KEY POINTS

- The English Companies Act 2006 does not contemplate the issue and registration of shares by a company via an electronic system of its own making, for example one based on blockchain technology or smart contracts.
- There is no reason *per se* why smart contracts or a blockchain are not suitable to store company records.
- In principle a court could made an order to rectify a register by adding a block or blocks to the blockchain or by ordering that a smart contract is updated.
- A nominee holding legal title to shares in an English company could decide to record the beneficial owners of the interests on a blockchain and transfer interests using smart contracts that add a block to the blockchain.

Feature

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Digitalisation of shares in an English private limited company

This article follows on from the notes in the article: 'Tokenisation in the real estate industry', published in the March 2020 edition of this Journal (2020) 3 JIBFL 198. That article referenced the practicalities of creating digital versions of shares in English companies. Since publication of that article, digitalisation of the economy in the UK and elsewhere has become a hot topic and a priority brought about by, among other things, increased remote working. Digitalisation of share capital, as noted in the March 2020 article, relies on smart contracts and/or blockchain or other new database technologies.

This article considers some of the technical aspects of the digitalisation of shares. The starting point is that, although digitalisation is now upon us, English company law has not recently been updated in this respect and the drafting of current legislation did not anticipate recent developments in technology. This article does not restate the commercial benefits of digitalisation because these are set out in the March 2020 article and many other places.

ISSUE OF SHARES

An English private limited company may issue shares in certificated or uncertificated form. In the case of certificated shares, the company must keep a register of members pursuant to ss 112 to 121 of the Companies Act 2006 (CA 2006) and issue certificates and comply with the rules on transfers of certificated shares in chapter 1 of Pt 21 CA 2006. In the case of uncertificated shares, the company must have its shares admitted to settlement in CREST (in accordance with the Uncertificated Securities Regulations made under chapter 2 of Pt 21 CA 2006). English law does not contemplate the issue and registration of shares by a company via an electronic system of its own making, for example one based on blockchain technology or smart contracts. It follows that the recent innovations in digitalisation that will be considered in this article relate to certificated shares.

REGISTER OF MEMBERS

Section 113(1) CA 2006 requires a company to keep a register of members. That is generally taken to mean that the company must have ultimate and sufficient control over a register containing details of the holders of its shares. That means it must be able to ensure, for example, that any purported transfer of shares that does not comply with the company's articles is not registered, a mistake discovered in the register is rectified (with the agreement of all interested parties or pursuant to a court order) and a transfer of shares is not registered until a proper instrument of transfer has been lodged with the company. It follows that if the register were to consist of blocks on a blockchain supported by smart contracts that identified each transferor and transferee, the board would need to have the practical ability to add a block and to prevent a block from being added to the blockchain. In addition, it follows that it must be possible at any time to extract from the smart contracts or blockchain the information which s 113 CA 2006 requires (that is, names and addresses of the company's members, the date on which each person was registered as or ceased to be a member, share numbers (if shares are numbered) and classes (if applicable) and the amount paid or agreed to be considered as paid on the shares of each member) in relation to all members. For that, it must be clear which and how smart contracts or blockchains relate to shares in the company.

CA 2006 permits "company records" (this includes a company's register of members (s 1134)) to be kept in "electronic form" and to be arranged in such manner as the directors of the company think fit, provided that the information is adequately recorded for future reference (s 1135(1)). If a company chooses to keep its register of members in electronic form, it must be capable of being reproduced in hard copy form (s 1135(2)). "Electronic form" is defined in ss 1168 (3) and (4). Company records in electronic form must be capable of being read. That is, the relevant information recorded electronically (for example on a smart contract or blockchain), must be capable of being displayed on a screen in the English language. The directors are also under a duty to take adequate precautions against falsification of electronic company records (s 1138). It follows that there is no reason, per se, why smart contracts or a blockchain are not suitable to store company records.

The register must be capable of being inspected by members of the public either at the company's registered office or the single alternative inspection location (SAIL) (ss 114(1) and 1136 CA 2006; Companies (Company Records) Regulations 2008). Sections 114 and 1136 together with the Companies (Company Records) Regulations 2008 require that the electronic "company records" (including the register of members)

are kept in a single location, either the company's registered office or the SAIL. On a literal interpretation this would preclude electronic information underlying the register of members (ie in smart contracts or on a blockchain) from being kept on different servers in different locations. It is arguable, however, that the register could consist of information that is stored in multiple locations (for example, electronic data stored on different servers) provided that it is capable of being inspected at a single physical location. The key points would be that the register collates from the smart contracts or blockchains the information required by s 113 and it is clear where that information can be inspected. It follows that (and in the context of increasing digitalisation in commerce) a purposive interpretation of ss 114 and 1136 (together with the Regulations) should conclude that where it is possible to display a readable, electronic register of members produced from underlying smart contracts or blockchains at the company's registered office or SAIL, it should be permissible for those to be stored on servers in different locations.

