

Insights

UK SHAREHOLDING REPORT A MISSED OPPORTUNITY FOR NEW TECH

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In July, the U.K. Digitization Taskforce released an interim report containing a series of potential recommendations for the government, regulators and market participants, in order to achieve full digitization of the U.K. shareholding framework.^[1]

The task force was established by the U.K. government in July 2022, with the mandate of eradicating paper-based processes in the securities settlement infrastructure for capital markets, and improving the U.K.'s current shareholding framework.

The report considered a variety of views on the architecture of a prospective fully digitized settlement infrastructure, including the possibility of using distributed ledger technology, or DLT, as a model for this.

However, to date, DLT has ultimately not been taken forward by the task force on the basis that the technology is still in its early stages and that practical steps would be preferable after years of false starts. Nevertheless, the task force noted in the report that it would conduct a further period of open engagement as part of preparations for a final report to the government, to be delivered next year.

Accordingly, the task force left the door open for future explorations of DLT, noting that other groups within the government were analyzing the possibilities that the technology could unlock.

The task force's recommendations have instead so far been moderate yet progressive. They have focused on, among other things, the removal of paper share certificates, ways of facilitating communication between issuers and investors, as well as the various legal changes needed to facilitate this. Nevertheless, such reforms retain the intermediated structure currently in place, and do not address wider issues around shareholder engagement and corporate governance.

In anticipation of the final report being delivered, we consider in this article the current model for market infrastructure and whether the task force's decision not to pursue the adoption of DLT was a missed opportunity that could have resolved the downsides of the current intermediated system.

THE PROBLEM WITH AN INTERMEDIATED STRUCTURE

At present, the majority of investors in the U.K. do not own shares directly. Shares are usually owned through a chain of intermediaries including banks, investment platforms and brokers. Under this arrangement, the investor – or ultimate beneficial owner – is not a registered member of the company, i.e., a shareholder in its purest sense, and owns only a beneficial interest in shares, not a legal one.

The reason for this intermediated structure relates to the practical reality that if an investor does not want to hold paper certificates, their shares will need to be held in dematerialized form via the U.K.-based central securities depository system, known as CREST.

Legal entities that hold shares in their own name in dematerialized form typically either become a CREST member or a CREST sponsored member. While retail investors can hold their dematerialized shares as a CREST personal member - this is a CREST sponsored member, the most common method for retail investors is to hold their interests through a nominee account operated by a broker as individual CREST accounts are prohibitively expensive.

The intermediated nominee structure, and the fact that there is no legal ownership, often means that the ultimate beneficial owners:

- Cannot exercise the right to vote without the consent of their intermediary. Even if the intermediary provides a platform to facilitate voting, it may be difficult for a company – an issuer – to confirm that the ultimate beneficial owner's vote was received and counted, particularly where their interest is held through a pooled nominee account;
- Have no ability to attend company meetings without the consent of the intermediary or a valid letter of representation, or to receive information and correspondence from the issuer if not shared by the intermediary; and
- Cannot be easily identified by an issuer that wants to engage with them to ascertain their views on matters relevant to the issuer or to participate in secondary capital raises or other corporate actions.

In the report, the task force argues that those who hold shares through intermediaries should enjoy the same rights as those who hold shares directly and therefore presents the requirement for intermediaries to have a baseline service level, including the following:

- Ability to vote;
- Confirmation that voting instructions have been received and actioned as instructed;
- Two-way communication channel between the issuer and the ultimate beneficial owner;
- Opportunity to participate in secondary capital offerings;

- Ability to receive shareholder notices and documentation digitally; and
- An easy facility to keep shareholder details up to date so that the issuer does not lose track of investor contact and bank details.

The task force's suggested baseline service level addresses multiple corporate governance issues but does not eradicate other key legal issues in intermediation. This includes the fact that ultimate beneficial owners:

- Cannot take advantage of certain statutory rights, such as a right to challenge a resolution to re-register a public company as a private company;
- Will not form part of the headcount for the purposes of approving a "scheme of arrangement"; and
- Can only make claims against an immediate intermediary – with whom they have a direct relationship – and not against the issuers directly.

The U.K. Law Commission, in an earlier report in 2020, also raised other legal uncertainties arising from an intermediated structure, including how losses should be allocated to an intermediary's insolvency if an ultimate beneficial owner's assets were held in an omnibus account that lacked sufficient assets to meet the claims of all investors.[2]

REFORM THROUGH DISTRIBUTED LEDGER TECHNOLOGY

Despite the downsides of intermediation set out above, DLT has been heralded by some as the basis for a reimagined shareholding framework. The technology represents a more radical approach that enables retail investors to be legal and direct owners of their investments, bypassing intermediaries, which in turn, improves transparency and the ability for shareholders to exercise their rights.

OVERVIEW OF DLT

At its core, DLT is a replicated, shared and synchronized ledger. The ledger is collectively maintained by a decentralized network of computers called nodes, each of which holds an identical copy of the ledger. Structurally, DLTs are made up of interlinked blocks that hold collections of recorded entries on the ledger.

