Response to Digitisation Taskforce Interim Report (July 2023)

25 September 2023

Introduction

The views set out in this response have been prepared by a Joint Working Party of the Company Law Committee and the Financial Law Committee of the City of London Law Society (CLLS) and the Company Law Committee of The Law Society of England and Wales (the Law Society).

The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

The Law Society is the professional body for solicitors in England and Wales, representing over 170,000 registered legal practitioners. It represents the profession to Parliament, Government and regulatory bodies in both the domestic and European arena and has a public interest in the reform of the law.

The Joint Working Party is made up of senior and specialist corporate and finance lawyers from both the CLLS and the Law Society who have a particular focus on issues relating to company law, corporate governance, equity capital markets, debt capital markets and financial transactions, and include members with particular expertise in relation to the holding and transfer of interests in equity and debt securities.

We are pleased to have the opportunity to respond to the Digitisation Taskforce Interim Report. In this response we set out (1) a high level summary of key points, (2) some general comments, (3) responses to the specific recommendations and questions (in the order that these appear in the Report) and (4) comments on the section of the report on legislative changes required. The Annex to this response contains a discussion of issues relating to the taking of security over shares.

We are strongly supportive of the proposal to move to system that removes paper-based processes in relation to the issue or transfer of shares in traded companies and where we have identified legal or other issues that would need to be considered before implementing the Digitisation Taskforce's recommendations, we would welcome the opportunity to work with the Taskforce and other stakeholders to identify legislative or practical solutions. We anticipate that any relevant legal issues are likely to be capable of being solved (principally through legislative changes) and that that the systems and technological changes needed to make any revised processes work effectively may pose a greater challenge in practice.

1 Key points

- We support the principle of change and moving to a system that removes paper-based processes in relation to the issue or transfer of shares in traded companies. For these purposes, we see Model 1 and Model 3 (as described in the Interim Report) as the most feasible models in the short to medium term.
- We support the reduction or removal of paper/hard copy requirements in respect of company communications and the execution of corporate actions (including voting at meetings, dividend payments, new share issues, takeovers and redemptions).
- We believe that an impact assessment and cost-benefit analysis accompanied by more detailed analyses of how each model would work in practice taking account of a range of potential scenarios should be carried out before deciding which model to proceed with. While improvements to the system of intermediated holdings may reduce the incentive for

retail shareholders to wish to hold their shares directly, any additional costs that might have to be borne by individual investors would have to be considered alongside the potential cost-savings to the market as a whole, including issuers and other market participants, such as those looking to take security interests over dematerialised securities.

- The analysis of the different models also needs to take into account relative impacts on the competitive position of the UK's financial markets and economy, including the attractiveness of the UK as a listing venue for UK and international companies (including for companies with multiple listings). In order to remain competitive, and particularly to attract companies to list and remain listed in the UK, the UK needs a system for holding shares in traded companies which does not act as a deterrent when compared to those used in comparable jurisdictions.
- Whichever model is selected, the legislative, regulatory and practical implications should be agreed and confirmed and a "roadmap" for implementation should be laid out, so that market participants can have clarity and certainty before they invest in developing new systems and educating investors about the choices.
- Regardless of which digitisation model is adopted, we believe that where shares are held through nominees, common protocols to enable rapid communications up and down the intermediaries chain are needed. These should be facilitated, if necessary, by legislation or regulation setting minimum standards. Straight-through communications in machine readable format should be adopted for corporate actions in line with international standards. Such communications standards are desirable from the point of view of the UK markets' international competitiveness and should also assist in ensuring that small shareholders can hold through nominees at a minimal cost, without being effectively disenfranchised in relation to voting, new share issues, takeovers and redemptions (as is often the case at the moment).
- The feasibility of Model 1 would depend on the development of secure verification and authentication protocols to enable transfers to be made efficiently through electronic processes, to replace current requirements for production of certificates.
- Model 1 would, despite the removal of certificates, mean the continuation of two-part registers. This would almost inevitably result in operational inefficiencies and increased costs, as security, information and other protocols on the non-CREST registers may not be fully aligned with the standards operated by CREST. The potential inefficiencies will potentially be multiplied across the market to the extent that a number of different registrars will operate non-CREST registers using different systems and communication protocols.
- Competitive market forces may operate to ensure that the current services provided by nominees are improved and enhanced, but we are not convinced that this could be relied on to provide a base level of service at a reasonable cost for retail shareholders who are forced to hold through nominees if Model 3 were adopted. Regulation may therefore be needed to compel nominees to provide a base level of service. We believe that smaller retail shareholders should be protected from having to bear the costs of a nominee arrangement which might be disproportionate to the size of their holdings.
- We can foresee a number of practical obstacles to effecting a transition to Model 3, especially including the need to persuade or compel shareholders to transition and deal with KYC and AML requirements. While some of these could be addressed through legislation to mandatorily transfer certificated holdings to a nominee, the question of the identity of such a nominee, and who should bear their costs, would need to be resolved. It would likely

therefore be necessary also to implement compulsory transfer mechanics - either through legislation or on an issuer-by-issuer basis through changes to the company's articles of association - in order to deal with certificated holdings for which a nominee cannot be found. There are also potential issues regarding the ability of Model 3 to deal with the companies that have multiple listings across different jurisdictions and trading venues.

- It needs to be recognised that many chains of intermediaries include non-UK intermediaries whom it will not be possible to regulate in the same way as UK intermediaries. Any barriers to overseas holders holding through nominees or directly in CREST, rather than in certificated form, need to be considered, including the implications of this model for companies with overseas branch registers or overseas listings where shares may need to be held in a depositary in the place of listing. It would be very undesirable to limit the potential for UK companies to maintain dual listings.

2 General comments

2.1 Scope of proposals

The Interim Report appears to be primarily focused on traded companies but suggests that its proposals for removal of share certificates should be extended to private companies. For traded companies, we agree with the assessment in the Interim Report that the case for retaining share certificates has been weakened, and the case for digitising shareholdings has been strengthened, by various developments in legislation, technology, investor sentiment and market practice over the last few years; and that the system of holding shares in UK traded companies needs updating and improving.

However, while we are generally supportive of change in respect of traded companies (subject to the comments made in this response), we do not believe that the abolition of certificates should be mandated for all companies. Any change in relation to private companies should only be embarked on following, and subject to, an appropriate cost-benefit analysis. In particular, any change is likely to impose unnecessary costs and burdens on private companies, many of which have been in existence with an unchanged shareholder base for many years; having to change systems and processes would likely have no economic benefit for them. Mandatory use of nominees, in particular, would be disproportionate especially for the many private companies whose shareholders are directors or are known to the directors. Use of certificates could, however, be optional for companies which are not publicly traded on the basis that, in the context of more closely held companies, it may be possible for other means of verification of shareholders to be used.

