CHANCERY BAR ASSOCIATION
TRANSPARENCY AND TRUST
RESPONSE TO THE DEPARTMENT FOR BUSINESS INNOVATION AND SKILLS' DISCUSSION PAPER

INTRODUCTION

1. The Chancery Bar Association is one of the longest established Bar Associations and represents the interests of over 1,100 members handling the full breadth of Chancery work at all levels of seniority, both in London and throughout England and Wales. It is recognised by the Bar Council as a Specialist Bar Association. Full membership of the Association is restricted to those barristers whose practice consists primarily of Chancery work, but there are also academic and overseas members whose teaching, research or practice consists primarily of Chancery work.

2. Chancery work is that which is traditionally dealt with by the Chancery Division of the High Court of Justice, which sits in London and in regional centres outside London. The Companies Court is a specialist part of the Chancery Division. The Chancery Division attracts high profile, complex and, increasingly, international disputes. The Companies Court itself deals with some 12,000 cases each year.

3. Our members offer specialist expertise in advocacy, mediation and advisory work including across the whole spectrum of company, financial and business law. As advocates members are instructed in all courts in England and Wales, as well as abroad.

4. This response is the official response of the Association to the Department for Business Innovation and Skills' Discussion Paper ("the Paper"). It has been written by Paul Marshall of No.5 Chambers and Josh Lewison of Radcliffe Chambers, and approved by the Association's committee.

5. The opportunity to respond to the Discussion Paper ("the Paper") is welcomed.

6. We are of the view that greater transparency is to be welcomed where this can be shown to promote public confidence and render the possible abuse of opaque ownership structures more difficult.

GENERAL OBSERVATIONS ON THE PROPOSALS

7. We consider that the proposals represent a major policy shift in company law. The existing architecture of the Companies Act 2006 is concerned primarily (though not exclusively) with legal owners of shares (characterized in the legislation as "holders" of shares or "members" of a company) rather than beneficial owners. The distinction is crucially that the legal holders are the *registered* owners of shares (whether these be in certificated or uncertificated form). The central importance of

this distinction was recently demonstrated in *Eckerle and Ors.* v *Wickeder Westfalenstahl GmbH and Anr.* [2013] EWCH 68 (Ch). The judge observed:

> "the literal truth is that the claimants hold the ultimate economic interests in underlying securities amounting to a specified percentage of shares held by Bank of New York on trust for the Clearstream[1] account holders whose customers the claimants are".

The fact that the company's articles entitled the claimants/beneficial owners to direct the bank how to vote did not avail them to establish their standing to apply to cancel a resolution to re-register the company as a private company. The relevant statutory rights were conferred on the legal, not beneficial owners. The judge reached his conclusion (without great enthusiasm) recognising that the statutory intention was to protect minority shareholders. The problem was that the claimants were only beneficially interested in the shares, having private rights that the legislation, for this purpose, neither recognised nor protected, rather than being members or holders of the shares (that is to say *registered* owners).

8. A reason for beneficial (and therefore indirect) interests, as distinct from the legal interest represented by being a registered holder, being given little recognition under present legislation[2], in part may be explained by the historic difficulty in readily giving recognition and effect to such off-register interests. The existence of electronic registries, and the development of dematerialized securities, in our view may offer possible means by which greater recognition and *effect* might be given to beneficial interests. This is particularly the case where beneficial interests in the future will be required to be identified and recorded (whether under a central registry or otherwise).

9. Experience shows that when significant statutory change is introduced in response to perceived problems, particularly specific issues, frequently there are unintended consequences. Where the issues in question engage the distinction between legal ownership and beneficial rights and conceptual distinctions that have developed incrementally over time in a nuanced fashion, this may be expected to be all the more likely. Such an outcome is not fanciful. Shortly after the introduction of the Proceeds of Crime Act 2002 the Bank of England Financial Markets Law Committee in a report "*Issue 69*" (October 2004) concluded that legal uncertainty created by the drafting of certain new statutory provisions (intended to prevent financial

[1] A settlement system for dematerialized securities (that is shares not in certificated form) performing a function similar to the UK system under Euroclear (CREST).

