaries and custodians are able to move beyond these boundaries.

b. Requiring issuers to recognise ultimate investors

Legislation could be adopted that requires issuers to recognise ultimate investors. This approach suffers from the problem that it is very difficult to identify in advance who the ultimate holder of securities will be. Issuers have no control over the length of the chain. The length of the chain is also subject to change as shares are bought and sold and pass through the portfolios of different investors who will all be associated with their own holding structures. Moreover, the number and identity of the intermediaries concerned is also subject to change. Custodians are able to move securities between sub-custodians and sub-custodians can delegate the holding of securities to other sub-custodians.

⁶⁸ Dirk Zetzsche, 'Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive' (2008) 8(2) JCLS 334 proposes to impose a duty on custodians to assist investor to vote and prohibit custodians from charging fees for this. This does not resolve the issue that voting instructions need to be processed at all levels. He also suggests that custodians should not charge fees for processing voting instructions so that the cost is borne by all investors (also those who are not voting). He suggests that custodians should be encouraged to negotiate common technical standards and that the 'principle of proportionality' should be extended to custodians, but does not further explain what the principle of proportionality would imply in the circumstances. Note also that a duty to exercise voting instructions already exists in English law: *Kirby v Wilinks* [1929] 2 Ch 444.

Issuers have to be able to identify shareholders without becoming involved in disputes about who the ultimate holder of the assets is. As has been pointed out by Professor Nolan, markets need 'simple, clear indicia of title which match the legal reality'.⁶⁹

It is very difficult to draft articles in a way that accurately identifies the holder of the ultimate financial interest.⁷⁰ *Eckerle* was a case where one would assume that this was doable. The company was incorporated in the UK and listed only on the German exchange. This creates some degree of stability. The fact the Clearstream's name appeared in its articles means that the company had made arrangements with Clearstream and anticipated that Clearstream would remain a custodian associated with the issuer for some time. It would seem that in those circumstances the ultimate investor could be identified ex ante with some degree of certainty. But, nevertheless, the wording chosen in the articles did not achieve the intended outcome.⁷¹

Moreover, the issuer was targeting the German stock market and would have had legal advice from the perspective of that market. A German lawyer looking at the articles of DNick Holdings would be forgiven for not spotting the problem. The German model, which in this respect would seem to also apply to foreign securities (albeit on the basis of the German notion of *Treuhand*), assumes that the ultimate investor has an interest in the underlying instrument.

While it is difficult to argue against this conclusion from the perspective of English law, it still illustrates the phenomenon. Shares are held through custody chains stretching cross borders. Ultimate investors believe these chains to be mere technicalities and consider themselves to be shareholders. In fact they are holders of an economic interest in an economic interest in a share and that is in the most simply of cases where there are only two intermediaries.

c. Ring fencing/property law

Ring fencing assets at the level of the custodians insulates the investor against the insolvency of the custodian concerned but does not connect him to the issuer. Moreover a ring-fenced right to certain assets does not protect an investor in circumstances where no securities can be

⁶⁹ RC Nolan, 'Indirect Investors: A Greater Say in the Company?' [2003] JCLS 73 at 81.

⁷⁰ See also RC Nolan, 'Indirect Investors: A Greater Say in the Company?' [2003] JCLS 73 at 92.

⁷¹ For further analysis on this point see Micheler, 'Intermediated Securities and Legal Certainty' LSE Legal Studies Working Paper No. 3/2014 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2336889 page 4-7.

found with a particular custodian. Where there are no securities none can be ceased. In such circumstances a personal claim against a custodian may exist. But that does not help the ultimate investor if his contract is with another custodian who was not responsible for losing the securities. As mentioned above, the immediate custodian is only liable for its own negligence and is likely to have discretion as to whether it starts proceedings recovering the lost securities.

It is worth noting that it is unlikely that custodians have a contractual obligation to act on behalf of clients to recover lost or stolen securities and may conclude that they do not have the time budget or money resources to instigate such proceedings. Under Euroclear's terms, for example, the customers invested in a particular issue share the loss of securities if they are mutilated, lost, stolen or destroyed.⁷² Euroclear can 'elect' whether to obtain reissuance of such securities.⁷³ If instructed by a participant of the system they obtain reissuance at the expense of the participant but only 'to the extent practicable'.⁷⁴ CBL term's state that in the event of 'mutilation, loss, theft, destruction or other unavailability of deposited securities' CBL 'may' apply for the issued of stop orders or initiate such other measures as CBL may deem appropriate under the circumstances and 'may' endeavour to replace such securities in accordance with the laws or practices of the relevant countries and terms and conditions of the relevant securities.⁷⁵

Regulation and the requirement for a separate account: Client separation rules have limitations in terms of determining the terms upon which assets are held at levels further down the chain.

d. Harmonisation of laws

I have explained elsewhere that the harmonisation of legal rules is unlikely to address the problems caused by custody chains.⁷⁶

⁷² Terms and Conditions governing the use of Euroclear (July 2013) article 17(a).