For these reasons, we suggest that the Digitisation Taskforce proceeds on the basis that the reforms will apply only to traded companies, at least in the initial implementation stages, and that adoption by private and/or untraded companies should be optional for those companies. The definition of "traded companies" for these purposes is open to discussion, but we suggest it should at least capture UK companies whose shares are traded on a UK regulated market or MTF (ie including listed and AIM-quoted equity issuers).

2.2 Design of the new shareholding model

While we support the case for digitising shareholdings of traded companies, this should be undertaken on a basis which ensures that the ability of investors (including, in particular, retail investors) to receive information and exercise voting and other rights in a simple, timely and cost-efficient manner is not impaired, but improved. Given the goal of increasing retail participation in UK

capital markets, the objective should be to establish a system that is better for retail investors than the current system of certificated holdings, and not just to benefit issuers and/or intermediaries.

Account also needs to be taken of other constituencies who hold their shares in UK traded companies outside CREST. These include overseas shareholders such as Cede & Co, the nominee for DTC (to enable the listing and trading of shares of UK (and non-UK) companies on a US stock exchange). Consideration also needs to be given to other holding structures of companies with overseas listings, including those with overseas branch registers. Unless these issues are considered as part of the proposed new system, there is a risk that the preferred Model will not enhance the competitiveness of the UK as a listing venue and might become a deterrent.

We believe that both Model 1 and Model 3 are more achievable, at least in the medium term, than alternatives such as replacing certificates/registration with a digital asset, digital "key", or using Distributed Ledger Technology (Model 4) or similar. We also understand that Model 2 (retail shareholders holding directly via CREST) is not practicable at present.

Model 1 – digitising the non-CREST register

Model 1 – in which shareholders could continue to choose to hold shares directly, in digital form, outside CREST – would involve having (i) a register of non-CREST (digital) holdings and (ii) a register of CREST holdings – i.e. as the Interim Report says, it would be "a digital version of the current system". This model is in many respects unique and may be considered at odds with the general move across many markets to dematerialisation through immobilisation/single register models which are more similar to Model 3 and this could be a negative factor in international perceptions of the UK markets.

Model 1 would, despite the removal of certificates, mean the continuation of two-part registers. This would almost inevitably result in operational inefficiencies and increased costs, as security, information and other protocols on the non-CREST registers may not be fully aligned with the standards operated by CREST. Fragmentation, and resulting potential inefficiencies, will be multiplied across the market to the extent that a number of different registrars will be operating non-CREST registers using different systems and communication protocols.

The feasibility of Model 1 would crucially depend on the development of secure verification and authentication protocols to enable transfers to be made efficiently through electronic processes, to replace current requirements for production of certificates. Appropriate measures would need to be adopted to enable secure verification of non-CREST holdings, and of the entitlement of the person seeking to transfer shares and/or exercise rights to do so, and to specify the manner of execution of electronic transfers, in order to protect the integrity and finality of such transfers. These digital processes would need to be accessible to retail shareholders including many who may be relatively unsophisticated and/or less technologically enabled than the retail investors who already hold through nominees.

Alongside the need to develop new technology and legislation to enable Model 1, there would still be the need for measures to improve the system of intermediated holdings, in particular as regards common communication standards, in order to ensure the UK's financial markets are efficient and competitive. The need to communicate directly with numerous retail shareholders holding small numbers of shares directly might add costs or barriers to the utilisation of straight-through processing and machine readable communications consistent with international standards (eg ISO20022) in relation to voting and other corporate actions such as distributions, takeovers, demergers, capital issues and redemptions.

Model 3 – mandatory use of nominees

Model 3 – in which retail shareholders would own a beneficial interest in shares, and the legal title would be held by a nominee who would hold and transfer them via CREST; and there would no longer be a separate certificated register / register of digital holdings outside CREST – has the advantage that it is not dependent on the creation of new technology or different formalities for transfers of, or title, to shares. It is also widely used already both by institutional investors in the UK market and by many retail investors who use broker nominees or hold shares in ISAs.

As compared with the UK's existing system and proposed Model 1, Model 3 is more similar to the systems found in many other major capital markets. Model 3 therefore may be regarded as more likely to help the UK markets to remain competitive, and to attract companies to list and remain listed in the UK. In this respect, it will be important to take into account changes and improvements to EU systems that may follow from the implementation of the EU Central Securities Depositories Regulation and amendments to the Shareholder Rights Directive that have recently been proposed by ESMA. In particular, these include proposals to improve mechanisms for communications by issuers and along the chain of intermediaries to enable interoperability and straight-through processing based on standardised and machine-readable formats.

Model 3 gives rise to a number of concerns in relation to its potential impact on retail shareholders who currently hold their shares in certificated form. We anticipate that the additional formalities (including KYC and AML requirements) involved in holding through a nominee would be regarded as an imposition by many such shareholders and this model could be difficult to implement as a result. Non-fulfilment of firms' KYC and AML requirements may prevent some bodies or individuals from being taken on as clients by potential nominees, and this would risk "dispossessing" those persons. It could also require a major publicity campaign to persuade shareholders to transfer their shares and there could a significant number of "dissenters" who refuse to do so on a voluntary basis, as well as many who fail to do so through inertia or inadvertent error or oversight. This means that it would likely be necessary to implement compulsory transfer mechanics either through legislation or on an issuer-by-issuer basis through changes to the company's articles association. The latter would allow issuers and their shareholders to choose whether to move away from certificated holdings but would mean that market-wide adoption of the new model may be slower and potentially incomplete. A compulsory transfer mechanism would not, of itself, overcome the need for KYC and AML procedures to be carried out by nominees, and practical problems and difficulties could still arise for some individuals as a result of transferring their holding into a nominee.

We believe that there are risks in relying entirely on market forces and competition to provide an appropriate level of service to shareholders, given that the universe of shareholders affected will comprise a significant number of relatively unsophisticated retail shareholders. We doubt that any proposal under which small shareholders who currently hold in certificated form would have to pay for the services provided by a nominee will be regarded as an improvement by those shareholders. These will include many older and potentially more vulnerable investors, as well as many who are likely to be relatively inactive in terms of seeking out and comparing alternative offerings, or switching from one provider to another. We believe that minimum regulatory standards should apply to ensure that investors will as a default receive a base level of service for no, or only a minimal cost, noting that there is no direct cost to investors in holding their shares in certificated form in their own names (other than potential costs associated with missing share certificates), with the ability to exercise their rights without having to deal with an intermediary.

We anticipate that a model that involved charges being mandatorily imposed on shareholders who wished to maintain their ability to exercise their rights and/or that involved the loss of the practical ability to exercise rights could be open to challenge as an infringement of property rights. To

counteract this the overall benefits of the system would need to be demonstrably greater than any loss of rights.