[2] Under which beneficial owners receive no protection, for example, as owners entitled to petition on grounds of unfair prejudicial treatment. That right only applies to *members* (CA 2006 s. 994(1)).

crime) represented a new area of legal risk for the United Kingdom's financial markets. (Some of these uncertainties were subsequently addressed by the Serious Organized Crime and Police Act 2006.[3])

10. That is not to diminish the difficulty of issues to which opaque ownership structures are known to give rise or the public importance of such issues.

11. In our view it is of importance that the policing and enforcement of any proposed new regulatory structure is properly resourced. For example, at present the majority of companies that fail to comply with the duty to file accounts are dealt with by their simply being removed from the register. The number of prosecutions represents a (very) small fraction of the number of companies struck-off for this reason.[4] On one view the existing regulatory structure is itself not effectively enforced.

12. There is room for further discussion about the funding of the proposals. It is by no means self-evident to us that the implementation of the proposals would be balanced in their cost and administrative burden by the corresponding, though limited, deregulation contemplated in the Paper.

PART A BENEFICIAL OWNERSHIP AND A CENTRAL REGISTRY

Question 6 Placing a requirement on beneficial owners to disclose their beneficial ownership of the company to the company?

13. We consider that there is an argument for the view that, rather than imposing a positive duty upon a beneficial owner to disclose that interest, the obligation should instead rest with the shareholder as legal owner. A template exists in the Isle of Man Companies (Beneficial Ownership) Act 2012.[5] The Act was passed in December 2012 in response an IMF recommendation in respect of (then) Recommendations 33 to 40 of the FATF that included the obligation to ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons. That requirement is identical to the requirement under Art. 29 of the Draft EU Fourth Money Laundering Directive ("MLD4"). Section 7 of the 2012 Act requires members of a company who do not own their membership interests beneficially (as well as legally) to give notice to a nominated

[3] Further, until the introduction of the "risk based" model for AML regulation, there was concern that the cost of implementation and compliance with the regulatory regime was having an adverse effect on competitiveness for businesses in the UK.
[4] Some 325,000 companies were struck-off 2009-2010 for failing to file returns.
[5] Royal Assent given 11 December 2012

officer and to provide certain prescribed details. Section 7(4) provides an offence of without reasonable excuse failing to inform the nominated officer or providing information that is false or misleading. Section 10 provides for the circumstances in which the nominated officer can be required to disclose the information as well as persons who may make a request for information together with the circumstances in which a request may be made. (The nominated officer will not, without an official request made under section 10, be compelled to provide information about the beneficial owner.)

Question 1 The proposed definition of beneficial ownership and its application in respect of information to be held a central registry?

14. We consider that a workable alternative to setting up a new central register of beneficial interests in shares, where the purpose of doing so is not to confer any particular benefit on the owner of those rights but, rather, to facilitate investigation by law enforcement agencies, might be:

(a) a register to include regularly updated information on directors and direct (legal) shareholders. This might include identification of a nominated officer to whom reports are made by those who hold shares on behalf of other persons (along the lines outlined under paragraph 13 above).

(b) A requirement that all persons that incorporate companies by way of business (TCSPs) be required to undertake due diligence on persons setting up a company and that this be regardless of the value of the transaction.

(c) Individuals registering a company directly be subject to due diligence.

Provisions along these lines would satisfy the requirements of draft Art. 29 of MLD4 and the FATF Recommendations because the relevant information concerning beneficial interests would be available both to the authorities and to the obliged person (company) as required.

Question 5 Placing a requirement on the company to identify the beneficial ownership of blocks of shares representing more than 25% of the voting rights or share in the company; or which would give the beneficial owner equivalent control over the company in any other way?

15. In our view, the definition of "beneficial ownership" as an aggregate interest in (blocks of) more than 25% of a company's aggregate voting rights, a requirement that is derived from the EU money laundering legislation, is liable to give rise to serious confusion in terminology.

16. It is understood that the term is contemplated as being used for identifying interests required to be registered on a central registry. Nevertheless the usage (transposed from EU money laundering provisions that concern customer due diligence CDD) conflates the separate concepts of:

(a) an indirect interest in shares of *any* given shareholder that is less than a legal interest (i.e. not being the *registered owner* of a share), including, typically, rights to direct the voting of the legal (registered) owner and to receive dividends and benefit from an increase in the share value; and

(b) the separate issue of proportionate voting power, exceeding 25%, as a means of exercising indirect control of the company itself (suggested to be by reason of possession of a blocking minority for certain purposes).

