ShareSoc
UK Individual Shareholders Society

PO Box 62, Chislehurst, BR7 5YB
Phone: 020-8467-2686
Email: sharesoc@btconnect.com
Web: www.sharesoc.org

The Kay Review
Department of Business, Innovation and Skills
Spur 2, Floor 3
1 Victoria Street
London
SW1H 0ET

Via email to: kayreview@bis.gsi.gov.uk

22 April 2012

Response to The Kay Review – Additional submission

Dear Sirs,

Having reviewed the Interim Report of the Kay Review and the submissions by other parties, we hereby submit some additional evidence. It also covers some points that have come to light since our original submission was made.

1. The Importance of Enfranchising Individual Shareholders.

Several respondents to the original consultation emphasised the need to improve the engagement with companies of individual shareholders and to ensure that they vote. Such shareholders have a direct proprietary interest in their investments and do not suffer from the same conflicts of interest or short term focus as do many institutional shareholders.

We said in our original submission that the reports from the Office of National Statistics probably underestimated the proportion of the UK stock market held by private investors. Indeed this was confirmed by the submission from APCIMS in which they said (based on research by the CASS Business School) that "*retail shareholders account for around 30 per cent ownership of FTSE 100 companies*". However in practice most of these shares are held in ISAs or other collective investment vehicles and the beneficial owners are not usually given a vote or even informed on the activities of the companies in which they indirectly own shares.

Indeed, this "disenfranchisement" of individual shareholders probably accounts for much of the shortfall in the voting response at company general meetings because institutions have improved their voting record in recent years.

Regrettably both companies and stockbrokers have conspired in their own interests over the last 20 years to ensure that retail investors are encouraged not to take an active interest in their stock market investments and to abdicate responsibility for monitoring what happens to companies. This has encouraged a "market casino" mentality where short term speculation is encouraged as against longer term investment.

One of the primary channels through which this change has taken place is the increasing reliance on nominee accounts. These accounts disenfranchise shareholders (with a few exceptions). Unfortunately the Government by regulation (no doubt supported by the main beneficiaries who are the stockbrokers), ensured that only nominee accounts could be used for ISA accounts which is the main investment channel for most stock market investment now by retail investors.

Even the minority of stockbrokers who do enfranchise their nominee account holders do so in a way that is both complex and tends not to encourage voting responses (i.e. take-up of the voting service). The provisions of the 2006 Companies Act were designed to improve enfranchisement but in reality have had very little impact due to excess complexity and lack of support from stockbrokers.

2. Use of Personal Crest Accounts

One obvious solution to the enfranchisement of retail shareholders would be the wider use of Personal Crest accounts. As the Interim Report of the Kay Review states: "*Personal shareholders can also become personal members of CREST, the trading and settlement system. However, such membership requires sponsorship by a broker, and only a few stockbrokers – principally large independent private client brokers – offer this service to their clients. HMRC rules require that shares held in an ISA are held through a nominee account.*"

The Interim Report also said "*One option is that personal CREST membership might be the normal means by which UK private individuals hold UK equities*" (para 3.33) and we certainly agree that introduction of this would certainly improve matters enormously. There is no good legal or technical reason why ISA accounts should not be held in the form of Personal Crest accounts (assuming that a linked deposit account to receive dividends and other cash movements is mandated). This simple change in Government imposed regulations would have major benefits with no disadvantages whatsoever.

In addition retail stockbrokers need to be encouraged(if necessary by legislation) to offer Personal Crest membership to their clients in <u>all cases</u> and not to stuff their clients into nominee accounts by default (which new investors often go into simply from ignorance of the alternatives).

3. How Nominee Accounts Undermine Shareholder Democracy

Shareholder democracy is at the core of a healthy corporate sector. Shareholder democracy enables shareholders to debate corporate governance and strategy issues, and influence the board of directors. But shareholder democracy relies on the ability of shareholders to communicate with each other, to form pressure groups if necessary and to encourage and co-ordinate voting on critical issues. In the latter case, it might also involve requesting resolutions or extraordinary General Meetings.

The mechanisms that were originally put in place under Company Law were quite simple. Shareholders were to be listed on the register, and anyone had access to that. So anyone could write to shareholders, and communicate their concerns or garner support. Technically these provisions are still there in law, but in reality have become obstructed in a number of ways. Here is a recent example of the problems in a small company called Intercede on which we are currently running a campaign:

A – The company register contains 300 names/addresses which we requested a copy of. After some argument it was supplied as a pdf document in the most inconvenient possible format so as to make it difficult for us to automatically process it for a mailing. Note of course that only postal addresses are held so the costs of communicating with shareholders under the new postal charges will become very large for most FTSE companies.

