AFME-AGC joint response to UKJT Public Consultation for a Legal Statement on Digital Securities

This response is on behalf of the AFME Post Trade Legal Committee and the Association of Global Custodians – European Focus Committee ("The Associations").

AFME[1], through its Post Trade Legal Committee, has previously responded to the Law Commission's Call for Evidence on Digital Assets in 2021, and its consultation on Intermediated Securities in 2019, as well as contributing to other DLT-related initiatives in the EU and UK.

The Association of Global Custodians – European Focus Committee ("AGC-EFC")[2] has engaged extensively with government and regulatory authorities throughout the world to support their work to better understand our industry and ensure the safe and efficient provision of securities custody services for the benefit of investors and the financial system as a whole. The Association continues to support these efforts and stands ready to provide assistance and information – within the boundaries of competition and antitrust constraints - as authorities require. The Association has actively participated in DLT-related initiatives across the EU, the UK and the United States.

The Associations have read with interest the UK Jurisdiction Taskforce Public Consultation for a Legal Statement on Digital Securities. We agree that the development of new technologies means that the legal position of securities issued under English law using Distributed Ledger Technology ("DLT") systems needs to be considered urgently in order to avoid English law being relegated as a legal system of choice for international capital markets. As the associations representing the largest part of the custody services sector, we wish to raise some points for consideration by the UKJT, as it considers the way forward. Our contribution is based upon practical experience, as

[1] The Association for Financial Markets in Europe (AFME) is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. We represent the leading global and European banks and other significant capital market players. We advocate for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work.

[2] Established in 1996, the Association of Global Custodians (the "Association") is a group of 12 global financial institutions that each provides securities custody and asset-servicing functions primarily to institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory and market structure. The member banks are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses. The members of the Association are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.

well as the work that has been undertaken for several decades to achieve more efficient and effective post-trade operations for the securities markets.

There are a number of challenges arising from the introduction of innovative technology and business models for the entire life cycle of securities transactions – primary issuance, secondary trading, clearing, settlement and custody – using DLT systems. Some of these are inherent to systems that are utilised and business models employed by market participants. Others are connected to the international features of securities markets. Still others are linked to unique features of English law. In this note, we highlight some key areas for attention, but our overarching concern is that there is a continuing need to address (and preferably codify) the status of dematerialised, book-entry, securities under English law. In order to place new systems for securities issuance, transfer, clearing, settlement and custody on a sound footing, it seems to us essential to recognise and address the outstanding problems of book-entry securities. Otherwise, outstanding problems will be carried forward from one set of systems to another; potentially becoming more pronounced as business models and the roles of securities intermediaries evolve.[3]

These problems have been identified in a number of papers over the years. We would point to the following as relevant for any work on digital securities, and have either provided a link or an attachment, as appropriate.

We note that the Law Commission is taking an observer part in the work of the UKJT, and that it is currently consulting on property law aspects of the markets in digital assets[4] as well as participating as an observer in UNIDROIT's Digital Assets and Private Law Project.[5] We have contributed to the work of the Law Commission and will continue to do so; but, in light of the scope of work of the UKJT, we would like to address several areas of concern in this note. Each is set out under a separate heading, below.

1. Shareholder Rights and Corporate Actions

The status of shareholders and their identification is a longstanding issue for issuers, intermediaries and investors. Issuers have an interest in knowing who their shareholders are, despite intermediated shareholding arrangements, such as custody services, which concentrate legal title in the hands of nominee companies used to safely segregate client holdings. Intermediaries both in the UK and elsewhere have an interest in arranging their services to provide the safest and most efficient holding arrangements for their clients, which often means the use of omnibus account structures through other intermediaries or at CSDs directly. Investors have an interest in exercising their rights as shareholders, such as voting rights and corporate actions, directly, despite the indirect holding arrangements they set up with their appointed intermediaries. These interests sometimes change or come into conflict, which requires interaction between two or more actors in the chain – i.e.,, which broadly may be described as: investor>global custodian>domestic custodian>registrar>issuer - to adjust their positions or operational arrangements.

[3] We therefore urge review of existing legislation – such as the Uncertificated Securities Regulations – to consider whether and how it can be augmented and made fit for purpose for securities across any technology platforms. We note numerous examples of a similar approach being taken in civil law jurisdictions, e.g., Luxembourg, Germany and France, in which existing dematerialisation regimes have been reviewed and adjusted in order to accommodate tokenized securities.