Each block contains not only the most recent entry, but every entry recorded since its inception. Proposed entries to ledgers are checked and validated collectively. If that proposed entry is accepted, every copy of the ledger updates simultaneously.

Accordingly, there is no central administrator to oversee or supervise the process. Because of its decentralized design, DLT potentially offers greater security, immutability and efficiency when

compared to traditional ledgers.

APPLICATION

A shareholding, trading and settlement platform built on DLT achieves the goals examined by the task force.

DLT could be used to embody an issuer's share register. Shares would also be dematerialized, bringing about significant time and cost savings in their administration. More importantly, DLT could remove intermediation completely.

Through DLT, investors would be represented as nodes and all transactions would be collectively confirmed and recorded on each investor's copy of the share register. A central clearing and settlement function would be unnecessary.

Accordingly, issuers could directly issue shares to investors without the use of CREST membership. Investors could also transact directly with one another without needing to give instructions to a bank, broker or investment platform.

This removes the need for reconciliations up and down the chain as the share register would accurately reflect the list of members. Direct transactions between parties also reduce the risks of improper settlement.

All investors would also be capable of owning the legal right to the shares and would enjoy full shareholder rights, including the ability to vote, attend company meetings, and receive communications generally. They would also have the right to bring claims against the Issuer directly and issuers would be able to directly engage their shareholder base, including for the purposes of secondary capital offerings.

DLT increases transparency, enhances engagement, and ultimately improves corporate governance. Finally, there would also be an open record of the issuer's ownership which would be in the public's interest.

With all these benefits, the question is: Why did the task force disregard the use of DLT and instead suggest that it needed to be realistic about what is achievable immediately?

The task force pointed to the failure of the Australian Stock Exchange in its long-running project to use DLT to update its settlement and clearing system, known as CHESS, as a cautionary tale of the complexities of being a first mover in this area.

The ASX situation resulted from a process commenced in 2015 to consider options to replace the CHESS system, whereby a company called Digital Asset was appointed to update the CHESS with a DLT solution. The new system was originally estimated to commence operations by the first quarter of 2021. However, the project experienced considerable delays and was ultimately shelved by the

Australian Stock Exchange in November 2022. Around AU\$250 million (\$164 million) was written off or de-recognized by the Australian Stock Exchange.

Accenture PLC conducted a review of the failed reform in November 2022 and found that there were a mix of technical and project management issues.[3] From a technical perspective, Accenture noted that DA's technology solution introduced latency and contention.

This effectively slowed down the exchange's ability to process transactions. There was an attempt by Digital Asset to improve transaction speed – using a technique called batch processing – but its effectiveness was constrained by practical limits in Digital Asset's native programming language.

Accenture also noted that from a project management perspective, there were various deficiencies in execution, as well as a misalignment of views between ASX and Digital Asset in terms of progress, risks and issues.

The failure of the CHES reform is cautionary. Implementing DLT is complex, and in our view, there are several important considerations:

- Proper technological design such that desired outcomes of DLT are achieved within cost and technical constraints;
- Tailoring mission-critical workflows so that they can exist within a distributed environment, rather than simply porting over existing practices from CREST;
- Strong technical leadership to unify teams across CREST and the technology developer in order to avoid siloed execution, reporting and misalignments on project delivery; and
- Detailed delivery and resourcing plans to be agreed between CREST and the technology developer.

Needless to say, the Australian Stock Exchange commenced its project in 2015 and since then, DLT has moved to the mainstream and become better understood. For this reason, it appears in our view to have been premature of the task force to disregard its application at the outset based on the experiences of the Australian Stock Exchange.

Admittedly, there are other legal issues that coincide with DLT's implementation, such as uncertainties involving the legal effect of actions taken on DLT and how obligations of participants should be conceived and enforced in a decentralized environment.

There are also important questions surrounding cost and interoperability of the technology across jurisdictions. However, this was the UK's opportunity to be bold and show that it is at the forefront of technology, but we have instead shied away from this.

The recommendations posed by the task force are not transformative, but are still an improvement of the financial market infrastructure. In order to enable a full transformation of the U.K. shareholding system, further reforms beyond share dematerialization will need to take place. Accordingly, in our view, the task force should have recommended that DLT be properly assessed.

The task force could also have explored how laws and regulations could have been amended to accommodate the use of this new technology in the future. A wider commission should also be undertaken involving industry participants to better understand the underlying mechanics of the current trading and settlement system and how it can be adapted to a distributed environment in the future.

Ultimately, if the U.K. is to benefit from a next-generation shareholding system, buy-ins from industry and clear timelines for delivery will be needed. For now, it appears we are going to have to settle for evolution, not revolution.

This article was originally authored by Tom Bacon and Andrew Tsang and published on Law360

FOOTNOTES

[1]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1168398/digitisation_report.pdf

[2]Intermediated securities: who owns your shares? A Scoping Paper

[3]<https://blog.digitalasset.com/news/digital-asset-statement-on-asx-chess-replacement-review>

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