One possible solution to these issues would be that, as a default, a central nominee, or issuer-sponsored nominees, should provide a basic level of service at no charge. Many current certificated shareholders do not in practice exercise voting or other rights and should not be forced to pay for a service that they do not need. Consideration should be given to how KYC and AML requirements would be met for those who default into such an arrangement. On balance, we believe a central nominee (possibly supported with funding from issuers) would be the better solution because individual corporate-sponsored nominees (i) would effectively perpetuate the current situation where issuers have to pay a registrar to maintain records of the owners, and process large numbers of documents and dividends etc; (ii) companies would not be able to use forfeiture provisions in their articles to eliminate gone-away investors because the registered holder has not gone away (this would be an issue that in future it would fall to the nominees to deal with); and (iii) will not promote competition between nominees and hence drive improvements in the services available to investors. If a two-stage process is adopted, as the Interim Report suggests, issuers are likely to want safeguards to be built in – e.g. to ensure that, if an investor has not voluntarily transferred their shares to a nominee of their choosing by a specified deadline, the issuer will be able to compel the corporate-sponsored nominee either to transfer the remaining shares to a "default" nominee (if one exists) or to sell the shares and pay the proceeds into Court or a Government-sponsored fund without the nominee or the issuer remaining unduly liable to the gone-away owner of the shares. Because nominees / custodians are subject to the CASS and other rules, this would probably need FCA co-operation.

For shareholders who have holdings in more than one company there are likely to be greater benefits that could be offered by nominees who might be able to provide enhanced services in relation to a "portfolio" of holdings and efficiencies from the shareholder's perspective in dealing with a single intermediary. Competition should be encouraged to develop enhanced offerings by nominees, subject to basic minimum levels of service being available.

Consideration should be given to reflecting expressly in relevant legislation that any costs associated with providing investors with nominee/intermediary services which are borne by an issuer would not constitute unlawful financial assistance in relation to the acquisition of shares in the issuer. Consistent with the position in relation to a number of analogous costs and arrangements, we would not regard such arrangements as normally falling within the prohibition, however there would be a helpful opportunity to address this expressly in any relevant legislative changes.

2.3 Transition and sequencing issues

Dealing effectively with transition issues will be essential to the success of whichever model is chosen. We believe that both Models 1 and 3 would require a coordinated programme of communication and education so that shareholders understand the implications of the changes. This would be essential for Model 3 so that shareholders understand their rights and options when selecting a nominee. Common communications and model wording for issuers and nominees to use should be developed, both to reduce the costs of drafting the necessary communications and to increase transparency and avoid the risk of confusion for investors resulting from different messaging.

As noted above, we see particular challenges being caused by AML and KYC requirements in respect of transitioning existing certificated shareholders to nominees under Model 3.

If Model 3 were adopted, we believe appropriate mechanisms for dealing with shareholder voting and other corporate actions in a rapid, frictionless, and secure way would need to be in place

(supported by legislative changes where necessary – for example, to support electronic communications across the full range of corporate actions) before compelling investors to give up their direct holdings and instead hold through nominees.

In particular, Model 3 raises significant questions about how to ensure that smaller investors holding through nominees retain the ability to interact with issuers by voting and participating in meetings, as well as in the context of other corporate actions such as rights issues, tender offers, takeovers, dividend reinvestment schemes, scrip dividend elections and redemptions. Appropriate common standards may need to be laid down to set out how nominees should deal with corporate actions. These may need to be enforced by regulation which would need to be in place ahead of the transition to the new model.

To achieve the transition to the new system, while it would be possible (as it currently is) for certificated shareholders at any time to transfer their shares to a nominee, to achieve a complete transition to the new model, we envisage that a default mechanism will need to apply to certificated shareholders who do not elect to transfer to another nominee of their own choice. As mentioned above, we believe this may represent a significant category of passive holders, as well as those who have “gone away” and may prove to be untraceable.

It is clear that many retail investors do not in practice exercise the voting rights attached to their shares – for example, where shares are held through an ISA. However, consistent with the goal of encouraging enhanced retail shareholder engagement, nominees should as a minimum be required to provide investors, at a reasonable cost, with the ability easily and efficiently to vote their shares (even if there will still be many retail shareholders who do not take advantage of this ability).

To achieve the full benefits of digitisation, particularly in the context of capital raisings, protocols would need to be put in place to ensure that there are clear standards applicable to corporate actions, so that investors who wish to be notified of, say, a rights issue can be informed in good time so as to be able to make their investment decision and transmit payment digitally.

2.4 Ultimate beneficial owners

The Interim Report uses this term without defining it. Decision-making rights, voting control and economic interests may belong to different persons, so that in many cases there is no single clear UBO. In some cases, the person who is the ultimate beneficial owner of shares may not be the person who has the right to make decisions or give instructions to the nominee in whose name they are registered and/or the issuer of the shares. For example, shares may be held on trust for a beneficiary on terms that it is the trustees who have powers of sale, the right to designate the destination of dividends and so on.

We believe that the current principle (the “no look through” principle) that companies do not need to look beyond the name on the register of members (and in the case of holdings registered in joint names can take instructions from the first-named) is an important and useful principle. It provides certainty to issuers so that they do not need to be concerned as to the apportionment of economic interests or who (other than the registered member) has the right to direct the exercise of voting rights, for example. Where an exception to this principle is made, issuers still need to have certainty that any person purporting to exercise rights is entitled to do so.

If Model 3 is adopted, it would be desirable establish a clear legal framework to facilitate the exercise of voting and other rights by enabling issuers to take instructions directly from a person nominated by the registered shareholder. Section 145 of the Companies Act 2006 (“CA 2006”) was designed to facilitate companies’ dealings with indirect investors and contemplates that articles of association may allow a person other than the registered holder to be nominated to exercise rights attached to

shares, with the company then being able to treat the nominated person as if they were a member of the company. Traded companies have not, as far as we are aware made use of such provisions, in part because there is insufficient detail in the legislation about how such arrangements would work in practice. In addition, section 146 CA 2006 makes provision in relation to companies traded on a regulated market for the nomination of a person other than the registered holder to have "information rights". These provisions have also not been widely taken up and are limited to the right to receive information from the company.

Where there is a chain of intermediaries we believe that it would be necessary to have regulatory or contractual provisions to ensure that, as between the various persons with an interest in the shares, the most appropriate person is able to be the "nominated person" with the ability to instruct and deal with the issuer. (The person who is to exercise rights or receive information will not necessarily be the same as the beneficial owner(s) in terms of economic interests.) As an alternative to relying on information flows up and down the chain of intermediaries, consideration could be given to reviewing and extending sections 145 and 146 CA 2006 (and related provisions) in order to create a clear framework for registered shareholders to instruct issuers as to who is entitled to exercise rights in relation to their shares.

If a nominee was required to identify as a "UBO" anyone other than the person with whom they had direct dealings, it would need to be made clear what steps they should take to determine the UBO's identity(s). The nominee should preferably be able to rely on the person for whom it acts to provide details of anyone else who is to receive information and give instructions, or receive dividends. If the process is made onerous and requires due diligence by nominees, it is likely to increase costs and/or reduce the pool of available nominees. Although institutions do have a significant amount of information because of AML and KYC requirements, it is not clear that UBO information is always available throughout the intermediary chain.