While this may be understandable, and of no real consequence in the context of money laundering and CDD, it will readily cause confusion in the context of registration of share ownership where it is envisaged that the same term will be used for distinct, though related, concepts that is to say, indirect ownership and indirect control.[6]

17. The Isle of Man Companies (Beneficial Ownership) Act 2012 by section 3 adopts as a definition of beneficial interest the concept of the ultimate beneficial interest in the membership interest (and provides that this may be traced through any number of persons or arrangements). A definition along these lines accords, in our view, with the concept of beneficial interest as this is commonly understood (see the comments by the judge in *Eckerle* above).[7]

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[6] That there is, perhaps, insufficient clarity and precision in the use of trust and cognate concepts under the Paper is further suggested by what to us appear to be the confusing terms in which questions 8 and 9 are framed: "8. Requiring the trustee(s) of express trusts to be disclosed as the beneficial owner of a company? 9. Whether it would be appropriate for the beneficiary or beneficiaries of the trust to be disclosed as the beneficial owner as well?"

[7] That beneficial ownership is commonly understood in this way is illustrated by, for example, the adoption by the Office for National Statistics in its biennial surveys of share ownership (under which ONS provides statistics for beneficial ownership by sector from sampled

18. In addition, in our view the Paper gives insufficient recognition to the ease with which beneficial interests may come into existence. Beneficial interests may arise in a wide variety of circumstances including where shares are held temporarily on behalf of another. Further, a beneficiary may be unaware of the existence or extent of their interest. A blind trust is an example.

19. An example of the readiness with which beneficial interests can be created orally is found *Hunter* v *Moss* [1994] 1 WLR 452. In that case the claimant claimed that as a condition of employment by the company the defendant had agreed orally to give him a 5% shareholding. The judge held that the sense of the conversation the defendant had had with the claimant was that the defendant would thereafter hold a 5% shareholding in the company under an oral express trust. The Court of Appeal dismissed the contention that because the shares had not been identified (as distinct from the issued shares generally) the trust (of intangible property) failed for want of certainty.

20. As to a proposed central registry for beneficial interests as such, once (a) an obligation is imposed upon companies and their shareholders to identify and record beneficial interests in shares; and (b) a central registry is established for holding records of beneficial interests, it is not obvious to us why the recording of beneficial interests on the register should be confined to those that exceed 25% of the aggregate votable shares.

21. It seems likely that the practical difficulty of identifying a 25% beneficial share (that has been widely attested to in the context of the Money Laundering Regulations), together with a requirement to maintain the information up to date (in the absence of which the entire exercise is largely denuded of benefit and purpose) is not materially different from or greater than the requirement for the identification of beneficial interests as such. If that be the case, we believe this would tend to militate against establishing a central registry of beneficial owners. The sort of mechanism outlined above under paragraph 14 would be more cost-effective and would represent less administrative burden. For those reasons in our view it should be preferred.

22. Further, in our view, the creation of a central registry for beneficially owned shares will represent a new, separate regulatory structure in parallel to that which already

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analysis of LSE returns) of a definition of beneficial ownership as the person or organization that benefits from the dividends or increase in share price.

exists. The identification of beneficial interests in shares will be the essential concern of this new regulatory structure without giving any new protection or effect to these. The sole concern appears to be facilitating investigation and enforcement. Without diminishing the requirement to facilitate access to information by law enforcement and tax authorities, such a result (a parallel structure for separate registration of beneficial interests under a central registry) would be anomalous and will fundamentally change the architecture of company regulation. Most obviously the concept of a *registered owner* will require further additional clarification *viz* "registered legal owner" and "registered beneficial owner". The inability of such a system of registration to give *effect* to the beneficial interests so registered (for example by addressing the problem recognised in *Eckerle*) might be seen to represent a substantial shortcoming and missed opportunity.