B – Of the 300 names/addresses, over 38% of the shares are held in nominee accounts and only 1.8% are held in the direct names of individuals (the balance is held by the directors and some named investment funds). The 38% represents a mix of institutional holders and personal individuals, but communicating with them is going to be extraordinarily difficult from past experience. If one writes to the nominee account address asking them to forward something to their beneficial holders, in general such communications are ignored. There is no legal obligation for them to do so and most will not.

This company is better than many other listed companies where the proportion of nominee account holders will be even higher. In reality the nominee account system and the lax regulation of share register access (which has not been brought up to date to match the modern world of electronic communication), fatally undermines most shareholder democracy actions. If it does not fatally undermine it, it makes it so expensive that only major institutions with already existing substantial holdings can pursue issues and few institutions have the urge to do this.

The wider use of Personal Crest accounts and the discouragement of nominee accounts (indeed we see no good reason why they should not be outlawed for most types of investors) would certainly be one way to improve this situation enormously.

Note that the Crest system already supports the recording of the beneficial owners of nominee accounts by the use of "designated nominee" accounts. The usage of this and the banning of "pooled nominee" accounts, would be one simple step to take.

The Interim Report also noted the difficulty for companies in obtaining information about the beneficial ownership of shares (using Section 793 requests). Most of these difficulties probably relate to requests in relation to institutional holders and particularly foreign entities. Why should any institutional holder be allowed to conceal their identity?

4. Quarterly Reporting and Interim Management Statements.

One aspect reported in the Interim Review was the "*wide consensus among respondents to the Review that quarterly reporting and the preparation of interim management statements have adverse effects on the behaviour of companies and investors*". We did not comment on this matter in our original submission and we do not support the general thrust of that statement. Whether we need detailed quarterly accounts may be questionable, although obviously most companies will be generating consolidated monthly accounts for their own internal purposes so it hardly seems like significant extra effort. However it does help for investors to receive some information on sales, cost and profit trends and some report on exceptional matters.

If the company does not provide such information (because it believes the market may over react to the news), then it will leak out in other ways – for example from meetings between analysts or institutional investors and the company.

As a result instead of open access to information by all investors we will revert to the "closed circle" of favoured insiders that has operated historically in the City of London, much to the disadvantage of many investors.

5. Over Emphasis on Large Companies and Inattention to Small Companies

One problem with many of the submissions to the Kay Review has been the lack of differentiation between the problems of FTSE-100 companies compared with smaller companies. Corporate governance, and the difficulty of shareholder engagement, is a different problem altogether in a diversely held FTSE-100 company to that of FTSE small cap or AIM stocks.

The general quality of board directors is generally high in FTSE-100 companies and their attention to corporate governance principles and moral standards is high, whereas it is, shall we say, more diverse in smaller companies.

But the economic growth in FTSE-100 companies (at least as measured by their share price performance over the last ten years) has not been great. If economic growth is to be pursued in the UK, more attention needs to be focussed on how the stock market supports the needs of smaller companies and provides finance for them. The main UK stock market tends to be a great platform for rapidly and efficiently trading the shares of large companies, but it does very little to promote smaller companies. The AIM market for the smallest companies is a particular problem in that respect in that many of the corporate governance issues are highlighted here. Indeed the AIM market in our view is now so disreputable in a number of ways that it actually discourages small UK companies from listing (and gaining finance via that means). The following is what we said in one of our recent newsletter about the AIM market:

> This article tries to explain why investing in the AIM market is so problematic, and what might be done to improve matters.
>
> Most of our Members invest in AIM companies as well as main market stocks. There are probably few such investors who have not seen particular problems in AIM companies. Let's look at some of the common complaints:
>
> **Poor Corporate Governance**
> Unlike the main market, where corporate governance has improved over the years because of the presence of the Combined Code, AIM companies are not bound by any specific code, and in practice ignore many of the provisions of the Combined Code—for example the requirement not to combine the roles of Chairman and Chief Executive without some explanation. The Quoted Companies Alliance (QCA) have produced "Corporate Governance Guidelines for Smaller Companies", but this is very weak in comparison with the Combined Code and there is no obligation on AIM companies to adhere to it (in the same way that the FSA imposes the Combined Code on fully listed companies). One reason why it is probably so weak is because the QCA represents and is funded by smaller companies—it does not represent investors. Incidentally the QCA have also recently published a "Remuneration Committee Guide", but again it is very weak in comparison with the A.B.I. remuneration guidelines.
>
> **The Backgrounds of Directors**
> One particular problem with AIM companies is that many of the directors do not have lengthy backgrounds in being directors of public companies. As a result, they often do not understand much about best practice in regards to corporate governance. Their experience is often in private companies which are closely controlled and where the company is in practice managed by a few "insiders". You might complain about the lack of diversity on FTSE100 company boards, but you don't get a seat on such boards without usually having some in-depth experience of listed companies and how they operate.