The need to communicate with decision-makers should be distinguished from the issuer's ability to make inquiries as to who is "interested" in its shares in the broadest sense (including persons who may have entered into agreements regarding voting over shares) under section 793 CA 2006. We agree that the section 793 process and legislation might be reviewed with a view to improvements such as facilitating the passing of inquiries up a chain of intermediaries, and delivery of timely responses to the issuer, without the issuer having to make multiple, iterative inquiries, resulting in an inefficient, time-consuming and costly process.

2.5 Taking security over shares

Shares over UK companies are commonly charged as part of financing transactions, where a security trustee or security agent (the "**security trustee**") (which is often a third party to the financing) will be granted security over such shares. Where such shares are not dematerialised, the security trustee will often be given the paper share certificate together with a signed but incomplete stock transfer form, allowing the security trustee to complete the stock transfer form in an enforcement scenario, to transfer ownership of such shares to either itself or another person. Changing current practice could cause disruption particularly for existing charges. Clarity is needed as to how security can be granted to security trustees if share certificates are removed or digitised and how such security can be enforced.

We consider that Model 1 is more likely to create issues in respect of taking security over shares than Model 3. See the Annex to this response for further details.

2.6 Impact on the headcount test for certain resolutions

The headcount test in section 899 CA 2006 requires a majority in number of members voting and a 75% majority of votes cast to pass a resolution to approve a scheme of arrangement under Part 26 CA 2006. This test can have unintended consequences in circumstances where large numbers of investors hold through nominees (so that one member on the register represents a much larger number of persons who are in reality the "heads" who should be counted for the test to work as originally intended).

We consider that the test no longer serves a useful purpose in its current form and note that it has raised issues on a number of schemes of arrangement. For example, the case of Re Dee Valley Group plc [2017] EWHC 184 (Ch) illustrated an attempt to manipulate the test by splitting a shareholding in an attempt to defeat a scheme. In that case, the court used its discretion to allow split shareholdings to be discounted and sanctioned the scheme. A number of mechanisms have also been deployed in order to avoid a "stalemate" on the majority in number test where the shares are held by a single member or a very small number of members, for example where all or the vast majority of the shares are held by an ADR depositary or by Clearstream where the company is listed outside London and its shares are traded in the form of interests in Clearstream. In Re Cardtronics PLC [2021] EWHC 1617 (Ch), where the only member was the ADR depositary, the court allowed a process whereby two of the directors converted their ADRs into shares and voted those shares in favour of the scheme in order to satisfy the majority in number test; and in Re GW Pharmaceuticals PLC [2021] EWHC 716 (Ch), where the vast majority of the shares were held by the ADR depositary, the court made a direction that a member which cast votes both for and against the scheme should be treated as voting in favour for the purposes of the majority in number test if it cast more votes in favour than against the scheme, and as voting against otherwise.

Given the potential for abuse of the statutory headcount test, we would support a review of the test, and note that the more recently introduced restructuring schemes under Part 26A CA 2006 (which generally reflect the approach on schemes of arrangement) require approval only by a 75% majority of votes cast with no majority in number test. This review would be all the more urgent if all investors were to be required to hold through nominees, reducing the number of a company's members to a very small number compared with the number of actual investors in the company's shares.

A review should consider abolishing the statutory headcount test for a scheme of arrangement and relying on the court's general discretion to take into account the number of investors who vote for and against a scheme, overall turnout and other factors it considers relevant (as discussed, for example, in Re Old Mutual Group plc [2018] EWHC 1875 (Ch) and Re Stellar Diamonds plc [2018] EWHC 1152). The Practice Statement on Schemes under Part 26 and Part 26A CA 2006 sets out a process to inform the courts, where interests are held indirectly, and it is proposed by the applicant that the votes to be cast at the meetings reflect the views of persons holding indirect interests. In such cases, the evidence presented to the court should set out the applicant's proposals for doing so and any facts justifying those proposals. This approach could enable the court to take into account a range of relevant considerations including potentially the number of ultimate investors on whose behalf a member cast its votes, rather than focusing purely on legal title holders. We note that a number of other common law jurisdictions have either dispensed with the majority in number test (eg Hong Kong) or given the court the discretion to dispense with the test on a case by case basis (eg Australia).

3 Recommendations and Questions

Recommendation 1 – legislation should be brought forward, and company articles of association changed, as soon as practicable to stop the issuance of new paper share certificates.

We are not clear if the intention of this proposal is to phase-in the operation of Model 3 by preventing new purchasers from acquiring shares except through a nominee who can receive shares in uncertificated form and requiring new shares issued as a result of a scrip dividend, rights issue or other secondary issuance to be issued only to such a nominee. In relation to new issues, this could result in very small holdings having to be held through nominees and we are not clear that this would be economically attractive for either shareholders or nominees (depending on the charging model). Existing certificated shareholders in this situation would (unless they transferred their entire holding to a nominee, which this proposal may be intended to encourage) end up having two separate holdings of the shares – one in their own name, and one in a nominee's name. We see this as risking added complexity and confusion, and it may be preferable to require all holdings to be transferred to a nominee (if Model 3 is adopted) in one go (albeit potentially over a reasonably long period, in order to give shareholders time to understand the new system and select a suitable nominee).

On the other hand, if the intention is to remove certificates while enabling shares to be held by a buyer in their own name, this would appear to be an interim form of Model 1 and the processes for transferring shares without certificates would need to be established (including what will replace certificates as evidence of a shareholder's entitlement/identity and dealing with arrangements for taking security over shares). If this is the case, it would involve educating investors about two different systems. It is also not clear to us that, if Model 1 works satisfactorily, there would be a compelling case for then moving to Model 3 on a mandatory basis, given the issues that we identify in this response.

We would not support legislation being brought forward to end the issue of share certificates before there is clarity on the functioning of the new model and it can be properly communicated to shareholders.

Recommendation 2 – the government should bring forward legislation to require dematerialisation of all share certificates at a future date, to be determined as soon as possible, in conjunction with Recommendation 1.

Given the usual lead time for legislation, it would make sense to establish a legislative framework for removing requirements for share certificates and pave the way for future developments. To ensure flexibility, amendments to the CA 2006 should include delegated powers to allow ministers to make future regulations as appropriate. As with recommendation 1, the abolition of share certificates should not be brought into force before putting into place the necessary rules, standards and processes for nominees, if Model 3 is adopted, or the new authentication processes for digital transfers, if Model 1 is adopted.

Question 1 – what would be an appropriate timeline to require all share certificates to be dematerialised to ensure that the communication arrangements necessary to allow previously certificated shareholders to have access to their rights are in place?

It is important that the proposals should not be implemented, especially if they involve mandatory movement of previously certificated holders to a nominee system, before adequate communication arrangements are in place. We do not have views on how long it would take to develop common communication protocols and systems. Ideally these should be developed by the market, supported

by regulation. We note, however, that where there are non-UK intermediaries within a chain this may be an obstacle to ensuring rapid communications up and down the chain whether on the basis of regulation or cooperation across the market. The communications arrangements would need to follow the relevant legislation being in place.