[4] Law Commission, *Digital Assets Consultation Paper*, Law Com No 256 (28th July 2022) ("Law Commission Consultation").

[5] See, https://www.unidroit.org/work-in-progress/digital-assets-and-private-law/

The extent to which innovative technology, such as a DLT-based system, will address these issues will depend on the system's design. The use of intermediaries arises from the needs of investors; and, as the recent Law Commission Consultation Paper has noted, there are questions to be resolved as to the meaning and methods of intermediated holdings in the context of new systems. They cannot be resolved by an algorithm based on a simple series of "If…Then…" instructions, which is the basis of computer coding, because discretionary actions, operational realities, and commercial relationships are all factors that also must be considered. We note the possibility of designing DLT systems based on segregated accounts, or direct holding arrangements, which could create operational efficiencies as well as improve transparency for both issuers and investors. What is needed is a legal basis for identifying and reconciling the competing interests that arise with respect to the rights of shareholders and their claims on issuers, the exercise of rights attached to securities, and the roles and responsibilities of intermediaries who provide a set of custody and related services.[6]

To take an example, if a German investor were to appoint a French bank as its global custodian, and the French bank were to appoint a UK bank as its sub-custodian, all with respect to a share in a listed UK company, the situation is already complex. The records of the registrar in the UK could indicate that a nominee company is the owner of the share. The UK bank, as the controller of the nominee company, would maintain book-entry account records evidencing the beneficial interest of the French bank for the account of its client. The French bank would have its own account record, evidencing the entitlement of its client, but no trust relationship with its client would be established (the rules of trusts being creatures of English equity law). The German investor would have a contract with the French bank, managing its role as an intermediary and the services it will provide with respect to the holding and administration of the UK share, including with respect to corporate actions. The issuer would have no visibility of the German investor, and the German investor would have limited power to exercise its rights with respect to the share, without the involvement of the French and UK banks. The steps they take, on a day-to-day basis, for the administration of the shareholding are linked but separate: e.g., dividends would be paid to the UK bank, which would hold them as client money for the account of the French bank as a custodian; but the French bank would reflect the funds in its own books as a debit (i.e., a debt owed) for the benefit of the German investor. The sale of the share would take place in a market, which might not involve any of the intermediaries, but the settlement instructions on the sale would be passed from the German investor (or its agent) to the French bank, which would instruct the UK bank, which in turn would instruct the CSD. On settlement, the identity of the new shareholder might be known to the registrar or another intermediary structure would become effective.

In this simple and commonplace example, there are issues of trusts, commercial agency, contract law and corporate law that are relevant and which may be brought to bear on the end investors rights -- and the combination of them can change depending on the nature and location of each investor. In the current world of book-entry securities, these considerations are addressed through the application of established legal principles, but there are *lacunae* that are filled through commercial and operational adjustments. For example, if the German investor was an activist fund that wished to intervene in a general meeting of the UK issuer, its relationship with the French bank would be relevant; but so, too, would be the arrangements in place between the French bank and the UK bank. It might be possible for a proxy vote to be arranged, so that the German investor could take part, but it might also be impractical or uneconomical for the UK bank to provide such a service. In the end, whether adjustments are made – and the form that they take -- is a function of the relationships among the various actors. There are arguments that the legal

[6] Competing interests may not just arise as between parties "in the chain". Third-party claims must be considered, too, with concepts of negotiability and good faith acquisition rules still needing to be considered: recent U.S. UCC amendments as well as the forthcoming UNIDROIT instrument (where this is called the "shelter" principle) address this aspect in connection with digital assets.

position ought to be more prescriptive, but there are counter-arguments based upon the need for commercial flexibility.

If the share of the UK company were issued on a DLT system, which is not purely part of the internal operations of the CSD, then issues would arise concerning the legal analysis of the relationships, roles, and responsibilities of each of the actors. In part this is because the roles of certain of the actors are addressed in English/Welsh law already (i.e., the issuer, the CSD, the registrar, and the domestic custodian). Any changes to their roles and responsibilities under statute ought to be the domain of statute, also, not least in order to maintain consistency. Questions about the investor's rights and their relationship to the issuer ought to be taken into consideration, as well, both for tokenised securities reflected on the DLT and for book-entry securities.[7]

2. Legal Certainty

Once trades in digital securities have been executed in financial markets, it is essential that legal certainty is provided with respect to both rights and entitlements. This can be supported if the following considerations are taken into account:

- An entry on the ledger should represent definitive direct rights against issuers that are enforceable by end-investors through intermediary chains, where relevant.