Indeed some AIM company directors seem to have little understanding of Company Law, or the responsibilities of directors as imposed on them by the 2006 Companies Act—the recent events at Media Corporation are a good example of these omissions.

The Quality of Companies
In general companies that list on the main market have an established and profitable business model. They must have a minimum trading record which demonstrates they are not just an idea that might turn into a successful business in due course. On AIM, almost anything goes—so long as the directors can tell a good story in the prospectus.

In addition many of them are now companies with their main operations, and registration outside the UK—even US companies that seem to find it easier to list on AIM than in their home markets. Such companies are not bound by the Takeover Panel code and in general often have poor corporate governance.

As a result, there is a high rate of delisting of AIM companies, for a wide variety of reasons. In March 2007, U.S. securities regulator Roel Campos suggested that AIM's rules for share trading have created a market like a "casino".

Delistings
Campos reportedly said: "*I'm concerned that 30% of issuers that list on AIM are gone in a year. That feels like a casino to me and I believe that investors will treat it as such*". These de-listings may be for a wide range of reasons, not simply financial difficulties. But there is a strong suspicion that the funds raised from investors in AIM listings are often squandered. You can tell this from the historic record of AIM Venture Capital Trusts who can only invest in new AIM share issues—they have a pretty dismal track record and many such companies have now changed their investment policies to avoid AIM.

Investors do get the distinct impression that often directors and the company's promoters take advantage of the listing to sell shares, and when it is no longer convenient to have the listing, then de-list with the result that investors are left as minority shareholders in unlisted private companies—not a happy situation to be in. With insiders often having large holdings, and only 75% of those voting required to support a de-listing, it is often difficult to defeat.

The policy of many wise investors of late has therefore been not to invest in new AIM listings, and not to buy shares soon after the listing, because the share price trajectory is typically downwards. The motto is to wait until the company has stabilised and is showing some real growth before investing.

Some Successes
It's worth mentioning there have been some great AIM success stories of course—companies such as ASOS (which went through some initial difficulties), Abcam, IDOX, Judges Scientific, Lo-Q, Monitise, F.W.Thorpe and some speculative natural resource stocks, but there have also been many failures. A higher failure rate might be expected because of the small size of many AIM companies, but what worries investors is more often the management failings that are evident, and even the lack of ethics in some cases.

The Role of Nomads
One peculiarity of AIM is the role of Nominated Advisors (Nomads) in the regulation of AIM companies. The AIM market is regulated by the LSE (not by the FSA as with fully listed companies). Although there are Listing Rules, a lot of the day to day supervision of companies is done by Nomads who are actually hired and paid for by the companies. In addition it is very common to have a Nomad who also acts as the company's broker, so there is an immediate conflict of interest. The broker wants to present the company in the best light and conceal bad news, while the Nomad needs to ensure it is disclosed.

The whole AIM market is in effect run in the interests of the LSE (who gain financially from having more companies listed), the companies that list and their insiders, and in the interests of the brokers and company promoters who gain fee income.

The interests of investors are marginalised and they have had very little impact on the setting of AIM regulations for example. It is not clear that the main stakeholders have much interest in improving the quality of AIM companies and their directors, because they probably make more money from the churning of company listings than anything else.

Weak Enforcement

One particular problem with the AIM regulation regime is the lack of effective enforcement. Even though a company, or its Nomad, have been penalised by a censure or a fine, this may not be publicly disclosed. In addition the fines for infringements are quite small—for example a fine of £250,000 on Nabarro Wells for failing to do adequate due diligence which resulted in a £375m fraud at Langbar—a company that listed with claims of large assets which in fact never existed.

High Spreads and Low Liquidity

One of the persistent problems with many AIM stocks is lack of trading in the shares. It is not a problem with all AIM companies, but many companies who have hit temporary difficulties or are simply not growing as expected become walking dead or zombies. Lack of market attention causes the shares to drift, investors don't trade them, and liquidity disappears. Market makers widen the spreads as a result—sometimes to more than 20%, which deters share trading even more. In such cases, directors see little point in maintaining the listing and incurring the cost. Even if they cannot de-list because of institutional shareholder opposition, they are stuck in limbo, with little ability to raise new funds.

Placings to Pals

Another annoyance to investors in the AIM market in the past has been the frequent occurrence of share placings at large discounts to the prevailing market share price to a favoured group of insiders. Shares are issued to directors and to a small group of other investors while existing minority shareholders cannot take part, i.e. there is no "open offer". Pre-emption rules are ignored (as followed by main market companies). Such placings, and particularly if done at substantial discounts, can be enormously prejudicial to existing investors because of the dilution that takes place. Even if a vote is taken on the placing, it can often be passed because of the large stakes in AIM companies held by insiders.