The register must be capable of being rectified pursuant to a court order. In principle a court can make an order to rectify a register by adding a block or blocks to the blockchain or by ordering that a smart contract is updated. It follows that a permissionless blockchain would not be suitable for a register of members but a permissioned blockchain that is controlled by the company would be suitable. In the same way, it follows that a court order requiring retrospective rectification of a blockchain so that it shows a person to have been a member of the company from a date prior to rectification could also be complied with in principle.

TRANSFER OF SHARES

Under s 770 CA 2006, a company may not (subject to certain exceptions not relevant here) register a transfer of shares in the company in its register of members unless a proper instrument of transfer has been delivered to it. A transfer purportedly registered in violation of this provision is ineffective. A "proper instrument of transfer" is not defined in CA 2006 but has been held to mean an instrument "appropriate" or "suitable" for stamping for stamp duty purposes (*Nisbet v Shepherd* [1994] BCC 91). It need not be an instrument complying in all respects with the formalities required by a company's articles or a stock transfer form as set out in Sch 1 to the Stock Transfer Act 1963.

Under s 17 of the Stamp Act 1891, a director of a company registering a transfer in the absence of a duly stamped instrument of transfer will incur a penalty not exceeding £300 (again, subject to certain exemptions). Directors should therefore not amend the register of members to record the transferee as the holder of the shares unless an instrument of transfer has first been stamped. Legal title to the shares cannot pass (subject to the exceptions) until a proper instrument of transfer has been executed by the transferor and stamped by HMRC (or certified as exempt from stamp duty so as to avoid a penalty under s 17 of the Stamp Act 1891).

The transferor and transferee of a share can appoint another person as their agent to sign a stock transfer form or other instrument of transfer on their behalf. A transferee can also pay the relevant amount of stamp duty to an agent for payment to HMRC on their behalf. It follows that in principle therefore, an agent could be appointed with power to complete a stock transfer form and to pay HMRC. These arrangements could be included in a smart contract to transfer shares and referenced in articles of association of a company.

A smart contract between a transferor and transferee can provide all relevant functionality, for example that: a transferor transfers shares to a transferee, the transferee transfers the price to the transferor (in fiat or a cryptocurrency), the transferor and transferee appoint an agent to complete a stock transfer form (and any other necessary documents) to effect the transfer, and the transferee transfers the amount of stamp duty in fiat currency to the agent for it to pay to HMRC.

Although the functionality described above is a simple matter for a smart contract, it follows from the stamp duty requirements noted above that the contract can only transfer the beneficial ownership of shares. The legal title would not transfer until the stock transfer form is registered by the company. The smart contract could be updated when it is partly executed, that is when money is transferred and the beneficial interest in the shares passes, but the electronic register of members complying with s 113 CA 2006 must not reflect the transfer at that point.

There have been developments in this area. Historically, instruments have been required to be stamped manually with a wet-ink signature by the transferor (or an agent). There have been proposals to digitalise the process, allowing for the electronic submission of instruments of transfer. During the coronavirus (COVID-19) pandemic, HMRC has changed its stamp duty processes and accepts electronic copy documents, electronic signatures and electronic payment. If these or adapted measures become permanent, it would follow that a system permitting tokenised legal ownership of shares is possible for an English private company.

NOMINEE COMPANY

It follows from the above that it has been difficult to transfer legal ownership of shares on smart contracts or a blockchain. Processes have been designed to include prior or parallel steps to satisfy the requirements of s 770 and the Stamp Act but they are not generally considered to be sufficiently compliant or worth the effort. The usual work around is simpler.

Beneficial interests in shares in a company can be recorded and transferred via any system. It follows that a nominee holding legal title to shares in an English company can decide to record the beneficial owners of the interests on a blockchain and transfer interests using smart contracts that add a block to the blockchain. In practice therefore a nominee structure is generally used in these circumstances. A nominee vehicle (usually controlled by the company) owns legal title to all the shares issued by the company and investors in the company own and transfer only the beneficial interest

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in those shares. The use of a nominee and transfer of beneficial interests enables transfers to be effected digitally using a representation (this is often called a security token).

