

Further Reading:

Intermediated Securities and the Rights of the Ultimate Investor [2016] 3 JIBFL 153

Virtual Money in the Virtual Bank [2016] 3 JIBFL 150

Bearish news for note investors [2015] 5 JIBFL 329

Intermediated Securities: Taking Stock

** by Professor Ben McFarlane*

Abstract:

Ben McFarlane considers the possible impact on the law of intermediated securities of some developments in the general law of trusts and of property.

Key Points:

- A key feature of the English law of intermediated securities is its dependence on the general law of trusts: developments in that general law, even if occurring in different contexts, may therefore be of relevance to investors in securities.
- There is some evidence in the general law of trusts of the courts moving away from a traditional conceptual approach to a more functional approach.
- Similarly, recent suggestions as to the disintermediation of securities holding also call for discussion of the general principles to be applied where registered entitlements are lost as a result of fraud.

A feature of a certain strain of Englishness is an optimistic faith in the ability of the enthusiastic generalist to rise to the challenges presented by a specific task. Certainly, in relation to intermediated securities, English law has eschewed the tailored codes, or statutory interventions, favoured in many other jurisdictions, leaving matters to be governed by the conceptual poetry of the general law of trusts not the functional prose of, for example, Art 8 of the UCC. The ultimate investor is not an “entitlement holder”, with specific rights laid out as by Art 8; rather, the investor has a beneficial interest, and is thus aligned with, for example, a co-owner of a family home.

There are both strengths and weaknesses in the English approach. As noted, for example, by Bloxham ([2014] 5 JIBFL 283, 287), some have doubted whether general rules are fit for a world of “complex and rapidly shifting dematerialised interests”. A significant problem would arise if the complexity were such as to mean that an investor could not identify any specific assets held for his or her benefit by an intermediary: conceptually, it is the relation of a duty to specific assets that gives the holder of the correlative right an equitable proprietary interest, and thus ensures that he or she is not a mere unsecured creditor. This does not mean, however, that segregation is always required: it is possible for A to declare a trust of a

freehold of land under which B has a 50% equitable interest, without dividing up the land. As first noted by Professor Goode ([2003] LMCLQ 379: see too [2012] 5 JIBFL 272), and as adopted in the RASCALS case ([2010] EWHC 2914 (Ch) at [232]; [2011] EWCA Civ 1544 at [69]-[77]), such a possibility is particularly important when dealing with assets such as shares: the subject matter of an investor's beneficial interest can be a proportionate one in an intermediary's entire holding of shares of a particular kind. The fact that interests in such assets are "complex and rapidly shifting" is not, in itself, an impediment to identifying an investor as a beneficial owner of a proportionate part of such assets. In the RASCALS case, indeed, Briggs J went further ([2010] EWHC 2914 (Ch) at [239]), finding that certainty of subject matter continues to exist even if the intermediary, exercising a power given to it in the arrangements with the investor, disposes of particular securities and acquires instead only a personal right against a third party to recover equivalent securities. In doing so, he made two points which vividly demonstrate the English approach of drawing on the general concepts of the law of trusts: first, as shown by, for example, trust interests in a solicitor's client account (see [241]), a personal right can clearly be the subject matter of a trust; second, as shown by the "beneficial ownership of matrimonial and other shared homes", a beneficial interest can exist even if there are factual uncertainties, at any particular time, as to its precise extent (the same point could also be made by drawing on the law of mutual wills). Such a technique can also be seen in Lord Neuberger's invocation of the floating charge when finding that it is possible for the subject matter of a proprietary estoppel claim to change over time (*Thorner v Major* [2009] UKHL 18, [2009] 1 WLR 776 at [95]): after all, the term "fund", in its financial sense, derives from the Latin for a piece of land.