23. There is an argument to be made, beyond the scope of this response, for a more integrated approach under which the identification and recognition of beneficial interests in shares would not merely represent a stand-alone regulatory structure, in parallel to the existing legislation, under which beneficial interests, though recognised and identified, are given no greater protection or effect than at present (*Ekerle* above). Electronic registers may well offer possibilities in this regard as observed (in a different context) by Professor John Kay in his Review of UK Equity Markets and Long-Term Decision Making (July 2012).[8] Professor Kay expressed the tentative view that a reduction of indirect (beneficial) share ownership in favour of direct ownership and greater engagement by those interested was desirable and would confer market benefits for the UK. It was suggested that electronic registers may facilitate this.

Question 3 Whether there should be exemptions for certain types of company? If so, which?

24. We consider that there is no principled reason for these or similar reporting/record keeping obligations to be imposed upon companies whose shares are traded on recognised exchanges.

Question 4 Extending Part 22 of the Companies Act 2006 to all companies as an aide to beneficial ownership identification by the company?

[8] http://www.publications.parliament.uk/pa/cm201314/cmselect/cmbis/603/60302.htm

25. We consider that there is no obvious principled reason why Part 22 of the Companies Act 2006 should not be extended on grounds that a company ought to be able to identify who beneficially own its shares.

Question 23 Whether beneficial ownership information held by the company should be made publicly available? How?

26. In our view no sufficient argument has been advanced in support of the contention that beneficial interests of shareholders recorded on a public registry should be open to inspection by the public at large. We are of the view that the default position should be that a person's beneficial interest in shares in a company is a private matter (an interest in property) arising out of private contract, and that strong reasons are required to displace that presumption. Further, the draft MLD4 provides that Member States should ensure that the information in connection with beneficial ownership should be accessible to relevant authorities and the obliged entities (draft Art. 29). There is no obvious reason for providing for super-equivalence ("gold plating"), in particular, where rights of privacy are engaged.

Question 27 Prohibiting the issue of new bearer shares.

27. The Financial Action Task Force recommends that the misuse of bearer shares and bearer share warrants should be prevented and that countries should do one of the following: (i) prohibit them, (ii) convert them into registered shares or share warrants, (iii) require them to be held with a regulated financial institution or professional intermediary, or (iv) require the bearer's identity to be recorded by the issuing company. Of these, the outright prohibition on bearer shares (together with conversion of those that exist) is the simplest solution. However, we can see that there may exist circumstances where bearer shares may serve a purpose and a residual position under (iii) and/or (iv) would meet the requirement of preventing abuse whilst facilitating the utility of such shares in appropriate circumstances.

Question 31 Whether we should more widely communicate the application of directors' statutory duties to all company directors and whether we should – alternatively or in addition – require nominee directors to disclose their nominee status at the name of the beneficial owner on whose behalf they have been appointed? Why? Why not? If yes, should that disclosure be made available on the public record?

28. Nominee directors, in accordance with the (revised) Financial Action Task Force Recommendations, should either be licensed, or the identity of the person nominating them should be required to be disclosed to the company or relevant company registry so that this information may be recorded. There is in our view no self-evident advantage of one of these over others, though since registration and identification of indirect interests appears to be the preferred modality for regulation, this may be convenient.

(Question 32 - *Whether we should make it an offence for a director to legally divest themselves of the power to run the company* - is not understood.)

Question 35 Whether we should prohibit UK companies from appointing corporate directors. Why? Why not?

29. The issue concerning corporate directors is not new. The report of the Jenkins Committee on Company Law (Cmd 1749) of 1962 expressed the view (paragraph 84) that:

> "The Report of the Patton Committee on Company Law Amendment in Northern Ireland (paragraph 17) says:
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> "In our view the responsibility of directors for wrongful acts contemplated by the Companies Acts has been the responsibility of natural persons and this has been lost sight of ...
>
> It is important that it should be known who is responsible for the conduct of a company .... A corporation cannot officiate as a director except by delegating its duty to some of its directors or some officer or servant. The person to whom these duties are delegated may change from day to day. Except by examining the minutes there is no means of finding out who at any particular time is exercising the functions of director when a corporation is director of a company."
>
> We agree with the views expressed by the Patton Committee and recommend that corporate bodies and Scottish firms should be prohibited from being directors."