⁷³ Terms and Conditions governing the use of Euroclear (July 2013) article 17(e).

⁷⁴ Terms and Conditions governing the use of Euroclear (July 2013) article 17(e).

⁷⁵ 16.

⁷⁶ Micheler, 'Intermediated Securities and Legal Certainty' LSE Legal Studies Working Paper No. 3/2014 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2336889.

8. Structural reform

The starting point towards a solution reducing the cost and uncertainties arising out of intermediation has to be that the number of intermediaries needs to be reduced and also that a direct connection between issuers and intermediaries has to be created. It is worth asking if it is possible to create a system which reduces the number of intermediaries operating between issuers and investors and also enables investors to directly connect with issuers. It seems that a point has been reached where it would be appropriate for a policy intervention facilitating the emergence of a central, direct and transparent settlement and holding system.

Until recently it would not have been possible to create such a system not even at a national level. For example, when intermediation started in Germany during the nineteen thirties, the means of communication was at a stage of development that required intermediation. It was not possible to create a central system which could be accessed by all German investors. Investors accessed their holdings through local banks which held deposits with regional banks which held deposits with the central depository. While it was not possible to create such a system when Germany created its central intermediary, there is no reason to conclude that the need for intermediaries continues to exist today.

The same is true for the UK where, before CREST was put in place, it made sense to have shareholder registers administered in geographical proximity to issuers. UK issuers communicate with shareholders using the contact information contained in the register. Issuer need up to date information and prior to electronic means of communication that can best be achieved by placing the administration of the shareholder register in proximity to the issuer. Registrars developed as a branch of the financial services industry against the background of this requirement. This has changed. It is now possible to administer these holdings centrally. Uncertificated UK securities and their transfers are managed centrally through CREST, an electronic system.

At a European level the existing network of intermediaries was set up using methods that were created before electronic communication became possible. They have continued to operate notwithstanding the fact that it would now be possible to create a central European facility. This makes holding securities cross border expensive and legally unstable. The problems caused by inserting a significant number of intermediaries between issuers and investors does not matter much when cross border holdings are infrequent. The issue becomes a matter for discussion and possible reform, however, for the European Union

which has set itself the policy objective to provide a framework which will facilitate a single European market.

It is worth keeping in mind that lobbying by existing market participants can have significant impact. Two recent examples illustrate this.

When the UK tried to develop an electronic settlement system after the paper crunch in 1987. The London Stock Exchange and its members tried to develop a system that would suit all of their respective needs and interests and failed. It proved impossible to achieve agreement. Part of the problem were the vested interests of existing market participants. The London Stock Exchange and its participants spent 7 years and some £400 trying to set up an electronic settlement system keeping all participants happy and taking away business from no one and failed. The developers of the new mechanism tried to achieve the impossible: create a new system while leaving the role of existing participants intact. In 1993 the Bank of England took over the reform process and put in place the current settlement system, CREST, which started to operate on 15 July 1996.

Another example of how intense pressure from existing market participants can be is the UNIDROIT Convention on Substantive Rules for Intermediated Securities (Geneva, 2009). The material available from the UNIDROIT website demonstrates that the working group planned to identify and remedy legal uncertainty and after substantial pressure from the industry delivered an instrument that is not explained by reference to issues of legal certainty and has no impact on existing market participants.⁷⁷

9. Conclusions

The thesis of this paper is that custody chains leave investors vulnerable when services are provided for by custodians negligently. They undermine the contractual arrangement between investors and their immediate service provider. They make the enforcement of securities against issuers very costly and complex and can thus reduce the value of the securities concerned. This can have systemic implications. Legal rules cannot ultimately address the problems associated with custody chains. Structural reform is required. A central, direct and transparent holding mechanism should be created. The paper observes that

⁷⁷ Micheler, 'Intermediated Securities and Legal Certainty' LSE Legal Studies Working Paper No. 3/2014 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2336889.

existing market participants have opposed previous attempts to put in place reform and predicts that they will continue to do so.



THE LONDON SCHOOL
OF ECONOMICS AND
POLITICAL SCIENCE ■



Systemic Risk Centre

The London School of Economics
and Political Science
Houghton Street
London WC2A 2AE
United Kingdom

Tel: +44 (0)20 7405 7686
systemicrisk.ac.uk
src@lse.ac.uk