Trust Law Committee Working Party

Equitable Problems in the Securities Markets

I. Introduction

This paper addresses a concern arising in the secondary markets for securities.[1] Section 53(1)(c) requires that dispositions of equitable interests be in writing. In the past it was not thought that this generally applied to the secondary securities markets, as securities have historically comprised legal as opposed to equitable interests. However, trends towards intermediation and computerisation have, it is argued, rendered the interests of many participants in the securities markets equitable as opposed to legal. The increasing practice is to trade securities electronically, with no written instrument of transfer. The question arises, how are these developments squared with the requirements of section 53(1)(c)? A further incidental question arises as to satisfaction of the requirement for certainty of subject matter to create a valid equitable interest, particularly when interests in specific securities are not allocated to specific clients.

II. The Concern

1. Section 53

The relevant provisions of section 53 of the Law of Property Act 1925 provide as follows:

> "**53 Instruments required to be in writing**.
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> (1)(c) A disposition of an equitable interest or trust subsisting at the time of the disposition, must be in writing signed by the person disposing of the same, or by his agent thereunto lawfully authorised in writing or by will.
>
> (2) This section does not affect the creation or operation of resulting, implied or constructive trusts."

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1 In the secondary markets, existing securities are transferred from person to person. In the primary markets, new securities are issued.

Where section 53(1)(c) applies, the purported disposition which does not comply with it is void, a nullity. Thus, in theory, if secondary market transactions are subject to the section, the lack of written instruments might reduce the rights of purchasers to mere contractual rights, leaving the purchaser of securities vulnerable in the event that the vendor becomes insolvent or seeks to transfer the same securities to a third party.[2]

2. Equitable Interests

A very significant proportion of securities in the secondary market are held through custodial arrangements. The traditional legal analysis of the custody of securities used to be as bailment, on the basis that the custodian held securities in the form of physical pieces of paper for the client.[3] (Under a bailment, the bailor retains a legal proprietary interest in the bailed assets.) However, as discussed below, with the computerisation of the securities markets, intangible electronic records increasingly replace physical paper. There can be no bailment of an intangible.[4] If modern custody of intangibles cannot be characterised as bailment, it needs to be characterised as a trust to achieve the result that the client has a proprietary interest in the custody securities. (Of course, under a trust, the interest of the beneficiary is merely equitable.) Parties are deemed at law to intend the legal consequences of their actions.[5] Therefore, the probable result of a custodian agreeing to hold intangible securities for clients on basis that the client continues to have a proprietary interest in them, is to create a trust. On this basis, the interests of investors which are traded in the secondary market are equitable interests.

There will of course be exceptional cases where the bailment analysis is still available,

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2 In practice, the risk of double dealing may be negligible where disposal is controlled by custodians or clearing systems, whose accounts record the initial transaction.

3 See *Re Hallett's Estates, Knatchbull v Hallett* [1874-80] All ER Rep 793, per Jessell MR at 708; *Kahler v Midland Bank* [1950] AC 24, HL. For custody of bullion, see *Dollfus Mieg v Bank of England* [1949] Ch 369.

4 See N.E. Palmer, Bailment, 2nd ed., London Sweet & Maxwell, 1991, p. 13, p. 99. See also R.M. Dias, Jurisprudence, (5 edn, 1985) Butterworths, London, 281.

5 *Swiss Bank Corporation v Lloyds Bank*, [1980] 2 All ER 419, per Buckley LJ at 426. Further, see *Clough Mill Ltd v Martin* [1985] 1 WLR 111

i.e. where the custody securities are held by the custodian in physical form.[6]

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6 Bailment is compatible with fungible arrangements, whereby the client does not have allocated rights to particular securities: see *Mercer v Craven Grain Storage Ltd*, unreported HL 17 March, (1995) 111 LQR 10.

3. No Instrument in Writing

Historically, bearer securities have been transferred by the delivery to the transferee of the paper instrument constituting the security. The historic method for transferring registered securities is by delivery to the transferee of the transferor's certificate together with a transfer form executed by the transferor; the transferee delivers these to the registrar who updates the register in the transferee's favour on the basis of that documentation.