Remuneration

Director remuneration in AIM companies often shows how these companies are run more in the interests of the directors and management than in that of investors. There are some particularly outrageous examples of poor remuneration policies with grossly defective performance incentives and wildly excessive total remuneration. Recent examples that ShareSoc has covered are Conygar and Intercede.

What to do about these issues is covered below.

How to Improve the AIM Market

It is surely in the interests of all stakeholders in the AIM market to tackle some of the issues covered in the previous article. Otherwise investors will not invest in it, and companies will list on other markets instead or stay private. The three key issues that ShareSoc perceives are:

1. How to improve the corporate governance of AIM companies, and their general regulation.

2. How to improve the quality of AIM company directors and enhance their ethics.

3. How to improve the liquidity and reduce the price spreads on many AIM companies.

ShareSoc has had a meeting with the Head of AIM recently as part of our advocacy role on behalf of shareholders. We have also met with other LSE staff on the liquidity issue. After discussing some of the issues, we have subsequently formulated these specific suggestions which we think might assist:

A—Individual shareholders (who are often substantial stakeholders in AIM companies) should be represented on the consultative body for AIM in the LSE.

B—Regulation should be toughened and all censure/penalties on Nomads or AIM companies should be publicly disclosed, i.e. they should be "named and shamed".

C—If a complaint is made to the LSE on a regulatory matter, complainants should be given some information on the progress of the case and ultimately what conclusion was reached (at present they often seem to disappear into a black hole).

D—There should be more stringent rules on initial listings and better due diligence, to stop poor quality companies coming to AIM. We think this is the best approach to prevent excessive numbers of de-listings.

E—The LSE should introduce an equivalent to the Combined Code for AIM companies including some guidelines on remuneration such as those published by the ABI. It might not be quite as onerous, with less bureaucracy involved, but there should certainly be specific rules on the number of non-executives, the need for a non-executive Chairman and the avoidance of dilutive placings for example. A few simple rules would be better than none, which is what we have at present.

F—The roles of company broker and Nomad should be clearly separated, i.e. the same organisation should not act in both roles.

G—There needs to be some basic education of AIM company directors on Company Law and Corporate Governance. We suggest that at least two directors of all AIM companies need to have been on such a course (which could be relatively short) and hence obtained a specific qualification.

H—Spreads and liquidity need tackling by imposing rules on market makers, with a minimum two market makers per stock.

As you can see, we suggest there are a number of ways in which AIM needs to be improved so as to provide a proper "junior" market for smaller UK companies. Regrettably we doubt that our suggestions will be taken up by the LSE and, as we said in our previous submission, we suggest that regulation of the AIM market should be taken over by the FSA rather than it remain as a self-regulated market.

6. Lack of Competence of Directors in Small Companies

As we have pointed out above for AIM companies, but it is a general problem in all small listed companies, many directors of such companies do not always have sufficient understanding of the responsibilities of the directors of a public company and their obligations to shareholders or other stakeholders. The present position is that anyone can become of a director of a limited company (with a few minor exceptions), and we would not wish to see any change in that general rule. But if a company is a Plc and hence has more than a few shareholders, or is publicly listed on any stock exchange (including AIM), then we suggest that some minimal qualifications should be imposed on one or more directors of such companies and suitable education courses developed.

7. The Efforts of Non-Executive Directors

Shareholders normally look to the non-executive directors to protect their interests and provide some countervailing influence and knowledge to the power of the executive directors. But it is apparent that they have not adequately performed this role in many cases.

One of the problems we perceive here is the limit on the time and effort put in by some non-executive directors simply because they have too many other commitments. For example, Coutts have reported that 31% of non-executives have between 5 and 25 such roles and we question whether such people can be adequately fulfilling their duties, particularly if they also have other business interests or are acting in an executive capacity in one or more companies.

We would like to see a specific limitation on the number of non-executive positions taken by directors in public companies (we suggest 3 would be an appropriate limit with some flexibility to go above that limit given appropriate justification), and some guidance also on the number of other executive roles or business activities.

That concludes our further submission to the Kay Review and we hope you will take notice of our comments.

Yours sincerely

Roger W. Lawson
Chairman

About the UK Individual Shareholders Society (ShareSoc)

ShareSoc represents and supports individual investors who invest in the UK stock markets. We are a mutual association controlled by the members with "not-for-profit" articles and incorporated as a company limited by guarantee. The organisation is financed by member subscriptions, donations from supporters and by the services we provide to members. More information on ShareSoc can be obtained from our web site at www.sharesoc.org (our objects are fully defined on this page: www.sharesoc.org/objects.html).