Much corporate water has flowed under the bridge since, but the reasoning remains compelling. Of course it may be said that individual directors are the

relevant actors on a corporate director's behalf. While that is true, the law in connection with a director's vicarious liability for the acts of a company remains to be fully worked out and, in our view, does not provide a satisfactory mechanism for accountability/liability.

PART B DIRECTORS

Proposal: Liquidators should be able to assign causes of action arising under ss. 213 and 214 IA1986 for fraudulent and wrongful trading.

Question 50 How frequently the possibility of bringing wrongful and fraudulent trading claims arise, are pursued and what value the existing civil remedies for wrongful and fraudulent trading provide?

30. We have not been able to carry out any survey so as to answer this question with a full analysis. However, from our knowledge and experience, the possibility of making applications under ss. 213 and/or 214 arises with some degree of frequency. Applications under s. 213 are difficult to pursue due to the necessity of proving fraudulent intent. They are therefore less frequently made than applications under s. 214. Section 214 provides directors with two main defences. The first is that it can be difficult to prove that there was no reasonable prospect of avoiding insolvent liquidation. Secondly, the director may have taken sufficient steps to avoid loss to creditors.

31. In addition to the difficulty of proving the elements under each section, directors often have few or no assets that might satisfy an order. The benefits of an application under either section may often not justify the costs of pursuing it.

Question 51 Whether, if liquidators were able to sell or assign wrongful and fraudulent trading actions, more actions would be taken? If so, how many more?

32. We do not believe that more actions would be taken if the cause of action were assignable. The considerations outlined above would still apply. However, third parties would not, as the law currently stands, benefit from liquidators' extensive investigatory powers. Further, third parties would not have the company's assets at their disposal to meet the costs of an application in the same way that a liquidator would.

Question 52 The extent to which creditors would benefit from this proposal?

33. The proposal envisages assigning the whole cause of action to a single creditor. That single creditor would incur all of the costs risk and take all of the benefit of any recovery. The benefit to the creditors as a whole, including any creditor who was an assignee, would be the purchase price of the cause of action.

34. Liquidators are officers of the court and discharge a quasi-public function. The fraudulent and wrongful trading provisions are class remedies that arise in the context of a process that is itself a class remedy. Liquidators are bound to discharge their functions properly, having regard to the interests of all the creditors. In addition, and as noted in the Paper, liquidators have wide investigatory powers that are not available to private individuals.

35. Potential assignees, by contrast, may be anyone. They might be creditors. They might be defaulting directors. They might be organisations aiming to profit by taking such assignments. The likelihood is that such persons would be aiming to take an assignment for less than the market value, their bargaining position enhanced by the liquidator's inability to pursue the action. Creditors would also expect a lower prospect of success due to the lack of investigatory powers such as examination and delivery up of books and papers.

36. In our view, the benefit to creditors is likely to be limited only to those creditors who are in a position to pursue actions themselves. The creditors as a whole are not likely to benefit to any appreciable degree. The most likely beneficiaries of such a proposal are likely to be lenders, who will often be floating charge holders. It is likely that if the proposal were adopted, confidence in insolvency as a class remedy would be diminished.

Question 53 What practical difficulties might prevent third parties pursuing claims and how these might be overcome?

37. We envisage that the greatest practical difficulty is the necessity to investigate thoroughly the affairs of the company and the conduct of the directors before an application can be made under ss. 213 and 214.

38. Liquidators have the powers under s. 236 IA1986 to require various persons to attend court for examination and to apply to the court for the productions of books, papers and records. In addition, s. 235 IA1986 imposes on a wide range of persons a duty to cooperate with the liquidator.

39. Potential assignees of a cause of action under ss. 213 and/or 214 would have none of those powers. The ability to obtain information would be limited to compliance with any pre-action protocol, response to the application itself and disclosure. There would be little or no opportunity for any extensive investigation prior to issue of the application, unless the liquidator carried out that investigation.

40. We do not consider that it would be desirable for the liquidator to carry out the investigation with a view to assigning the cause of action. To do so would involve the use of public or quasi-public powers in the pursuit of the private benefit of a single creditor rather than the creditors as a whole. Similarly, we do not regard it as desirable that the public or quasi-public powers provided for by ss. 235 and 236 IA1986 should be exercisable by private parties for their own benefit.