- Entries on the ledger should be considered a form of intangible personal property, which provides protections such as good-faith acquisition, insolvency remoteness (e.g., from the other participants or operators of the DLT system), certainty in financial collateral arrangements, and identification and the application of governing law.

- Rules applicable to the transfer and disposition of rights (e.g., settlement finality, security arrangements, good-faith acquisition) in any asset must be clearly established and supported.

- A centralised governance framework for which appropriately regulated and supervised market infrastructure is responsible. Technology affords the possibility that such a framework could be established in different ways: what is important is that the framework creates predictable and certain outcomes for market participants. Key elements of such a framework would include rules defining the rights, obligations, responsibilities and liabilities of the framework (as market infrastructure) as well as those of the members, participants, issuers and/or clients using or participating in it. These rules should address, *inter alia*:
    - The governing law of the framework, which would apply to all the parties mentioned above;
    - A pre-litigation dispute resolution mechanism;
    - Insolvency protection measures under relevant insolvency law, including rules on shortfalls;
    - The jurisdiction for bringing legal action (presumably England or Wales).[8]

[7] We note that entries on the blockchain (a distributed ledger) may not be considered the register under English law. Whether it is or isn't does not detract from the overarching considerations that we describe.

[8] It is no coincidence that these recommendations align closely with similar requirements proposed by the European Securities and Markets Authority (ESMA) for DLT Market Infrastructure under the DLT Pilot Regime. See, *Consultation Paper, On guidelines on standard forms, formats and templates to apply for permission to*

- Clarity is needed as to what law governs - and which court is approached - if the above-mentioned rules are to be applied or if an aggrieved party seeks redress. This should be based on location of account, consistent with the well-known "Place of Relevant Intermediary Approach" (PRIMA), in order to ensure continuity of existing national law principles on governing law. This, in turn, emphasises the criticality of establishing such a "location" or something approximating this under the rules of the above-mentioned centralised governance framework.[9]

Finally, it must be assumed that post-trade intermediaries will continue to act for investors by providing access to DLT-based systems. For this reason, we emphasise that the core records of intermediaries – whether or not their records reflect ownership entitlements - will be a function of what is recorded on the ledger.

3. Statutory change or common law decision-making?

Our recommendation is that a statutory foundation be provided for digital assets as a class of personal property, generally. We note that the Law Commission's proposals prefer, as the main sources of law, common law decisions informed by the opinions of experts. In our view, this is an approach that will be insufficient to provide the legal certainty required to support the development of markets in digital assets, including in particular digital securities. Issues like the balancing of interests among securities issuers, intermediaries, and investors require primary and secondary legislation; as seen, for example, in the SRD II and its implementation in the UK.[10]

We do not envision that litigation can or should be the primary motor for legal reform in an area based upon innovative technology that breaks down the traditional (and highly regulated) roles and responsibilities of actors in securities markets. While disputes will arise, which require the assistance of the courts to resolve, the focus of cases on particular facts and arguments in the interests of the parties is unlikely to lead to clarity where it is needed most. In the book-entry securities markets, there are problems that never reach the courts, because the actors resolve them between themselves in commercially appropriate ways; leaving academics to speculate on

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operate a DLT market infrastructure, ESMA 70-460-34 (11th July 2022), p. 18. We believe it is in the UK's interest to harmonise and align sensibly with regimes covering the same kinds of digital assets (tokenised securities) in other major markets in order for the UK to remain a major and desirable market for market participants and intermediaries who operate on a trans-national basis.

[9] We note – as does the Law Commission – that different principles may need to be employed in the case of other kinds of digital assets that may not involve the existence of a centralised governance framework.

[10] Work is also being carried in the United States on investor rights in securities by the American Bar Association Business Law Section "Task Force on Securities Holdings Infrastructure". The task force most recently has been focused on whether to propose reform to the U.S. Uniform Commercial Code Article 8 ("UCC Article 8") to address perceived problems in the effectiveness of the exercise of investor rights. The task force's overall mandate is to (i) examine the infrastructure for the intermediated holding of securities in the United States, (ii) identify. analyse and assess the significance of any problems associated with the infrastructure, and (iii) identify and assess plausible means of addressing any problems. Meeting notes of the task force are available at: https://www.law.upenn.edu/live/files/11214-a-hreflivefiles11214-meeting-notes
This is ***separate from and in addition to*** recently approved amendments to the UCC that were developed by American Law Institute and the Uniform Law Commission's UCC and Emerging Technologies Committee: the amendments include a new UCC Article 12 that would govern entitlements to and the transfer of rights in certain intangible digital assets that have been or may be created using new technologies, with Article 8 covering digital assets that parties choose to treat as "securities entitlements" thereunder. See:
https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=67fe571b-e8ad-caf8-4530-d8b59bdca805.