Recommendation 3 – the government should consult with issuer and investor representatives on the preferred disposition of 'residual' paper share interests and whether a time limit should be imposed for the identification of untraced UBOs.

We agree with the recommendation to consult on how to deal with "residual interests" – i.e. if Model 3 is adopted, the interests of persons who have not provided the issuer with details of a nominee to whom their shares are to be transferred within a specified timeframe. We note, though, that this is a matter that could be dealt with under articles of association and there does not necessarily need to be a single approach. However, if a uniform approach is to be adopted, there would need to be a duty on companies to make the necessary arrangements.

Consideration should also be given to the best way of dealing with persons who are not "untraced" within the terms of the company's articles of association but who for some reason are unable to find a nominee to act on their behalf, as well as those who simply fail to do so. The suggestion of maintaining such holdings in a nominee account for a period would mean that those holders would not lose their share rights, whereas use of the Dormant Assets Scheme entails a sale of shares with the holder only being entitled to reclaim the proceeds of sale. Whichever of the three suggested options is used, it is likely that companies will need to change their articles of association, unless overriding statutory provisions are made to enable these arrangements.

If holdings are ultimately in nominees, the problem of untraced shareholders for issuers should disappear, although nominees may still have customers who are or become untraceable.

Question 2 – What approach should be taken to the disposition of 'residual' paper shares, and should a time limit be imposed for identifying untraced UBOs?

Maintaining the shares in a nominee account until the end of the current period for dealing with untraced shareholders (typically at least 12 years) would be the approach most consistent with current rights if Model 3 is adopted.

Question 3 – with regard to 'residual' certificated shareholdings attributable to uncontactable shareholders, do you support each issuer having the option to manage these residual interests themselves within the authority contained within their articles of association as well as having the option to transfer the proceeds of sale to the UK's Dormant Assets Scheme?

We support the ability of issuers to manage residual interests (ie certificated shareholdings which are not transferred to a nominee by a specified time), under their articles of association. As noted above, however, most companies would need to change their current articles of association to manage residual interests because standard provisions on untraced shareholders would not necessarily apply to these residual certificated holdings. We have no objection to the proceeds of sale of untraced/residual holdings being placed in the Dormant Assets Scheme subject to shareholders being provided with appropriate information and warnings about the scheme, including the fact that shares would be sold rather than being held in the scheme. Companies may need to change their current articles of association in order to make use of the Dormant Assets Scheme.

Question 4 – Is the ability to have digitised shareholdings held on a register outside the CSD important to issuers or UBOs?

The ability to hold directly and exercise rights directly, and without having to deal with, and potentially pay for the services of, an intermediary is something that is valued by some shareholders. We do not believe that the existence of a second register, of itself, is either a concern, or important, to issuers or shareholders. We believe that if Model 1 were adopted, electronic processes for transfer of shares into CREST could be managed in a way which would be much more seamless than the current paper-based processes.

There may be overseas investors who prefer or are required to hold shares in their own name rather than through nominees in CREST and it would be undesirable to deter such investors from investing in UK traded companies. Overseas shareholders who do not hold through CREST currently include entities such as Cede & Co, the nominee for DTC (this is an issue for companies whose shares are to be listed and traded in the US market, as the shares must be deposited with DTC, acting through Cede & Co). Consideration also needs to be given to other holding structures of companies with overseas listings, including those with overseas branch registers. Given the complexity of the issues involved, and the fact that they impact only a minority of traded companies, we have not included detail here about the issues that would need to addressed, but we would be happy to discuss these with the Taskforce if helpful.

Question 5 – do you agree with the taskforce recommendation that the optimal architecture is for all digitised shareholdings to be recorded in the CSD and managed and administered through nominees?

We think further work and a cost benefit analysis is needed before this question can be answered fully but have noted some initial observations below.

Under Model 3, shareholders who are not CREST members or sponsored CREST members would have to use a nominee. When these shareholders are no longer able to hold shares in their own name, it will be necessary to ensure that nominees are prepared to pass on information from the company and enable voting and the exercise of other rights, at no (or a reasonable) cost to investors. As a practical matter this will require common communication protocols and processes (supported by appropriate legislative or regulatory changes) to ensure transmission of the relevant information in an efficient way up and down the chain.

Shareholding through nominees has the benefit that it does not, of itself, require the adoption of new processes or legislation (although mandating it will do so and setting minimum requirements for nominees will require either legislation or regulation). However, to mitigate the impact of holding in intermediated form for those investors previously in certificated form, and to benefit the UK equity markets more generally, current voting and corporate action processes and communications should be significantly improved. Drawbacks commonly encountered by listed companies which operate with digitised holdings via a CSD include lack of visibility over ultimate owners; lack of transparency over voting ahead of meetings; and greater lead times needed to allow for flow of information to owners.

To the extent possible, there needs to be market-wide adoption of processes to ensure rapid communications up and down the chain of intermediaries. This includes information passing from issuers to investors (for example notices of meeting and of other corporate actions); and information passing from investors to issuers (for example, voting instructions, and take up of rights or other elections relating to corporate actions). In relation to corporate actions, it should be noted that as well as general notices such as notices of meetings or of new capital raisings which will be announced to the market and published on the issuer's website, the outcomes for individual investors of corporate actions also need to be passed promptly up the chain to them. For example, if a shareholder who is a director is not informed by their nominee of the receipt of shares under a

dividend reinvestment plan, the director may be in breach of their obligations to notify share dealings to the market.

While competitive market-driven services are likely to suffice for many, as indicated above, we are concerned that they may be difficult to access for some smaller shareholders. Although investors may vary in the level of service they require, we believe that regulation is likely to be necessary to ensure that investors are provided with a minimum service enabling them to receive information and exercise rights and are not subjected to unreasonable charges for holding investments through a nominee.

In light of the disadvantages of moving to a fully nominee-based model, as discussed above, further consideration should be given to Model 1 and whether it offers a better solution. Model 1 would be less disruptive of shareholders' rights, but would depend on the development of digital processes for authentication and verification of holdings and for electronic transfers and corporate actions that would provide the market with certainty and confidence in a paper-free system and would operate seamlessly with the CREST register.

We believe that a cost-benefit analysis and a more detailed analysis of how each model would work in practice taking account of a range of potential scenarios should be carried out before deciding which model to proceed with.

Question 6 – do you agree that the dematerialisation of current certificated holdings would be optimally pursued in a two-stage process, first to dematerialise to a single nominee (which could be sponsored by the issuer, an intermediary acting on its behalf or a collective industry nominee) and second to allow individual participants to move their beneficial interests to a nominee of their choice electronically?

We agree that this would in principle be a suitable way of transitioning to Model 3, but we also think that there should be no reason why investors should not be able to move to a nominee of their choice immediately.

Particularly for investors who have shares in multiple companies, consideration should be given as to how to streamline this process and the communications surrounding this so that it is as simple to understand and efficient as possible.