However, trends towards the computerisation of the securities markets in the late 20th century have removed the role of paper in many transactions. Two developments in particular are relevant here, namely immobilisation and dematerialisation. Both developments are intended to increase efficiency and security in the settlement of securities transactions by reducing reliance on paper documentation.

(a) immobilisation

Immobilisation involves the holding of securities through a depositary or clearing system. Holders of securities participate in the depositary system, and securities and cash accounts are opened in their names as participants by the depositary. In order to deliver securities from participant 1 to participant 2, the depositary debits the relevant securities account of participant 1 and credits that of participant 2. This signifies that the depositary now holds the securities on behalf of participant 2. The underlying securities do not move, and hence the term "immobilisation". If the securities are to be delivered for cash consideration, the depositary simultaneously debits the relevant cash account of participant 2 and credits that of participant 1.

The international securities markets are dominated by two international depositary systems, namely Euroclear based in Belgium and Cedel Bank based in Luxembourg (together, "the Clearers"). The Clearers are international in the sense that they settle securities issued from a wide range of jurisdictions. The Clearers do not hold the underlying securities directly, but rather sub-delegate custody of the securities to sub-depositaries located in the various issuer jurisdictions.[7] (Some of these sub-depositaries are called common

[7] It is convenient to hold securities locally, so that the sub-depositary is able to communicate directly with the issuer and local tax authorities.

depositaries, because they act for both of the Clearers).

b. **dematerialisation**

A further development is dematerialisation, whereby no paper is issued, immobilised or otherwise. In the case of dematerialised bearer securities[8], the issuer of securities arranges with a clearing system to issue securities "directly onto the screen". The securities are constituted by the electronic records maintained by the clearing system, and transfers are effected by debiting and crediting the accounts.

In the case of dematerialised registered securities,[9] legal title to the securities remains determined by the register maintained by the issuer. The clearing system maintains accounts recording the entitlements of participants to the securities, and these accounts should accord with the register. The registrar no longer requires to receive a share certificate and transfer form to effect a transfer, but rather accepts electronic transfer instructions from the clearing system. Transfers are recorded initially in the clearing system, and subsequently reflected in the register.

c. **no instruments of transfer**

In the case of all of the above systems, no instruments of transfer are required for deliveries between participants, which are effected by electronic book entries in the clearing systems.

Parties to transactions may issue confirmations in writing. However, it is not the invariable practice to issue a written confirmation to a counterparty. In any case, these are in the nature of records only, and do not purport to effect the transfer of securities. Moreover, it would not necessarily assist to argue that confirmations amount to written dispositions, as they may post date the date of

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8 The term "dematerialised bearer securities" may be considered self-contradictory. It is used to signify securities which, had they not been dematerialised, would have been in bearer form. An example is dematerialised sterling debt securities in the Central Moneymarkets Office.

9 Examples of dematerialised registered securities are gilts in the Central Gilts Office, and equities in CREST.

the transaction.[10]

4. Statutory Disapplication

In the case of gilts settled through the CGO and corporate registered securities settled through CREST, section 53(1)(c) is disapplied by statute.[11]

5. Relevant Transactions

Where there is no such statutory disapplication, the impact of section 53(1)(c) falls to be considered. The heart of the concern involves the formal or informal commercial settlement systems operated by financial institutions in London. Three examples in particular are relevant here.

- *Internal settlement*. Where both the vendor and the purchaser of securities use the same custodian in London, delivery will in practice be effected by that custodian simply amending its own records, by debiting the relevant securities account of the vendor and crediting the relevant securities account of the purchaser. This is referred to as internal settlement.[12] If the custodian acts as trustee and not as bailee (so that the interests of clients in the custody securities are equitable), such a transaction potentially falls within the scope of section

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10 Most sales of securities seek to achieve delivery versus payment ("DVP"), whereby the delivery of the security is synchronised with the payment of the purchase price. DVP would of course be lost if the securities are only effectively delivered with a confirmation post dating the payment of the purchase price.

11 See (in the case of the CGO) section 1(2) of the Stock Transfer Act 1982 and (in the case of CREST) regulation 32(5) of the Uncertificated Securities Regulations 1995 (SI 1995/3272).