how the lacuna ought to be filled. Where disputes do reach the courts, the results may not provide satisfactory clarity even if they do reach the "correct" result. [11]

A firm statutory foundation for digital securities would be significantly more desirable than a Legal Statement by the UKJT in order to ensure that digital securities are subject to a framework providing legal certainty and necessary predictability, including with respect to shareholder rights. We are concerned that an informal approach to setting seminal principles carries a material risk of market disruption and which negates the potential benefits.

Moreover, we also note – as did the Law Commission in its Consultation[12] - that the UNIDROIT Digital Assets and Private Law Working Group (the "UNIDROIT Working Group") is developing a set of international principles designed to facilitate transactions in digital assets. We note the Law Commission's recognition in its Consultation that the guidance of the UNIDROIT Working Group "provides strong support for the law of England and Wales to explicitly recognise a third category of personal property rights that would be able to better embrace digital assets" and that they consider that their proposals will be important in this respect as they will provide "a clear and logical foundation from which to develop further, more conceptually difficult, legal principles on an equally clear and logical basis (including regulatory intervention if and where appropriate)."[13] The Law Commission explains:

> *If our law does not evolve in this way, it risks being overtaken and therefore overshadowed by other jurisdictions, including the US and those UNIDROIT Member States that implement the recommendations of the UNIDROIT Working Group more swiftly.*[14]

We agree with this sentiment. However, we would go further. In describing proposed requisites of "**exclusive control**" and "**rivalrousness**", the Law Commission acknowledges the concepts involved are "highly nuanced".[15] While we agree with the Law Commission that it is inevitable that concepts like these in the end will be left to courts in common law systems to better define,[16] the fundamental ruleset against which courts operate still needs to be established by statute, as will be the case in the United States with the adoption of the aforementioned amendments to the UCC and – perhaps more important – as envisioned by the UNIDROIT Working Group. In other words, we would be very concerned at the prospect of leaving the digital securities framework to development according to common law principles that only look to the UKJT for "guidance" instead of statutory law.

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[11] *See, e.g.,* *SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch), at, 88. Tesco asserted that the law failed to keep pace with the development of post-trade services supporting dematerialised securities - and argued that because the ultimate investors held shares through more than one intermediary (in this case, overlapping trusts), they had no interest in the securities. The court, in dismissing this claim, wrote that the Financial Services and Markets Act 2000 ("FSMA") should be read to effectively protect investors because ". . . the draftsman and legislature did understand the market in intermediated securities, did not intend to strip away the rights of investors who chose that mode of holding their investment, and must have been persuaded that the words they used were appropriate to preserve and enhance those rights". The court's reasoning is important to consider for what it ***didn't*** say, *i.e.*, that ultimate beneficial owners' rights are clearly protected through the chain through trusts or otherwise based either on an interpretation of the common law or a facial reading of statutory law.

[12] See, Law Commission Consultation, para. p. We note that the Law Commission is an observer sitting on both the UNIDROIT Working Group and the U.S. ULC Committee. See, para. 1.47, p. 9.

[13] See, Law Commission Consultation, para. 4.92, p. 74.

[14] Id.

[15] See, Id., paras. 5.57-5.68, pp. 89, *et. seq.*

[16] "… our preferred concept of control aligns with the UNIDROIT Digital Assets and Private Law Working Group's 'control principle' for digital assets. According to the principle's explanatory notes, control is a 'purely factual matter' or a 'factual standard'. Furthermore, our concept of control aligns with the views expressed by several eminent consultees in response to our call for evidence." Id., para. 11.87, p. 211.

We therefore don't share the Law Commission's comfort in relying on "iterative legal developments" because we do not share the Law Commission's confidence in whether and the way in which "courts will turn to the broad concept of control as a matter of default" or how they will "draw on necessary, analogous case law in other jurisdictions, and the UNIDROIT Working Group's Control Principle, to help them develop the concept of control under the law of England and Wales."[17]

Further to this, the establishment of relevant case law is likely to take a significant amount of time. This period of uncertainty might stifle the growth of the DLT market in the UK, whereas a statutory instrument would immediately resolve this.