Question 7 – do you agree that facilitation of shareholder rights should be left to market forces, with full transparency as to whether access to such rights is available and where it is, clear communication around ease of access and charges allowing shareholders to choose between full service or lighter touch models?

We agree with the need for transparency and principles of shareholder choice, as well as the desirability of allowing competition in the services provided. However, if Model 3 is adopted, we believe it would be necessary to have some regulatory intervention to ensure a base level of service at a reasonable cost. This may involve requiring traded companies to provide a nominee who will provide a full range of services to its investors. Alternatively a nominee company could be established to provide the services for shares in all traded companies. The latter would be less cumbersome for any shareholders who have shares in multiple companies.

Some standardisation of communications by traded companies or their agents, and by service providers, around the initial process and the services offered may need to be mandated to maximise transparency and so that it is simple for investors to understand and compare different service offerings.

Although the report says that three major retail-focussed platforms currently offer access to voting rights, it does not follow that this will always be the case. Although there have been recent developments with more providers offering a voting service to beneficiaries, these do not necessarily equate to facilitating direct voting by beneficial owners. It may not be sufficient to leave facilitation of shareholder rights to market forces, as experience shows that, for many years, the market has not offered a cost-effective way for shareholders to hold shares through a nominee that ensures they receive information and can exercise rights.

Recommendation 4 – Intermediaries should have an obligation, as a condition of participation in the clearing and settlement system, to put in place common technology that enables them to respond to UBO requests from issuers within a very short timeframe.

We agree with this recommendation in principle, but it is open to discussion whether such an obligation should be imposed by legislation or regulation. We do not see this as likely to be achieved by contractual terms alone, whether with the CSD or with issuers (as implied by Question 8), since the intermediaries may include a number of intermediaries in a chain, who may not have a contractual relationship with the CSD or the issuer. Overseas shareholders, in particular, may, hold through intermediaries who are not based in the UK and it may be difficult to impose standards on overseas entities. As explained above, issuers may want information about people with interests in their shares who are not UBOs.

Question 8 – What should the service level agreement be between issuers and the intermediation chain, with regard to the provision of UBO information? With regard to turnaround time and the frequency of request, what would constitute 'fair usage' of that process – essentially a 'baseline' obligation? Should aggregation be permitted such that individual UBOs below a minimum percentage ownership need only be communicated in aggregate; what should that percentage be?

There is a distinction between information that the issuer is entitled to under section 793 and information it might need in order to communicate with decision makers regarding exercise of voting rights or participation in a capital raising.

In principle there is no reason to impose restraints on issuers' use of the s.793 regime (where issuers are not normally concerned about small holders) but they would need to access information about all holders, including small holders, in order to communicate with them. Intermediaries should be required to pass on all information put out by the issuer within specified time limits to all people for whom they act as nominee, however small their holding. Intermediaries should also be required to pass back the exercise of all votes and other rights for all people for whom they act, however small their holding, within a specified time limit. It may be necessary to set different time limits for different corporate action

Question 9 – do you agree that only issuers should have the ability to access information below the level of what is recorded on the company's share register? Should there be restrictions on how issuers can use that information, including sharing the information?

We do not see any need to change the restraints that apply to the use and accessibility of information under the section 793 regime.

Recommendation 5 – Intermediaries offering shareholder services should be fully transparent about whether and the extent to which clients can access their rights as shareholders, as well as any charges imposed for that service.

We agree that transparency will be important. See the comments on standardisation and clarity of communications above. We believe that minimum standards would need to be enforced by regulation.

Recommendation 6 – Where intermediaries offer access to shareholder rights, the baseline service should facilitate the ability to vote, with confirmation that the vote has been recorded, and provide an efficient and reliable two-way communication and messaging channel, through intermediaries, between the issuer and the UBOs, as described above.

We believe that the digitisation mechanism should not be introduced if it would result in current certificated shareholders, who wish to exercise them, being effectively deprived of their rights to exercise votes etc. either because voting is not possible through the nominee service or because of the charges associated with having such a service. In particular, fixed charges levied on an annual basis could have a disproportionate impact on returns for smaller retail investment holdings. It would be a retrograde step if the system and/or its costs were such as to discourage small shareholders or make investment in equities by retail shareholders less attractive. While mandating a baseline minimum level of service would ensure shareholders were not disenfranchised, the incentives for nominees or issuers to absorb costs to ensure that small shareholders are not disadvantaged may not exist without regulation. We also note that, given that many retail investors do not in practice vote their shares, there should also be the ability to opt out of a voting service, particularly if this were to involve (additional) costs.

Although we are not sure how widely exercised it is in practice, the right to confirmation of electronic voting already exists under the Companies (Shareholders' Rights to Voting Confirmations) Regulations 2020, so in that respect, the key issue will be the ability of the nominee to pass on this information to the investor. These regulations only require confirmation to be provided "as soon as reasonably practicable" and it would be important that any obligation on a nominee to pass this on to the investor does not unduly extend timelines for voting/decision making.

Recommendation 7 – Following digitisation of certificated shareholdings the industry should move, with legislative support, to withdraw cheque payments and mandate direct payment to the UBO's nominated bank account.

We agree this may be helpful, although companies can achieve the same ends by changing their articles if a sufficient majority of their shareholders agree and many traded companies have already done so. We note the difficulties discussed above in defining a "UBO". The company needs to be certain that payments are paid to a bank account that has been properly nominated by the appropriate decision maker, who may not necessarily be the "ultimate beneficial owner".

As the Interim Report suggests, ending cheque payments and requiring investors to provide the issuer with their bank details in order to receive dividends could help to prompt untraced shareholders to come forward . We do not think ending cheque payments should be mandatory for private companies.

4 Legislative changes required

We agree that section 786 CA 2006 (together with section 788) could be used to make regulations to require traded companies to adopt arrangements under which title to securities is to be transferred without a written instrument and to prohibit the issue of share certificates, and override provisions in articles of association which require the issue of a share certificate.

We agree that section 786(1)(b) CA 2006 could not be used to make regulations to mandate the use of CREST with intermediation through a nominee, as this would have the practical effect for many shareholders of meaning that they could not hold the shares in their own name and effectively control the exercise of their rights, contrary to section 786(3) – given that many shareholders are not in practice able to become CREST members.

We note that Article 1 of Protocol 1 of the ECHR allows interference with possessions provided that the interference is in accordance with the law, pursues a legitimate aim in the public and general interest and is proportionate, striking a "fair balance" between the aim pursued by the State and any adverse impact on the property rights of persons affected. Whether the interference is proportionate will require consideration of different factors depending on the circumstances of the case. If mandatory shareholding through nominees is the model adopted, the question of whether the interference with existing shareholders' rights is proportionate would depend on factors including the extent to which the rights of formerly certificated shareholders were able to be effectively exercised by them and on the costs involved.

We agree that FCA rules could require intermediaries to adopt common technologies to respond to information requests, to establish baseline service levels for clients to access shareholder rights and to be transparent about the services they offer and the charges imposed. We note that some overseas shareholders, in particular, may hold through chains of intermediaries some of whom are established outside the UK and who would therefore not be subject to FCA regulation.