In the case of dematerialised securities in the CMO, it is considered that section 53(1)(c) does not apply, as the interests of participants are legal and not equitable. This is because, in respect of dematerialised securities, the Bank of England as operator of the CMO does not act as custodian. Therefore no custody trust arises under which participants' interest would be rendered equitable. Delivery within the CMO takes place by attornment by the Bank in favour of the transferee participant.

12 "Internal Settlement" is defined by the Bank for International Settlements as "A settlement that is effected through transfers of securities and funds on the book of a single intermediary. An internal settlement requires both counterparties to maintain their securities and funds accounts with the same intermediary". Cross-Border Securities Settlements, May 1995, Basle, Glossary.

53(1)(c) under the principle in *Grey v IRC*[13]

- *Commercial clearing systems*. Certain banks offer a commercial clearing service in London, permitting participants to settle trades with other participants by book entry. In such cases, internal settlement arises not coincidentally, as in the above scenario, but as a matter of course. Again, if the banks hold participants' securities as trustee and not as bailee, section 53(1)(c) falls to be considered.

- *Depositary receipts*. Under depositary receipt ("DR") programs, underlying securities are held by the depositary on express trust for DR holders, so that the DR represents an equitable interest. Until recently, DR programs were usually established under New York or Luxembourg law, using depositaries located in those jurisdictions. A recent development is the establishment of DR programs under English law using London depositaries[14]; this development may bring the secondary market in DRs within the scope of section 53(1)(c).

  In the case of DRs, the use of clearing systems may assist. English DRs may be settled through CREST, in respect of which section 53(1)(c) is expressly disapplied by statute, as indicated above.

  Usually, European DR programs are settled through the Clearers. It may be argued that the use of the continental Clearers takes the transaction outside the territorial scope of the section.[15] (A further argument may be available under the Rome Convention, relating to the formal validity of contracts[16].)

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13 [1960] AC 1.

14 This is due in part to the liberalisation in 1994 of the London Stock Exchange's regime for listing DRs.

15 This argument rests on the proposition that the interest of participants in securities held through the Clearers is located in the jurisdiction of the Clearer, and not in that of the underlying issuer. This proposition will be discussed fully in a further paper to be published by the Trust Law Committee.

16 Under article 9 of the Rome Convention (implemented in the UK by the Contracts (Applicable law) Act 1990), a contract is formally valid if (broadly) it satisfies the requirements of either the law governing the transfer or the law of the jurisdiction in which either of the parties (or their agent) is situated.

This may help where either a foreign law bargain or a foreign situated party is involved. However it would not help with English law bargains between parties situated in London, unless routed through a agent situated abroad.

The chief concern in practice therefore remains internal settlements taking place in London, where neither CREST nor the Clearers are involved.

III. The Answers

1. Constructive Trusts

One ready answer to the questions posed by section 53(1)(c) is to argue that the interest of the purchaser of securities is protected under a constructive trust. It is well established in equity that, when A enters into a specifically enforceable contract to transfer his property to B, A will hold that property as constructive trustee for B, on the basis that Equity looks on that as done that which ought to be done. It would be unconscionable for A to deny B's interest in the property.[17] Of course, contracts for the sale of securities in the secondary markets are not specifically enforceable. However, there is clear authority in *Chinn v Collins*[18] that such contracts do give rise to constructive trusts *when the purchase price is paid*.[19]

Thus, even if the contract of sale is prevented from delivering the equitable interest from A to B by section 53(1)(c), the same result is achieved under a constructive trust when the purchase price is paid by B to A, under the principle in *Chinn v Collins*. A constructive trust is not subject to section 53(1)(c), by virtue of section 53(2).[20]

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17 Oughtred v IRC [1960] AC 206. See also *Neville v Wilson* [1996] 3 All ER 171.

18 [1981] AC 533 (HL)

19 "Then the respondent contended that, granted the identity of the shares sold with the settlement shares, he could not be regarded as a beneficiary in respect of them because he could not get specific performance of the agreement. …in my opinion the whole contention is misconceived. The legal title to the shares was at all times vested in a nominee for N.M.R. (C.I.), and dealings related to the equitable interest in these required no formality. As soon as there was an agreement for their sale accompanied or followed by payment of the price, the equitable title passed at once to the purchaser, viz. Anthony…" *Chinn v Collins* [1981] AC 533, per Lord Wilberforce at 548. See also *Re Lind [1915] 2 Ch 345* and *Palette Shoes Pty Ltd v Krohn* (1937) 58 CLR 1.