Moving beyond questions of rivalrousness or exclusive control, we would apply a similar approach to other key relevant elements identified by both the UKJT in its Statement and the Law Commission in its Consultation.[18] We briefly address additional elements identified by the Law Commission as they might relate to digital securities as follows:

- Regarding the adoption of an **innocent acquisition rule** by statute rather than relying solely on common law interpretations), we agree with the Law Commission's sentiment, "it is important for the law of England and Wales to remain as consistent as possible with international developments." We are heartened to see that, here, the Law Commission recommends that the best approach is by way of legislation, as opposed to relying solely on common law development.[19]

- Regarding the **holding of interests in digital securities**, we respectfully disagree with the Law Commission's provisional conclusion that "no law reform (particularly any statutory reform) is required to clarify the legal position in relation to subject matter certainty requirements for creating a valid trust over commingled, unallocated holdings of crypto-tokens."[20] Whilst the RASCALS case (by way of example) may provide some comfort, reflected in the opinion of Briggs, J., that a beneficial co-ownership share in a fungible bulk of securities is a more "persuasive" than alternatives[21], we see no reason why this should not be addressed as a default assumption in statutory law, absent provision to the contrary as agreed by the parties.

- Similarly, contrary to the provisional view of the Law Commission[22], we believe a default assumption of the **imposition of a trust** is sensible unless the parties specify otherwise. This would operate to protect underlying beneficial owners as a matter of course through potentially multiple intermediaries while still respecting party autonomy should parties wish to adopt a different approach. Whilst we understand the Law Commission's concern about extending this principle not only to conventional intermediary custodians and custodial exchanges but also potentially to certain (centrally controlled) "lock and mint" facilities[23], we see no reason to make a distinction regarding default assumptions in view of the overriding need for a common understanding and approach to the nature of investors' rights in their acquired property – particularly in the event of an insolvency. Whilst we realise that the adoption of an approach founded in trust concepts is not a

[17] Id., paras. 11.124-11.127, p. 223.
[18] Id., paras 13.76-13.80, pp. 264-265.
[19] Id., para 13.94, p. 268.
[20] Id., para 16.74, pp. 348-349.
[21] *Re Lehman Brothers International (Europe) (in administration), Pearson v. Lehman Brothers Finance SA* (RASCALS) [2010] EWHC 2914 (Ch) (upheld [2011] EWCA Civ 1544).
[22] Law Commission Consultation, para 16.105, p. 357.
[23] "These could include crypto-token bridges, wrapping protocols, collateralised lending arrangements, fractional ownership, and collateralised tracker-token issuance platforms."

panacea (e.g., this does not provide guaranty against a shortfall of intangible assets where an intermediary fails to segregate sufficiently today), we believe a common approach nevertheless would provide the most clarity for all stakeholders. We therefore recommend a statutory basis of holding premised on a trust (absent specification otherwise an account provider and an account holder).[24]

- Regarding ***"stapled" rights*** specifically in relation to ***tokenised securities***, the Law Commission points out in Chapter 14 ("Linking a crypto-token to something else") of its consultation:[25]

> *…it is perfectly possible that crypto-tokens/crypto-token systems could be used as a register or record for rights to which they are linked. Such systems would operate in much the same way as registers or records for shares, securities, and other registered intangible assets. With respect to shares, securities, and other registered intangible assets, market participants recognise that entries in the relevant register generally provide only prima facie evidence of title. But market participants also recognise that the register entries will only be updated when specific methods and instruments of transfer are complied with. So, in respect of registered shares, for example, market practice, common law, and statute operate together to build the "strength" of the link between the entry in the share register and the share itself. The combination of these things works to create a link so strong that legal title to corporate shares is sometimes described as "constituted" or "vested" in the registered holder (instead of evidenced by the entry on the register). Again, it is possible that a similar effect could be achieved with a register or record that was based on a cryptotoken/crypto-token system, instead of some other record-keeping method.[26]*

We agree with the Law Commission that there is no reason why a link cannot be as strong as it is with record keeping or registration systems that do not rely on crypto-tokens/crypto-token systems.[27] However, while the Law Commission acknowledges that it is possible for legislation to create a "very strong" statutory link between a crypto-token and a thing external to the crypto-token system (such as rights associate with a security), it avers that "[t]he statutory link would be imperfect".[28] The Law Commission therefore does not recommend the adoption of legislation providing for a "broadly-defined" statutory link, instead leaving it to be addressed "as practice develops in particular areas" with "specific, limited legislation [as] might be appropriate and/or necessary to establish the relevant statutory link."[29] We strongly urge consideration of such legislation in the context of digital securities given the significant level of uncertainty that contractual consensus alone would achieve with respect to the role that DLT plays in the constitution and registration process. This carries the risk of considerable confusion around ownership of crypto tokens, what such tokens represent relative to the property interests in the securities themselves.

