NEWS BRIEF

Issuer liability for intermediated securities: an unsettling debate

In a significant decision that clarifies the scope of issuer liability towards holders of intermediated securities, the High Court has dismissed an application by Tesco plc to strike out claims relating to its alleged false reporting of its financial position in 2014 (*SL claimants v Tesco plc [2019] EWHC 2858 (Ch)*). The claims were brought under section 90A of the Financial Services and Markets Act 2000 (FSMA) (section 90A) by two groups of claimants that held intermediated securities in Tesco. The essential issue in dispute was whether the claimants held an interest in securities given that they held them in dematerialised form through custody chains.

The dispute

The claimants held shares in Tesco in dematerialised form through the Certificateless Registry for Electronic Share Transfer (CREST). As is commonly the case, the claimants each held their shares in Tesco through financial institutions providing custodian services. Therefore, each of the relevant shares was registered in the name of the custodian and was held on behalf of the relevant claimant as the ultimate investor. The majority of the shares were held in custody chains, with a series of intermediaries between the ultimate investor and the shares; that is, the custodian and one or more sub-custodians.

The claimants brought claims under section 90A for losses arising from investment decisions that were made allegedly in reliance on Tesco's reporting of its financial position in 2014. Tesco applied to strike out the claims on the basis that the nature of the interests held by the claimants did not fall within the scope of paragraph 8(3) of Schedule 10A to FSMA (Schedule 10A) (*see box "Section 90A of FSMA"*). Tesco argued that:

- As the claimants held their shares in custody chains, they did not have an "interest in securities" as required by paragraph 8(3) of Schedule 10A. To bring a claim under section 90A, claimants must have a proprietary interest in the securities, not a purely contractual or economic interest.
- None of the claimants had acquired or disposed of an interest in securities as required by paragraph 3(1) of Schedule 10A. Tesco contended that these terms relate only to dealing with the shares themselves, whereas all that the claimants held was a beneficial interest which may be created or extinguished depending on how the custodian, as the legal owner, deals with the shares.

Application dismissed

The court dismissed the strike out application.

Interest in securities. In relation to whether the claimants held an interest in securities, the court accepted Tesco's position in a number of respects:

- Where there is a chain of intermediaries, the ultimate investor does not have a direct proprietary interest in the underlying security and cannot enforce directly against the issuer any rights held in the chain of sub-trusts (following *Pearson and others v Lehman Brothers Finance SA and others [2010] EWHC 2914 (Ch), www.practicallaw.com/8-504-5589*).
- An interest in securities must denote something more than a contractual right or economic interest in the securities.
- It is essential to identify the real subject matter of equitable interests or proprietary rights, and it would be wrong to treat sub-trusts as devices that can be looked through in order to identify the true interest held by the ultimate investor.

However, the court held that the "right to a right" held by the ultimate investor in the custody chain is, or can be equated to, an equitable property right in respect of the underlying shares, and that this right qualifies as an interest in securities for the purpose of Schedule 10A.

Acquire or dispose. The court did not accept Tesco's narrow interpretation of the terms "acquire" and "dispose". Referring to the Supreme Court's decision in *Akers and others v Samba Financial Group*, the court acknowledged that the term "disposal" is capable of applying to a transaction which involves the destruction or termination of an interest, and held that the term "acquisition" should consequently be given a correspondingly broad remit (*[2017] UKSC 6; see News brief "The nature of trust assets: home and away", www.practicallaw.com/7-639-2687*).

Practical implications

This is an important judgment which establishes that:

- The ultimate investor in a custody chain holds an equitable right, or the equivalent of an equitable right, in the intermediated securities but has no direct proprietary interest.
- Schedule 10A will not be engaged in relation to mere contractual rights or economic interests in securities but, provided that a qualifying interest exists, the terms "acquisition" and "disposal" will be construed broadly.

Given that the majority of the transactions in publicly held shares in the UK are in dematerialised form through CREST, with paper shares due to be phased out by 2025 and the widespread use of intermediaries in the CREST market, the court observed that the case raises issues of obvious systemic importance.

Tesco accepted that its construction of Schedule 10A would render the compensation regime ineffective in relation to claims by parties that hold their shares through intermediaries. The court noted that if Tesco were correct it would reveal a "fundamental hole" in FSMA and mean that the provisions in issue were unfit for purpose. Although the court ultimately ruled against Tesco, it is clear from the judgment that it found the current position to be unsatisfactory. It referred to the concerns raised by the Financial Markets Law Committee and the Law Commission, as well as by academic commentators, about a potential disconnect between the market practice of intermediation and the legal rules that govern it. The court also said

that it was "unsettling" and "uncomfortable" that the statutory regime should be open to such legitimate debate in how it applies to market norms.

The court disagreed with Tesco's submission that the draftsman and legislature had simply overlooked or misunderstood the legal attributes of intermediation, and had unintentionally used language that does not conform to it. While it acknowledged that a different form of definition might have been clearer, the court took the position that the draftsman and legislature had: understood the intermediation market; not intended to remove investors' rights; and been persuaded that the language they used was appropriate to preserve these rights. The court concluded that, in line with the conventional approach to statutory interpretation, the words should be interpreted to give effect to the intended purposes of the legislation.

It remains to be seen whether the decision will lend impetus to calls for reform of FSMA, including in response to the call for evidence issued by the Law Commission in August 2019 in connection with its scoping study into investor rights in a system of intermediated securities (*www.practicallaw.com/w-022-1185*). While the decision may have resolved the ambiguity in question, a comprehensive review to ensure that the statutory regime reflects modern market practice would seem to be beneficial for investors and issuers of shares alike.

Pending any changes to the legislation, the judgment confirms that Schedule 10A applies to claims brought by parties holding intermediated securities. Tesco had raised concerns that this outcome would introduce uncertainty as to the scope of Schedule 10A and increase the risk of multiple claims in respect of the same share transactions. The court acknowledged that the possibility that both the custodian, as legal owner, and the ultimate investor, as equitable owner, will have standing to bring claims is an inherent risk that cannot be excluded. However, it considered that this risk is unlikely to create a substantial problem. The court noted that the custodian is likely to have been merely a passive recipient that would not have made any investment decisions in reliance on the published information, and that it is not clear in any event why a custodian would wish to bring a claim in competition with the ultimate beneficiary. If this situation did transpire, the court indicated that it would be within its power to insist on a single claimant to vindicate the same right.

Section 90A of FSMA

Section 90A of the Financial Services and Markets Act 2000 (FSMA) and Schedule 10A to FSMA (Schedule 10A) provide that issuers of securities will be liable to pay compensation to persons who have suffered loss as a result of misleading statements or dishonest omissions in certain published information relating to the securities. Paragraph 3(1) of Schedule 10A provides for compensation to be paid to a person who "acquires, continues to hold or disposes" of securities in reliance on these statements or omissions. Paragraph 8(3) of Schedule 10A provides that references to the acquisition or disposal of securities include the acquisition or disposal of any "interest in securities".

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