It thus seems that a long-standing concern as to the applicability of general trusts concepts to intermediated securities has now been addressed. The Financial Markets Law Commission, in its 2004 Report, also emphasised that the "[m]odern thinking is that an investor's claim should in general lie only against its own intermediary, with no look-through to upper-tier intermediaries or the issuer". The general law of trusts captures this point precisely: if, for example, A holds on trust for B1, and B1 then declares a sub-trust in favour of B2, then B2's rights are against B1 rather than against A. It would not make conceptual sense if B1 were to "drop out", or if B1's own beneficial interest were to cease to exist, as that beneficial interest is the very subject matter of the trust in favour of B2 (see e.g. *Nelson v Greening & Sykes* [2007] EWCA Civ 1358 at [47]-[57]). The recent confirmation of the general "no-look-through" principle in *Secure Capital SA v Credit Suisse AG* [2015] EWHC 388 (Comm) and *re Public Joint Stock Company Commercial Bank 'Privatbank'* [2015] EWHC 3299 (Ch) has, however, raised concerns as to the precarious position of an ultimate investor (see e.g. [2016] 3 JIBFL 153), which can be weakened by contractual terms which limit the liability of upper-tier intermediaries, or give them wide powers to deal with securities, for example by using sub-custodians (see Micheler [2015] CLJ 505). Certainly, if there is a perception by an ultimate investor that he or she is the "owner" of the underlying asset, with direct rights against an issuer, this is at odds with the conceptual position under English law (by way of contrast, compare e.g. the position in Japan under the BETA regime whereby only the account holder in the lowest tier is regarded as having a property interest). We can consider

three possible responses to this disjunction between the investor's misconception and the conceptual position.

First, one method of aligning expectations and practice is to alter the former, by emphasising the limited nature of the rights of an ultimate investor: whilst the proprietary protection provided by a trust is of course important, it does not mean that the investor has direct rights against an issuer, nor does it prevent the terms of contracts higher up the chain from having an impact on the investor's rights. Certainly, investors should at least pay close attention to the contractual terms governing their relationship with the immediate intermediary, and in particular the powers that the contract may give the intermediary to deal with the subject matter of the trust. One recently-suggested means of managing expectations for bond investors, for example, is for ratings agencies to take into account the absence of direct rights against an issuer when rating an issue (see [2016] 3 JIBFL 153, 154). It may also be useful to bear in mind how investors may benefit both from personal claims against an intermediary (unavailable of course if holding assets directly) and, at least indirectly, from the systemic advantages of an intermediated system of holding (see *Secure Capital* [2015] EWHC 388 at [59]).

Second, it is important to note that some developments in the general law of trusts may strengthen the position of an ultimate investor and align it more closely with an expectation of "economic ownership". Indeed, those developments are noteworthy, and unorthodox, precisely because they seem to prefer a functional approach, focussing on the location of value, to the more traditional conceptual approach, which looks instead to the precise nature of a party's rights. In *Shell UK Ltd v Total UK Ltd* [2010] EWCA Civ 180, [2011] QB 86, for example, the defendant's carelessness led to a large explosion at the Buncefield oil storage terminal which damaged fuel storage and pipeline facilities used by the claimant. The claimant suffered serious economic loss through its inability to supply fuel to its customers. Title to the land and facilities was however held by two service companies subject to a trust, and the claimant was one of the beneficiaries of that trust. The defendant's argument, accepted at first instance and consistent with authorities such as *The Aliakmon* [1986] AC 785 (HL), was that the claimant had no cause of action, as it had neither legal ownership nor possession of the damaged property. The Court of Appeal characterised the claimant's loss as economic, but nonetheless found that the case fell within an exception to the general rule against recovery of pure economic loss, as the existence of the trust meant there was a "special relationship" (at [136]) between the claimant and the damaged property, and indeed that the claimant was "the 'real' owner", so that it would be "legalistic" to deny recovery (at [132]). Recovery was therefore allowed, although subject to the requirement that the trustees should be joined in any action. The specific reasoning of the Court of Appeal can be attacked, as exceptions to the general bar on the recovery of pure economic loss are based on a special relationship between claimant and *defendant*, not between the claimant and some property. It is no surprise that such a conceptual point was overlooked, however, as the court's emphasis was on the function of the trust, in allocating economic ownership of an asset, and showed a desire to protect such ownership against third party interference, thus aligning a real world expectation of "ownership" (however misinformed) with the legal outcome. The decision

may therefore be of interest where, for example, the economic interest of an investor is affected by the actions of a third party. If such a third party has acted carelessly in performing a contract with an intermediary, then, although the investor is not a party to such a contract, the terms of the contract may modify any duty of the third party to the investor: in cases involving recovery in tort of pure economic loss, the precise terms of an assumption of responsibility by the defendant can be critical (see e.g. *White v Jones* [1995] 2 AC 207 (HL) at 268), and to that extent, the burden of a intermediary-third party contract may have an effect on an investor, particularly where (as is often the case where the third party is a sub-custodian), the investor has given the intermediary a wide power to enter into such relations with third parties (compare e.g. *The Pioneer Container* [1994] 2 AC 324 (PC): even a claim of a legal owner of goods can be limited by the terms of a sub-bailment, if the power to make such sub-bailments was given by the owner to the initial bailee).