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[24] Providing this kind of clarity – clear imposition of trust principles – would align with best industry practice in any case, including with respect to such key practices as proper segregation of accounts for customers. This obviously is consistent with fiduciary principles under trust law and would align with regulatory (e.g., FCA) expectations, which generally impose client asset requirements founded on these principles.

[25] Law Commission Consultation, p. 291.

[26] Id., para 14.41, p. 291.

[27] See, Id. para. 14.43, p.292.

[28] Id., para 14.56, p. 295.

[29] Id., para 14.57, p. 296.

Legal certainty will be essential to the development of DLT-based markets, which can in our opinion only be provided through statutory instruments, as opposed to case law.

- The UKJT's Consultation's questions regarding "Transfer" overlap significantly with Chapter 17 of the Law Commission Consultation, which addresses law reform considerations affecting crypto-token custody arrangements, specifically:

  i. Whether the validity of certain transactions under trust-based crypto-token custody arrangements might be subject to the statutory formalities in section 53(1)(c) of the Law of Property Act 1925 ("LPA 1925") and, if so, how such formalities could be satisfied.
  ii. Whether the efficient and speedy resolution of crypto-token custodian insolvencies would benefit from changes to the allocation of shortfall losses arising in connection with commingled unallocated accounts or pools of crypto tokens held on trust.
  iii. Whether crypto-token custodians would benefit from having an expanded range of options for structuring legally-effective custody facilities, by extending or developing an equivalent to the concept of bailment which could apply to arrangements in respect of crypto-tokens.

  We address these points in turn:

  i. Section 53(1)(c) of the LPA 1925: An explanation of the state of the law, the principal concern raised by section 53(1)(c) LPA 1925 and various views and considerations are set out comprehensively in Chapter 17 of the Law Commission Consultation, so we will not repeat it here. We agree with the Law Commission's concern expressed in the summation of this discussion that "any actual or perceived ambiguity as to the scope of section 53(1)(c) LPA 1925 could undermine confidence in the efficacy of numerous activities undertaken in connection with crypto-token custody arrangements if they have been structured under or characterised as being governed by trust law."[30] Common examples of the activities that could be affected are provided in subsequent passages of the Law Commission Consultation– all of which we recognise and agree are accurately described. We especially note and appreciate the Law Commission's identification of new fact patterns that could emerge due to the availability and use of new technology, such as dealings in tokenised securities that involve transfers of control from one network address to another (a) where the recipient address is controlled by a different person (other than to the custodian in its capacity as trustee) or (b) where the recipient address is either an address with no (or no known) private key or an address controlled by the custodian in its capacity as trustee.[31] We also note that the Law Commission considers transfers that may occur both "on"- and "off-chain".[32]

     We agree with the Law Commission's concern about perceived uncertainty regarding the application of section 53(1)(c) LPA 1925 to emerging and growing industries such as crypto-token markets and that perceived lack of legal clarity could disincentivise market participants in the crypto-token sector from drawing on the utility and flexibility of trusts for structuring crypto-token custody arrangements under the law of England and Wales.[33]

[30] Id., para 17.23, p. 363.
[31] Id., paras 17.30-17.35, p. 365.
[32] Id., paras. 17.36, et seq., pp. 365, et seq.
[33] Id., para. 17.42. p. 368.