20 Where a custodian holds securities on trust for A and A proceeds to hold the securities on bare trust for B (because A has no active duties as trustee) the second trust operates as a transfer of the equitable interest from A to B. This is on

A possible difficulty with this approach lies in the question of allocation; the issue is not considered in *Chinn v Collins*. In many cases, a sale of securities will relate to a particular number of securities within the vendor's holding. Thus the question arises, to which particular securities within the vendor's holding is the constructive trust to attach? Some case law indicates that an equitable interest cannot arise under a trust in such circumstances for want of certainty of subject matter.[21] However, there is more recent (although doubted) authority against this.[22] In any case, even if want of allocation were to defeat a constructive trust, it seems most likely that the consideration provided by the purchaser would lead the purchaser to acquire an equitable interest under a charge.[23] Such a charge would not be registrable under the Companies Act 1985 as it arises by operation of law and not by the act of the vendor. Thus, in practice, concerns about allocation may be more theoretical than real in this context.

In any case, however, the constructive trust argument would not assist with gratuitous deliveries of securities.[24]

3. No Disposition

A further argument is that no dispositions are involved, so that section 53(1)(c) is not applicable. In the case of negotiable instruments in traditional physical form, it has been persuasively argued that negotiation does not involve a transfer, on the basis that the person taking the instrument under a secondary market transaction does not derive

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the basis that equity "looks through" a bare trust under the principle in *Grainge v Wilberforce* (1889) 5 TLR 436; see also *Re Lashmar* [1891] 1 Ch 258; *Corin v Patton* (1990) 64 ALJR 256, per Mason CJ and McHugh J at 272, 273. See also *Re Tout & Finch* [1954] 1 WLR 178; and *Re Arthur Sanders* (1981) 17 BLR 131.

21 See *Mac-Jordan Construction Ltd v Brookmount Erostin Ltd (in receivership)* [1992] BCLC 350, 56 BLR 1,CA approved in *Re Goldcorp Exchange Ltd* [1995] 1 AC 74.

22 See *Hunter v Moss* [1994] 1 WLR 452 and *Re Harvard Securities* [1997] 2 BCLC 369.

23 See *Swiss Bank Corporation v Lloyds Bank Ltd* [1979] 2 All ER 853; [1980] 2 All ER 419; [1981] 2 All ER 449.

24 In cases where there is no purchase price (e.g.where securities are delivered as collateral for stock loans) the requirements of the rule in *Chinn v Collins* are arguably satisfied by the non-cash consideration (e.g. the delivery of the loaned securities). Even when securities are delivered as part of a release of excess margin, adequate non-cash consideration is arguably given by the satisfaction of a condition subsequent (the arising of a margin excess).

title through any transferor, but rather by virtue of his status as bearer or holder in due course; his rights under the instrument derive from the direct original covenant of the issuer to pay the bearer.[25]

It appears that this argument does not apply directly to internal transfers, because of the element of intermediation. The client whose account is credited under an internal transfer does not take physical possession of a negotiable instrument.

In cases where the custodian holds a discrete physical instrument for its clients, it could of course be argued that an internal transfer involves attornment by the custodian, so that the receiving client is the bearer by virtue of constructive possession. However, as indicated above, this paper is concerned with the more problematic cases where the custodian does not hold discrete physical assets for its clients, so that the interest of the client is equitable. Attornment is of course associated with bailment of a physical asset, and cannot apply to an intangible subject matter.

Nevertheless, one may still seek to apply the argument by analogy. The customary arrangements for custodians offering internal settlement is to commingle the assets of its various clients[26]. Therefore the property interest of each client must depend on co-ownership. This co-ownership arises under an equitable tenancy in common whereby the custodian holds, for example, all the ICI shares in its commingled custody account rateably for all clients to whose accounts it has credited ICI shares. A client's interest in the pool of ICI shares arises by virtue of its joining the class of clients to whose accounts ICI shares are credited. The position is akin to changes in the membership of unincorporated associations; although new members become entitled to equitable interests in association property, writing has never been required for changes in association membership.[27] As with negotiable instruments in traditional bearer form, property is acquired not by virtue of a transfer (or chain of title) but on the basis of the individual assuming a certain status that automatically confers a proprietary interest. One might refer to this as succession rather than transfer, and argue that it does not

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25 See JS Ewart, Negotiability and Estoppel (1900) 14 LQR 135.