Section 126 CA 2006 provides that trusts shall not be entered on the register of members of a company. Therefore, provided that the transfer of a beneficial interest in a share is recorded in writing and signed, English company law does not prescribe how ownership of beneficial interests must be recorded (if at all). This provides flexibility with regard to most aspects of the design of the system. This includes how title to a security token is to be evidenced. It may be by the nominee issuing some sort of certificate or voucher, keeping a record or register of who owns these, or not doing any of these things. It includes the form in which any record or register is to be kept. This may be in hard copy or electronically including by way of smart contracts and a blockchain. It includes how title to tokens is capable of being transferred. This may be by adding a block to a blockchain. There are different technical solutions for effecting this. There may be one smart contract for all shares or one for each share, for example. The practical requirement is simply that the nominee or someone on its behalf keeps a record of beneficial interests so that the company (or the nominee) knows who to contact in relation to any dividend payments, voting rights and other administrative matters. None of this is prescribed, although of course there must be compliance with relevant generally applicable CA 2006 provisions such as those in Pt 9 relating to the exercise of members' rights.

It also follows that external practical requirements, such as complying with a court order that resolves a dispute about whether a person other than the person recorded as owner on a smart contract or blockchain is the true beneficial owner of a share, can be complied with in a straightforward manner.

OTHER RELEVANT MATTERS

In addition to the points above there is a range of other matters that require analysis in this context. These are the same as are applicable to all digitalisation projects. In this subject area they include:

- The requirement for transfers of beneficial interests to be in writing – under s 53(1)(c) of the Law of Property Act 1925 the disposition of a beneficial interest in a share must be in writing and signed. A readable electronic document displayed on a website providing for the transfer together with an "I accept" button, or something similar, can be considered to satisfy the requirements for writing and a signature. In *Bassano v Toft* [2014] EWHC 377 (QB), Popplewell J held that clicking on an "I Accept" button amounted to a signature for the purposes of the Consumer Credit (Agreement) Regulations 2010. The opinion of the late Mark Hapgood QC did not agree that this was generally applicable, however. The Interpretation Act 1978 defines "writing", and this is often referenced in these circumstances. Simply adding a block to the blockchain when a security token representing the beneficial interest in a share is transferred will not by itself satisfy statutory requirements for writing and a signature. But if the transfer were also recorded in a smart contract that might satisfy the requirement. After execution, the document would need to be stored or capable of being displayed by reference to the underlying smart contract or blockchain.
- The law relating to electronic signatures – an electronic signature is capable of satisfying a statutory requirement for a signature (including the small number of statutory requirements for a document be executed "under hand" (such as s 1(1) of the Stock Transfer Act 1963)) provided that there is an intention to authenticate the document. Some parties to contracts have preferred wet ink signatures in any event as a policy matter but change has been forced upon them by the coronavirus (COVID-19) pandemic. Electronic signatures are now widely accepted (other than where they are not suitable for either a technical or practical reason: for example, lasting powers of attorney, or documents requiring submission to HM Land Registry. HM Land Registry permit electronic signatures provided they comply with the requirements set down in HM Land Registry's practice guide 8 on Execution of deeds (updated a number of times during the last six months, most recently on 7 September 2020). The Law Society published updated guidance on 18 June 2020 on virtual execution and e-signature during the coronavirus (COVID-19) pandemic.
- The use of company/common seals – electronic signature platforms include functionality to allow for electronic company seals but there is no case law or guidance on the use of company seals for virtual signings. It is likely that they do not currently fulfil the requirements of the CA 2006 for seals to be "engraved".

This article is intended to set out the technical reasons for current practice in transactions where shares in an English private limited company are digitalised, often referred to as tokenisation. At the same time, it illustrates that English law is not making things easy for developers and commercial users of new technology. The benefits of and the need for digitalisation in commerce and the economy generally have been shown in the last few months. English commercial and corporate law should serve these commercial interests. It has been said it is like we moved from 2020 to 2030 in a weekend. That is a challenge for English commercial and corporate law. We have done this gradually; now we need to do it suddenly. ■

Further Reading:

- Tokenisation in the real estate industry (2020) 3 JIBFL 198.
- Tokenisation and digital assets: blockchain in capital raising (2020) 1 JIBFL 57.
- LexisPSL: Banking & Finance: Fintech and the debt capital markets.