We welcome and strongly endorse the Law Commission's proposal for clarifying legislation. However, whilst the Law Commission recommends reform that appears to take a simple one-size-fits-all approach, and which certainly offers the benefit of setting out relatively simple statutory-based principles[34], we believe its other option for reform ("Option 2(b)")[35] makes more sense in view of our above-expressed recommendation for a centralised governance framework for tokenised securities. Option 2(b) - in introducing new statutory provisions that confirm the formality requirements for certain specified dealings in equitable entitlements undertaken through specified holding and transaction arrangements – would specifically address entitlements represented by entries in ledgers subject to centralised control. In this context we agree with a ruleset modelled on equivalent rules developed for intermediated securities set out in the Geneva Convention on Substantive Rules for Intermediated Securities, which we historically have endorsed and continue to endorse. In particular, we urge – where possible - the adoption of a uniform approach to all securities held for customers ***regardless of technology used***: there is no reason why Articles 11(1) and 11(2) of the Geneva Convention - which provide that acquisitions and dispositions of intermediated securities can be effected by authorised credits and debits to the securities accounts of the relevant parties maintained by their respective intermediary, with "no further step…necessary" for such dealings to be legally valid - could not be employed in this context. The Law Commission notes that, alongside provisions for entitlements in professionally operated, centrally-controlled ledgers, a corresponding set of rules could also be developed for dealings in other forms of tokenised equitable entitlements, including those subject to decentralised ledgers,[36] but the need for this is reduced or possibly obviated to the extent that a centralised governance framework is employed.

ii. Shortfalls: we agree with the Law Commission that targeted some form of intervention should be considered in order to provide confidence to crypto-token custody clients that their commingled assets are protected from the general creditors of an intermediary in the event of its insolvency. We believe that statutory intervention providing clarity on this point is sensible rather than waiting for the common law to be tested.

However, the question of whether or not client assets maintained by an intermediary should be considered insolvency remote viz. an intermediary is different from the question of how to handle shortfalls should they arise. Here we caution against blunt instruments that may be premised on overly simplistic assumptions. It is important to retain lessons learned from the 2008 financial crisis since issues around the possibility of shortfalls fundamentally are no different conceptually in the DLT context.

Post-crisis reform measures imposing new and/or different regulatory requirements on intermediaries varied depending on ***types*** of intermediaries and the activities undertaken by them. For example, the UK undertook an overhaul of

[34] The Law Commission recommends amending section 53(1)(c) LPA 1925 directly to incorporate:
(a) an express qualification that disapplies it to specified dealings in equitable entitlements; and (b) an express recognition of various forms of electronic communication and records as satisfying the in writing and signature formalities. Both revisions would be expressed as matters of general principle and not by reference to any particular category of assets. See, Id., para.17.55, p. 372, and para. 17.57, p. 373.
[35] Id.
[36] Id.

its client asset rules, imposing extensive new requirements on intermediaries, including brokers, and relevant insolvency law.[37] A number of improvements were made in regulations to improve the UK FCA's client assets regime, particularly so-called "behavioural" enhancements around good recordkeeping, enhanced reporting to clients, improved understanding around the client assets regime (i.e., requiring disclosure of the protections it affords and its limitations) and increased clarity around certain intermediaries' intra-group relationships.

Because, for the most part, concerns that arose regarding disposition of client assets were about ***behaviour***, we do not believe there is a fundamental problem with substantive law. Therefore, we believe that any concerns regarding contractual undertakings of intermediaries to clients should be addressed in this context: a "regulatory overlay" is appropriate in order to clarify and enhance contractual obligations to be imposed on intermediaries.

Perhaps most important, difficulties relating to intermediated securities – regardless of technology employed - tend to become visible in cases of insolvency of intermediaries. Insolvency, its rules and how it is administered, therefore, constitute the true testing ground for whether and how intermediated securities are maintained and protected sufficiently in the interest of ultimate investors. Under the UK model, beneficial interests, and therefore trust property, fall outside of the insolvency estate of a trustee.[38] However, the time taken either to get before a court or to engage with an administrator in order to obtain consent to enforcement of rights is inevitably longer than the needs of participants in financial markets typically allow. This was particularly highlighted in the case of the failure of Lehman Brothers International (Europe) ("LBIE"), who dealt with thousands of counterparties, with the result that a very significant passage of time was required to adequately identify and return assets belong to those counterparties, even if under English law those assets would have been considered "held in custody" by Lehman International.[39] The Lehman experience inspired UK reform measures, including measures adopted to improve on the accuracy and speed with which customer assets could be identified and returned in an insolvency.[40]

In 2014, HM Treasury ('HMT') published the final report of an independent review it commissioned of the SAR (the "SAR Independent Review").[41] This report

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[37] "*We [the FCA] increased our focus on client assets protection following the failure of Lehman Brothers International (Europe) ('LBIE'). We did this by creating the Client Assets Unit (bringing together specialist risk, supervision and policy functions) and making various improvements to the client assets regime, such as enhancements to auditor reporting, reintroduction of the Client Money and Asset Return ('CMAR') and the creation of the CASS operational oversight function ('CF10a')."* See, PS14/9, Review of the client assets regime for investment business and Feedback to CP13/5 and final rules (June 2014).