26 Of course, clients assets generally are segregated from the custodian's house assets.

27 See for example *Carne v Long* (1860) 2 De GF & J, 45 ER 550 and *Neville Estates Ltd v Madden* [1961] 2 All ER 769. Further support for this approach is found in *Ashby v Blackwell and Million Bank* (1765) Amb. 503. See also Underhill & Hayton, Law of Trusts (15th ed) pp.216-217

involve a disposition for the purposes of section 53(1)(c).[28]

IV. Conclusions

Section 53(1)(c) is anachronistic. It replaces section 9 of the Statute of Frauds Act 1677. The latter statute was passed at a time when electronic records were inconceivable, and a disposition that was not in writing would necessarily be oral. One would expect the courts to endeavour to prevent the section from operating to defeat *bona fide* commercial transactions. It has been suggested in this paper that good arguments are available under existing law to show that the section does not affect the electronic securities markets.

However, although considered robust, these arguments are fairly complex. In due course it may be considered suitable to simplify the position by statutory provision. This could put the matter beyond doubt, by disapplying section 53(1)(c) from electronic securities settlement or custodial systems that meet certain criteria. Such criteria might include the authorisation of the operator in the UK, and possibly inclusion on a list maintained by the Treasury for the purpose.

It may be suitable also to disapply section 136 of the Law of Property Act 1925, which requires that legal assignments of choses in action should inter alia be in writing. This would assist any electronic settlement system where no intermediate trust is involved.[29]

[The Treasury (by email of 9 September 1998 from Richard Duncan) in light of the above, has stated: "We will seriously consider disapplying s. 53(1)(c) as part of a package of changes to the Uncertificated Securities Regulations which we are planning for later in the year. We plan a public consultation exercise before the changes are executed, so that there will be a chance to gauge market reaction at that stage."]

V. The Allocation Problem

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28 It is clear from *Grey v IRC* [19650] AC 1 that a disposition involves the movement of property in an asset from one person, or class of persons, to another. No such movement is involved here.

29 This would be useful where the negotiable status of the securities involved is in doubt.

Section 136 is disapplied along with section 53(1)(c) for the CGO and CREST(see section 1(2) of the Stock Transfer Act 1982 and regulation 32(5) of the Uncertificated Securities Regulations 1995.

Such disapplication may assist the transfer of dematerialised securities int he CMO.

Custody of securities generally operates on an unallocated basis, in that the securities held for different clients are commingled together ("Commingling").[30] In order to avoid the risk of client securities becoming available to the creditors of the custodian in its insolvency, the client must be able to assert proprietary rights in them. As indicated above, the client cannot assert proprietary rights in intangibles by way of a bailment, and therefore has to claim an equitable proprietary interest under a trust if it is to avoid custodian credit risk.

There has been some concern in the London legal community that Commingling has the result that a purported trust in favour of a client may fail for want of certainty of subject matter. Concern about this problem ("the Allocation Problem") has focused on a series of cases in which tangible assets held in custody on a commingled basis were made available to the insolvent custodian's creditors.[31] If O owns 12 cases of Chateau Lafite 1961 and tells P that O now holds 3 cases on trust for P, no equitable title passes until O has earmarked which 3 cases are held for P. However, if O had declared he held the 12 cases on trust for O and P in the proportions 3:1, then P would forthwith be equitable tenant in common of one quarter of the holding of 12 cases.[32] In the former case, O has not divested himself of his beneficial ownership in any specific cases out of the twelve (until earmarking some) while, in the latter, O has divested himself of one quarter of his ownership of 12 cases. However, if O does not retain any beneficial entitlement because he declares he holds 3 cases for X and 9 cases for Y, then X and Y between them are absolutely entitled to equitable ownership of all 12 cases, even though having no specific entitlement to any particular 3 cases or 9 cases: by operation of law through their Saunders v Vautier rights as collective beneficial owner, X and Y are beneficially entitled to one quarter and three quarters respectively of the whole 12 cases.