A similar focus on economic “reality”, again producing effects which may be of interest to investors, is apparent in the recent judgments in *Menelaou v Bank of Cyprus plc* [2015] UKSC 66. The claimant bank had agreed to release its charge over the parents’ home on the basis that it would then acquire a charge over a new, smaller home to be bought by the parents. That smaller home was acquired in the name of a daughter and the charge apparently granted over it was invalid, as it had not been signed by the daughter. The Supreme Court held that the bank nonetheless had a security right: it could be subrogated to the unpaid vendor’s lien over the smaller home, as the purchase price of that home was paid using money which became available as a result of the bank’s agreement to release its charge over the parents’ home. The important point for present purposes is that the Supreme Court, viewing such a subrogation claim as based on unjust enrichment principles, also accepted (with the exception of Lord Carnwath) that such enrichment could be made out even if the bank could not show any proprietary right in the money used to buy the smaller home. Lord Clarke, for example, (at [32]) commended taking a “broad” approach to the question of whether there was a sufficient causal connection between the bank’s action and the acquisition of the smaller home, taking account of “‘economic’ or ‘commercial’ reality”. It might previously have been thought that, not least because the bank was arguing that it had a proprietary right, tracing principles would have to be met in order for the bank to establish the necessary connection. It seems, however, that this is not required to establish an unjust enrichment claim: the connection can be established without tracing through a set of identified transactions to identify one right as a product of another, as long as it can be said that the “economic reality” establishes a link between loss to one party and gain to another. This approach may thus assist an investor in making a claim against a third party, even if the complexity of the intermediary’s dealings, or a lack of segregation of assets, means that traditional tracing rules cannot be satisfied. Indeed, in his dissent in *Lehman Bros International (Europe) v CRC* [2012] UKSC 6, Lord Walker at [85] referred to the “very precarious form of protection” provided by a trust without segregation, owing to the risk that the “element of trust property in unsegregated funds will rapidly become untraceable”. The possible use of an unjust enrichment claim to bypass tracing requirements certainly appears to increase protection for some investors but, in a reflection of Lord Walker’s concerns in the *Lehman* case, it is not clear what effect such claims might have on those other investors who

can establish rights under the tracing rules, and nor is it clear that a “sufficiently close casual connection” test (particularly if applied as a second possibility, to be considered in addition to the tracing rules) will reduce the practical problems that arise when applying the approach preferred by the majority in *Lehman* (see [2015] 5 JIBFL 260).

A third response is to try to meet an investor’s expectation of ownership by providing a new system of direct, rather than intermediated, holding of assets. It has been suggested that the technology behind cryptocurrencies might allow such direct holding to be combined with speedy, simple dealings (Micheler [2015] CLJ 505, 531-533): as bearer securities give rights to the holder of a document, so might cryptosecurities give rights to the party identified in a form of electronic register. It is again important to consider the wider law, in particular the causes of action available to an initial holder of a registered intangible who falls victim to a fraud. In *Armstrong v Winnington* [2012] EWHC 10 (Ch), the deputy judge found that the claimant, initially registered as holding numbered EUAs (EU allowances to emit carbon dioxide), could bring a claim in knowing receipt against the defendant, which, as the result of a third party fraud, had been registered in place of the claimant as the holder of those EUAs. This depended, however, on the somewhat unconvincing proposition that, when gaining access to the claimant’s electronic account, the fraudster had gained such control over the claimant’s EUAs that it could be regarded as holding those rights on trust for the claimant. It was also said that, if the fraudster had no such rights, a proprietary restitutionary claim would have been available against the defendant, based on the claimant’s subsisting legal property right. The difficulty there, however, is in equating ownership of a physical thing with an intangible right: the latter right, unlike the former, does not, in itself, impose duties of non-interference on third parties (see e.g. *Your Response Ltd v Data Team Business Media* [2014] EWCA Civ 281). The point is that it is not only the phenomenon of intermediation that may limit the rights of an investor; the nature of the underlying right itself may also have such an effect.

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