If it were felt necessary to mandate the withdrawal of cheque payments we agree this might require primary legislation. Changes to the model articles could be made by secondary legislation but changes to the model articles may not be appropriate if the change is to be restricted to traded companies.

We have not undertaken a full review of the legislative changes that would be required in the context of the digitisation of shares for the purposes of this response to the Interim Report, but we would be happy to discuss such changes further with the Digitisation Taskforce and relevant government departments as the proposals are progressed. However, we would in particular highlight the following areas where legislative change may be necessary or desirable:

- As discussed in paragraph 2.4 above, consideration could be given to broadening the indirect investor provisions in Part 9 CA 2006 to enable registered shareholders to nominate another person to exercise rights as shareholders.
- Consideration could also be given to reviewing the provisions of section 793 to enable improved communication flows in relation to issuer requests for information regarding persons interested in their shares.
- As discussed in paragraph 2.6 above, greater use of nominees would suggest that the headcount test should be reviewed.
- Similarly, it may be appropriate to review provisions which confer rights where a number of members acting together, such as section 314 and 338 CA2006 relating to rights to circulate information and requisition resolutions.

- The CA 2006 provisions on shareholder communications should be reviewed in order to ensure communications with shareholders can be fully digital.
- While we believe that issuers should not be prevented by the general prohibition on financial assistance for the purposes of an acquisition of shares from bearing nominees' costs for smaller shareholders, it would be useful to confirm in legislation that the prohibition does not apply to such arrangements.

See also our comments in relation to the taking of security over shares set out in the Annex to this response.

FOR FURTHER INFORMATION PLEASE CONTACT:

Lucy Fergusson (lucy.fergusson@linklaters.com)

Annex – issues relating to taking security over shares

As stated in paragraph 2.5 of this response, clarity is needed as to how security can be granted to security trustees if share certificates are removed or digitised and how such security can be enforced, in the absence of a paper share certificate and executed stock transfer form which can be held by the security trustee in the case of shares that are not in CREST. It should be noted that the rights of a charge-taker are very different from the rights of a person nominated by the legal owner of a share to act as their proxy or otherwise exercise legal rights because in the latter case the legal owner always has the power to terminate the authority which they have delegated. Where a charge is granted, on the other hand, the charge-taker has proprietary rights which must be effective against the issuer; the charge-giver must not be able to carry out any act that the issuer is entitled to accept as terminating the interest or right of the charge-taker or its exclusive dispositive power over the charged shares. Any operational solution must be consistent with and support these fundamental legal considerations. This Annex describes the issues we have identified.

Traded companies

We consider that Model 1 is more likely to create issues in respect of taking security over shares than Model 3 for the following reasons:

1. The CREST system already provides a well-recognised, respected and widely-used function for the taking of a fixed charge/equitable mortgage over uncertificated units of a security, namely the "escrow" functionality. This allows for any bank or other collateral-taker (whether as a CREST member or by appointing a CREST member as its "escrow agent") to take exclusive control over the charged CREST securities, and to maintain that control (and enforce the security interest) without any further reliance upon or need to have any other recourse to the collateral-giver or the participating issuer. Under Model 3, even if the retail investor holds its entitlement in relation to the CREST securities by way of credit to a securities account in the books of a lower-tier intermediary, they (or their intermediary) will be able to instruct through the chain an equitable transfer by way of security of the uncertificated shares (held at the top-tier) by the top-tier nominee entering a "TTE" ("Transfer to Escrow") instruction to credit the charged securities to an escrow account of the lender (or its agent/nominee) as escrow agent in CREST. The records of the intervening intermediaries will also record that, while the entitlement of the investor or its upper-tier intermediaries remains vested as a trust or equivalent entitlement, it is subject to the security interest and cannot be disposed or dealt with upon instruction by the investor/intermediary unless or until the charged shares are moved back into the available balance of the top-tier intermediary in CREST upon redemption of the charge. This is an operational equivalent to a fixed charge or equitable mortgage because the securities, at the top-tier, remain in the legal ownership of the top-tier nominee held (on a continuing trust, but subject to the collateral-taker's equitable fixed charge/mortgage) for the benefit of the immediate lower-tier intermediately and so on down the chain to the collateral-giver, and so that the collateral-taker does not need to be entered onto the register as legal owner under a legal mortgage – which it may not wish to be for tax, accounting or other legal reasons. Under such an arrangement, the investor (and its upper-tier intermediaries) retain their entitlement in or in relation to the underlying (charged) shares, but the relevant records will reflect that operational control over the relevant entitlement is no longer vested in the investor/relevant intermediary as (continuing) account-holder.

2. Under Model 1, in order to provide equivalent functionality to the "escrow" functionality supported in CREST under Model 3, the registrars could develop (or be required to develop) operational procedures that allow for the collateral-giver to remain as legal title holder on the

digitised non-CREST register, while transferring absolute operational control over the charged securities to the collateral-taker (or its nominee). It should be noted that the rights of a charge-taker are very different from the rights of a person nominated by the legal owner of a share to act as their proxy or otherwise exercise legal rights, because in the latter case the legal owner always has the power to delegate the authority. Where a charge is granted, on the other hand, the charge-taker has proprietary rights which must be effective against the issuer and the charge-giver cannot carry out any act that the issuer is entitled to accept terminates the interest or right of the charge-taker or its exclusive dispositive power over the charged shares. Any operational solution must be consistent with and support these fundamental legal considerations. Model 1 faces two key challenges for the taking of a fixed charge or equitable mortgage. First, if the registrars were required to develop such functionality, this would: (i) be a new and additional (and possibly unexpected) cost for them, (ii) be untested and so market confidence in the functionality would need to be earned, and (iii) require collateral-takers (or their agent/nominee) to have a contractual relationship with the relevant registrar governing the operation (and related legal and liability issues arising out of the operation) of such functionality – which may be a material issue where there are a number of registrars operating under Model 1, as opposed to the centralised escrow functionality available in CREST under Model 3. Second, if it were proposed that the registrars should not develop such escrow or equivalent functionality, the relevant security interest would in practice need to be effected by the registrar interacting with the CREST system to put the charged shares into escrow in CREST under a member account of the registrar or its nominee. At a philosophical level, we are concerned that this undermines the point of Model 1 in that the investor will no longer have legal title to the charged shares, which will be held on trust for their benefit by the registrar itself or by the registrar holding such legal title through its nominee.