One would then assume the same principle applies if O owns 1200 shares in Lafite Co Ltd and then either tells P he now holds 300 on trust for P or that he holds the 1200 shareholding on trust for O and P in the proportions 3:1 (these are mutually exclusive alternatives). By the very nature of things P cannot acquire equitable (or legal) title to specific assets until it is known to what specific assets his interest relates,[33] so the former intention is ineffective to create any trust while the latter creates a valid trust.

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[30] In some cases, it is not possible for the custodian to operate on any other basis, for example where the securities are held through a Clearer such as Euroclear that does not offer client-specific segregation.

[31] Most importantly, *re London Wine (Shippers) Ltd* [1986] PCC 121 and *Re Goldcorp Exchange Ltd* [1995] 1 AC 74

[32] Re London Wine Shippers Ltd [1986] PCC 121

[33] Re Goldcorp [1995] 1 AC 74. The position would be the same if O was dealing with his bank account containing £1200 and declared to P that he held £300 on trust for P

However, in Hunter v Moss,[34] the Court of Appeal, in dealing with an *inter vivos* trust, made a false analogy with a testamentary gift of 50 shares to X and the remaining 900 to Y, so as to uphold an *inter vivos* declaration of trust of 50 shares for P where O retained the remaining 900 so one could not ascertain which 50 were supposed to be P's and which were supposed to be O's. In the testamentary case, the deceased has clearly divested himself of all his beneficial interest, while in the *inter vivos* case, it is not clear in respect of which shares he has divested himself of all his beneficial interest. The true *inter vivos* analogy is where O declares himself trustee of 50 of his shares for X and the remaining 900 for Y whereupon O has divested himself of all beneficial interest, and so X and Y together can claim the 950 shares (like the 12 cases in the example at the end of the penultimate paragraph).

Neuberger J upon an undefended liquidator's summons in Re Harvard Securities [1997] 2 BCLC 369 naturally felt obliged to follow the Court of Appeal, although aware of the strength of the criticism in Underhill & Hayton, Law of Trusts and Trustees (15th edition) p 61 and the fact that in Australia it was accepted that Hunter v Moss was wrong.

If it turns out that Hunter v Moss is incorrect, an allocation problem arises where the custodian in one transaction buys 1500 bonds on behalf of itself and 2 customers, intending to buy 900 for itself, 400 for B and 200 for C but which 900, 400 or 200? Does this mean that no trust for B or C can arise, so that they are relegated to a contractual claim, or can the custodian be regarded as intending to hold the 1500 on trust for itself, B and C in the proportions 9:4:2? No problem will arise if the custodian allocates 600 bonds for B and C to a larger segregated pool of such bonds exclusively held for clients as tenants in common in proportionate shares.[35] Where the custodian holds a segregated pool of the relevant fungible assets for clients *and itself*, it seems likely that the court will find that there is a necessarily implied intention to create a tenancy in common trust although, to avoid any problems, the custodian's documentation should create an express tenancy in common trust.

In practice, therefore, it seems that the allocation problem should only create problems in the most unlikely event of a custodian wrongfully not creating a segregated pool of the relevant fungible assets for its clients (or for itself and its clients). Thus, there does not seem to be a strong case for new legislation to deal with such unlikely eventualities.

Indeed, there does not seem to be a strong case for legislation to intervene to regularise the

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[34] [1994] 1 WLR 452

[35] Re Clowes (No 2) [1994] 2 All ER 316,325-327

effect of Hunter v Moss by treating a sale or declaration of trust of a specific number of shares owned by S (the seller or settlor) as a sale or declaration of trust of the fraction of S's shareholding represented by the specific number of shares eg, on the lines of the Sale of Goods (Amendment) Act 1995. Except for shares in private companies, S will not normally be a registered shareholder. Where Nominee plc is registered shareholder of 10 million shares in Bigg plc and S acquired an interest in 10,000 of such shares, S is an equitable tenant in common with a one thousandth equitable interest in the shares held by Nominee plc on trust for S and other interested persons. Thus, if S purports to sell, or to declare himself trustee of, "4,000 of my Bigg shares" to or for B, this is an impossibility, so he must be taken to have intended to sell or declare himself trustee of 40 per cent of his equitable interest, which is certain enough.

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