[38] We noted further above the prospect of further statutory clarification of this result.

[39] The transcript of the emergency hearing in the High Court of Justice, Companies Court, before Mr. Justice Morgan, Monday, 22nd September 2008, between (1) RAB Capital PLC, (2) RAB Capital Market (Master) Fund and Lehman Brothers International (Europe) highlighted the difficulties that may be encountered in seeking the return of customer assets in a large, complex insolvency setting.

[40] See, generally, *Investment Bank Special Administration Regulations 2011 (SI 2011/245)* (the "SAR"), available at: www.legislation.gov.uk/uksi/2011/245/pdfs/uksi_20110245_en.pdf. We note the SAR is referenced in the Call for Evidence, at p. 24 (footnote 100).

[41] See P. Bloxham, *Final review of the Investment Bank Special Administration Regulations 2011* (January 2014), available at:
www.gov.uk/government/uploads/system/uploads/attachment_data/file/271040/PU1560_SAR.pdf

contained a large number of recommendations, which were intended to achieve better results for clients by accelerating the process for distributing client assets and reducing costs. These included introducing a bar date for the processing client money claims, facilitating transfers of client relationships and positions, allocating costs of distributing client assets to, and covering shortfalls with, the general estate and exploring methods to speed-up reaching determinations of legal issues on the interpretation of SAR and CASS in an insolvency.

Following the SAR Independent Review, the Investment Bank (Amendment of Definition) and Special Administration (Amendment) Regulations 2017 (the 2017 Regs) came into force on 6 April 2017. The 2017 Regs aimed to extend and strengthen the existing regime. Despite being a special administration regime for "investment banks", the regime applies more widely, including to virtually any regulated firms holding client assets – excepting "deposit-taking" banks, which of course are subjected to a different insolvency regime.

The detailed workings of the SAR are set out in the Investment Bank Special Administration Regulations 2011 (the Regulations) and the Investment Bank Special Administration (England and Wales) Rules 2011 (the Rules), as amended. The SAR's rules and regulations interact closely with the Financial Conduct Authority's (FCA) Client Asset Sourcebook (CASS), which sets out a detailed framework for the segregation and protection of client assets, including money, held by investment banks and CASS includes rules dealing with an investment bank's failure.

The clear lesson learned from the financial crisis is that regulation, insolvency and private commercial law must all be considered and addressed together so they operate – together - by creating favourable conditions for the protection of ultimate investors both ***before*** and ***after*** the insolvency of an intermediary.

We provide this history as we believe it illustrates the limitations of what can be achieved in solely in private commercial (statutory) law: the question of how to deal with shortfalls is particularly contextual and, we believe, reliant on regulatory and supervisory requirements and insolvency law based on applicable existing legal principles in order to respond to changing facts, circumstances and behaviours.

iii. We agree with the law commission that bailment is not an appropriate concept for intangible assets including digital securities.

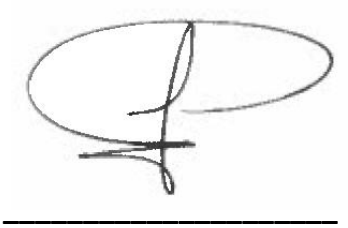
- We note that collateral arrangements are not a subject of the UKJT consultation, however, any discussion of transfers of digital securities would seem incomplete without considering other kinds of dispositions, such as the use of digital securities as security in commercial arrangements. Chapter 18 of the Law Commission Consultation addresses this topic in some detail and contains proposals around whether and the extent to which existing law should be revised. This includes consideration of reform of the Financial Collateral Arrangements Regulations ("FCARs")[42] to address longstanding concerns regarding possession and control, which remain unsatisfactorily resolved in connection with book-entry securities to this day – leaving obvious potential gaps in connection with digital securities. We believe this may be a relevant and important area for the UKJT to consider and would welcome further dialogue on it.

[42] See, fmlc.org/wp-content/uploads/2018/03/Issue-1-Collateral-Directive-Report.pdf.

AFME's and the AGC's members include securities intermediaries from the investment banking, brokerage and custodian services sectors. We would be very happy to meet with the UKJT in order to elaborate on digital securities considerations that we have been addressing and which arise in the context of the current Consultation. We trust that our combined experience will prove helpful to the work of the UKJT and look forward to hearing from you. Please do not hesitate to revert with any questions or comments.

31st October 2022

John Siena
Chair, Association of Global Custodians
European Focus Committee



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