3. In the absence of using escrow or equivalent functionality (under which legal title remains in the collateral-giver, its immediate intermediary or a high-tier intermediary, but operational control is vested in the collateral-taker) it is not clear to us that it will be possible to replicate the interests, rights and obligations associated with a fixed charge/equitable mortgage over shares in the digitised environment. It would, of course, be possible for a collateral-giver to instruct the complete debit of its securities account with its immediate intermediary or (if the collateral-giver is itself entered on the relevant register of members) the transfer of its legal title to the collateral-taker (or its nominee), but such an operation would not be the equivalent of a fixed charge/equitable mortgage effected (in the certificated environment) by or under the deposit of the relevant share certificate(s), blank proper instrument of transfer and security power of attorney. This is because either the operation would effect a transfer of legal title (i.e. by way of legal, and not equitable, mortgage) or would completely divest the collateral-giver of its interest in or in relation to the legal title held by its immediate intermediary or an upper-tier intermediary (i.e. the only interest that would remain in the collateral-giver under such an arrangement would be its equity of redemption).

4. We have also considered whether, if Model 1 were adopted, a digital equivalent to the practice of handing over share certificates and a stock transfer form could be replicated by the legal holder granting the charge or mortgage (1) giving a power of attorney to the person taking the security to give them authority to make the transfer and (2) depending on the verification protocols to be followed to effect a transfer (for example, a requirement for a PIN to be given), giving them the information needed to effect the transfer – so equivalent to signing an instrument of transfer. If the system required a new PIN to be generated for a transfer, rather than involving a PIN that is used for everything, that might not work as the security holder would need the owner to provide the new PIN. An alternative approach might be to require the owner to notify

the registrar that a charge has been granted, such that the effect of this notification would be that the registrar would not be able act on an instruction of the owner to dispose of the shares or to issue a new PIN until there is a notice from the charge-taker that the charge is released. For this kind of arrangement to be equivalent in effect to the CREST escrow functionality, the issuer/registrar would have to be under a legal obligation not only not to allow a transfer or other disposition of the charged shares, but also not to accept any instruction from the legal owner as to the termination of the charge-taker's rights: the charge taker must have exclusive control. This would require a change to the CA 2006 as it would require an exception to be made from the rule that trusts should not be noted on the register (section 126 CA 2006). As stated elsewhere in this response, we believe that the no-look through principle is an important one because it provides legal certainty. Any exception would need to be carefully defined in legislation.

Private companies

The remit of the Digitisation Taskforce includes consideration of whether the arrangements for digitisation can be extended to newly-formed private companies and as an optional route for existing UK private companies. As stated elsewhere in this response, we believe that the reforms should apply only to traded companies, at least in the initial implementation stages, and that adoption by private and/or untraded companies should be optional for those companies.

Should the reforms extend to include private companies, there would need to be an effective mechanism for taking a fixed charge over shares in this type of company. Potentially this might involve the creation of an escrow account mechanism along similar lines as the CREST system, but any such a proposal would need to be included in any legislation to effect the reforms. It should also be borne in mind that where security is currently taken over shares held in CREST, the percentage shareholdings are often very small, reflecting the fact that the companies whose shares are being provided as collateral are publicly-traded companies, and the security over the shares may not be the key collateral for a financing transaction. Accordingly, the issues identified with dematerialising shares would be felt more acutely where security is taken over shares in private companies. In many financing transactions, security will be taken over 100% of the issued share capital of a private company, including over all the shares issued by wholly-owned subsidiaries, which may include intermediate holding companies. A charge over the shares in the ultimate holding company or an intermediate holding company may be looked to as the single point of enforcement for the certain financing transactions, and as the key collateral; in some cases, asset security will not be taken as the share security is the key collateral.

Currently, when taking security over shares, the register of members is generally regarded as definitive evidence of ownership (a share certificate being prima facie evidence of title) and a copy would typically be provided as a condition precedent to a borrowing under a loan agreement so that finance parties and their advisers can verify the shareholder and the shareholding which is being secured. This raises the question as to how such checks would be made where shareholdings are digitised. We note that in the case of uncertificated shares, there is a statutory obligation on participating issuers to make the issuer register of members and the record of uncertificated shares available for inspection at all times: see paragraph 6 of Schedule 4 to the USRs. In relation to Model 3, further consideration and analysis would need to be given, first, as to how to protect the continuing priority of the holder of a fixed charge/equitable mortgage of CREST shares/securities over any floating charge that is taken by a CREST settlement bank over the (charging) CREST member's stock accounts; and, second, to support the efficient and effective enforcement of the fixed charge-taker's security interest in the event of any suspension of the charge-giver's CREST membership. We understand that a number of legal and operational devices are used today to manage these

risks, but we believe that if Model 3 were to be adopted, a wider market review is likely to be appropriate (in conjunction with EUI) to ensure that any residual issues are fully and properly resolved.

Concerns around transitional arrangements

Thought needs to be given to transitional provisions for existing security arrangements. Forcing a holder of existing certificated shares to hold through a nominee may require the current holder to transfer legal title to a nominee; this would constitute a disposal of an asset and potentially breach a non-disposal covenant given in a financing document, as well as breach any prohibitions on shares being held by nominees and breach any representations as to legal ownership of the shares, thus requiring amendments to financing documents to reflect the new shareholding structure. Also, a nominee might expect some form of security interest over the asset; this too may potentially breach a negative pledge and/or create priority issues in relation to existing security interests. Further, it is likely that if a fixed charge holder only holds the relevant certificate(s) at the transition date (i.e. it is not recorded on the register of securities as the charge/mortgage is equitable only), it will not be privy to any communication made by the issuer as to the new means (e.g. PIN or other means of validation/authentication under Model 1) required to effect a transfer of the securities upon dematerialisation – which we would expect to be made, in the normal course, solely to the person recorded as the legal holder of the charged securities – and/or arrangements will not automatically be put in place at a system level to protect the fixed equitable interest that the collateral-taker has in the shares or other securities when converted into dematerialised form (i.e. it will no longer have negative and/or positive control over the charged shares or other securities when held in dematerialised form). This creates fraud and other operational risks for a collateral-taker, if not managed properly.

It is not clear from the Interim Report how the benefits of the Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003 No. 3226), as amended (the "**FCARs**"), will apply to shares and other securities which exist only in digital form. Shares, bonds and certain other securities currently fall within the definition of "financial instruments" for the purposes of the FCARs and, therefore may be the subject of a title transfer financial collateral arrangement or a security financial collateral arrangement ("**SFCA**"); SFCAs in the form of share charges are commonly used in financing arrangements, with the "control" necessary under the FCARs being demonstrated by the collateral-taker holding a (paper) share certificate and a stock transfer form. SFCAs are not required to be registered under the Companies Act 2006. Further consideration needs to be given to ensuring that the benefits provided under the FCARs, including the exemption from registration of SFCAs and the ability of a collateral-taker to appropriate financial collateral, are not lost or diluted through the transition to digital securities.

The potential issues identified above need further thought in order to achieve a balanced solution which avoids the potential for disputes, loss and/or unnecessary legal costs, perhaps through grandfathering existing security arrangements, providing legislative "overrides" to any contractual prohibitions or restrictions affecting compulsory dematerialisation and/or the development of robust standard market transitional arrangements to minimise fraud or other operational risks associated with the compulsory dematerialisation of shares or other securities subject to fixed charge/equitable mortgage arrangements as at the transition date for a particular share/security, although the implications of that approach will need further thought.