41. In our view, the practical difficulties and the difficulties in overcoming them suggest that it would not be practical or desirable to permit the assignment of causes of action arising under ss. 213 and 214 IA 1986.

Question 54 Whether safeguards would need to be introduced to prevent certain parties acquiring such a claim? If so, to whom should they apply and what form should they take?

42. The particular safeguards canvassed by the Paper are safeguards to ensure that the defaulting directors or persons connected to them do not take assignments so as to prevent the action from being brought. In our view, provided that the claim was acquired by a director or connected person at a proper market value, there would not necessarily be any financial detriment to the creditors.

43. The risks associated with permitting directors and connected persons to acquire causes of action are, first, that they may be acquired at less than their true value and, second, that confidence in the insolvency regime might be diminished. The directors themselves are likely to be in a position to know whether or not there are good grounds for bringing an application against them under ss. 213 and/or 214 IA 1986. It will therefore be in their interests to acquire the causes of action as swiftly and inexpensively as possible. The public perception of the acquisition by directors of causes of action against them is likely to be negative.

44. We consider that an improvement in transparency would be a useful safeguard against abuse. We would therefore suggest that any proposal to assign a cause of action to a director or connected person be put to a vote by the creditors.

Question 55 Whether this proposal would improve confidence in the insolvency regime?

45. We do not believe that it is likely that the proposal would result in more actions being brought. We do not believe that creditors would generally benefit from the assignment of causes of action. We therefore do not believe that this proposal is likely to improve confidence in the insolvency regime.

Proposal: Giving the court a power to make a compensatory award against a director.

Question 56 The benefits of giving courts the power to make a compensatory award against directors?

46. If courts had such a power, we believe it would be likely that the courts would exercise it. Without any indication of any guidance as to the level of compensation and the means of its assessment, we are unable to comment on the likely benefit to creditors, particularly in comparison with the costs.

Question 57 The potential costs and drawbacks of this proposal?

47. We envisage two major drawbacks. The first is that the proposal envisages using a public power for private ends. The second is that incorporating a financial aspect into disqualification proceedings is likely to reduce the scope for compromise by the giving of undertakings and will thus increase costs.

48. At present, the Secretary of State brings disqualification proceedings. They are brought pursuant to a public power, the purpose of which is the protection of the public from the actions of persons who are not fit to act as directors. The proposal is that proceedings for compensation would be brought for the benefit of some or all of the creditors of insolvent companies. We do not believe that it would be desirable for public money to be used to pursue private benefits. At present, solicitors and barristers engaged on behalf of the Secretary of State are engaged at fees considerably below market rates for private work. We do not believe it would be appropriate to make their services available to private parties at those discounted rates.

49. Frequently, disqualification proceedings are compromised by the director giving an undertaking not to act for a specified period. Such undertakings are an effective means of achieving the public protection function without incurring the time or cost of a trial. We believe that introducing a further financial element beyond

recovering the costs of the proceedings is likely to make reaching a compromise more difficult. The result is likely to be an increase in the time and cost of pursuing proceedings, which will in turn reduce the resources available to bring them. Our concern is that confidence in the disqualification regime is likely to be diminished and the public protection function undermined.

Question 58 Who should receive any monies recovered by action: should it be creditors generally or left to the court to determine?

50. We believe that the default position ought to be that monies be applied for the benefit of the creditors generally, with a residual discretion for the court to order otherwise.

Question 59 Whether the IS (acting on behalf of the Secretary of State) should be able to request and agree a compensation award from a director when it accepts an undertaking from the director not to act in the management of a company for a certain number of years?

51. If the Court is able to make a compensation award, we consider it desirable that the Insolvency Service and/or the Secretary of State ought to be permitted to agree to such an award as part of a compromise agreement.

Question 60 Whether this proposal would improve confidence in the insolvency regime?

52. We believe that this proposal is unlikely to increase confidence in the insolvency regime and may serve to undermine it. It is likely to result in a decrease in the efficiency of the public protection regime as it will increase the difficulty in reaching a compromise. That will place a greater burden on the courts and the Secretary of State. In addition, we are doubtful that the public would consider it appropriate to use public money for the private benefit of creditors.

13th September 2013