SHAREHOLDER COMMITTEES

A way to improve shareholder engagement

This document explains how shareholder committees might be used in the UK to improve corporate governance and the oversight of companies by their shareholders.

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A WAY TO IMPROVE SHAREHOLDER ENGAGEMENT

FOREWORD

It is widely acknowledged that there are a number of problems with the governance of public companies at the present time. Despite the introduction of the Combined Code, the presence of nominally independent directors, the annual re-election of directors and of other changes in recent years, there are still frequent failings by boards. For example, the excessive and rapidly rising pay packages of directors in some companies has been highlighted by many commentators as an example of the difficulty that shareholders have in influencing the board of directors of companies. Indeed, although improved “engagement” with companies by institutional investors has been promoted in the Stewardship Code, in practice it still seems to be ineffective. That is not just because investors do not try to have some influence, but because ultimately they can be ignored.

The reason for this is because directors in essence appoint themselves and are not directly accountable to shareholders other than at an Annual General Meeting which has become rather a formal ritual where no real scrutiny of the affairs of the company takes place (most shareholders, particularly the major institutions, do not attend). As regards board remuneration for example, although there is a vote on the Remuneration Report, which is only “advisory” of course, this is a retrospective review of past decisions by the board and has little real influence on future pay trends except in extremis.

More explanation of the nature of some of the problems that result is given in our Policy Manifesto (in the Section entitled “Why these policies are needed”) – see www.sharesoc.org/policies.html for our full policy manifesto. One of our proposals in the Manifesto which we see as key to solving these problems is the introduction of “Shareholder Committees”. Such Committees could enable shareholders to regain ultimate control over the business which they own, without affecting the operational management of the company in any way.

Continued....
This document has been written to explain how Shareholder Committees could solve the perceived problems, and how in practice they might work, without laying down all the detail which would have to be subject to further work and debate. But the key aspect is that they might bring about a change of corporate culture where the boards of companies recognize they are the stewards of the company on behalf of the shareholders, and should work with them, rather than them perceiving their role as the only competent body to oversee the affairs of the company. In other words a more “consultative” approach.

Obviously this document has been written by an organization that promotes the interests of private shareholders, who have been particularly abused by developments in recent years. Although directly or indirectly they represent a substantial proportion of the shareholders in most public companies, their views are generally disparaged and their voting rights have been lost. But the proposals contained herein are not intended to give them or anyone else a privileged position, but to generally improve the lot of all investors in public companies. In addition the proposals should improve the health and vitality of the UK commercial scene so that the UK can effectively compete in world markets.

Roger W. Lawson
Chairman
Shareholder Committees – What Are They?

Shareholder Committees can take many forms. But as discussed in this document we suggest **they should primarily take on the role currently taken by board sub-committees that recommend on the appointment on new directors and that recommend on board remuneration.** They would also have a role in reviewing the appointment of auditors.

Their recommendations would be made to the board who would then put them to the Annual General Meeting in the form of appropriate Resolutions. It is important to emphasize that they would have no binding authority or statutory position in Company Law – at least not as initially envisaged. This means that no changes are required to legislation to implement such a concept. They might be adopted in the Articles of companies if the shareholders desired it, although that is not a pre-requisite, or as recommendations for good practice in the Combined Code.

They could be applied to all kinds of public companies from the largest to the smallest – indeed in any companies where the shareholder base is so diverse that they lack effective means of communication with the board and the ability to influence its decisions on the three matters mentioned above.

Such a Committee would not be dictating to the directors how they managed the affairs of the company, and neither would they be determining company strategy. They would simply be advising the board on the three specific areas and would normally expect the board to follow their recommendations in those areas – as the board does at present from existing board sub-committees in general.

Clearly there might be some debate if the board did not agree with the recommendations so as to achieve a consensus. However, just as companies consult their major shareholders at present before making important decisions, the board could consult such a Committee on anything they chose simply on the basis that this would be a convenient forum from which to take advice.

We envisage one Shareholder Committee for each company covering all the three issues mentioned, not separate ones for each function, simply on the grounds of keeping the arrangements as simple as possible.
Who Would Sit on a Shareholder Committee?

In essence, shareholders should dominate these Committees (or in the case of corporate shareholders, their representatives, of course). But it would be important for the board of the company to be able to present information and put proposals to the Committee so we would anticipate that at least one board director would sit on the Committee – probably the company Chairman.

Should there be other stakeholder representatives on the Committee? We suggest there might be, subject to the discretion of the board and the Committee. For example, it may be a good way to introduce an employee representative, or a representative of the local community where a company has a major impact on local affairs. The more varied voices and the wider spread of views the better in achieving a consensus on many issues. Employees might have a lot to say about levels of board pay for example, but we see such non-shareholder representative as being in a minority even if they were introduced.

Is This a New Idea?

Shareholder Committees are not a new idea, and ShareSoc cannot take credit for inventing the concept. Indeed a shareholder “Nomination Committee” for the appointment of directors and determining their pay has been in use in Sweden for some years, and how this system operates in practice was well described in a report from Tomorrow’s Company entitled “Tomorrow’s Corporate Governance” – see www.tomorrowscompany.com/publications.aspx

That report suggested that such a system could evolve in the UK, just as it did in Sweden, given some commitment from companies to improve shareholder representation. Otherwise the use of such a system in Sweden seems to have had a positive effect on shareholder engagement. Note that the structure of shareholdings in listed companies in the Swedish stock market is somewhat different, though not now enormously different, to that of the UK market. Likewise main board operation and company law is of course different in minor ways. But in essence there are more similarities than differences and these are not sound arguments for dismissing such examples as irrelevant.

There have been past attempts to introduce shareholder committees in the UK (for example there was a private bill introduced by an M.P. in Parliament). These were aimed to improve shareholder engagement and improve the influence of minority shareholders so they had broader objectives than those contained herein. The proposals also contained some obvious practical difficulties, and as a result did not gain widespread support at the time.
How Would Committee Members be Selected?

It is important that the Committee Members are representative of a broad section of the shareholder base. Likewise the largest shareholders should have more representation (if they so wish of course) so that their views are adequately represented. It is also wise that Committee Members should have some knowledge of the affairs of the company concerned and the market in which it operates (i.e. they should be “informed” investors), and that they have some general background in financial and business affairs.

Within those general parameters there are many ways that Members could be selected. For example, the four or five largest shareholders could be invited to nominate members, with other members being co-opted from smaller shareholders as necessary so as to provide a broader representation.

The shareholder base of a UK listed companies is often now very diverse with no one shareholder holding more than a few percent and a “long tail” of smaller institutional holdings. In addition there are often many holdings from foreign entities (who should certainly be encouraged to participate but might have practical difficulties in doing so). In addition there are often significant numbers of private shareholders although their apparent representation might be less than in reality because they are concealed behind a few nominee accounts (see below for discussion of private shareholder representation).

In reality, it may not matter exactly how Members are selected because most shareholders are likely to have a common interest in promoting the long term success of their investment (and hence the company). Those who are short term holders or traders in the shares may not have an interest in participating in any case.

The key differentiation between the proposed arrangements and the existing one is that the Committee will have the interest of the shareholders as their main concern, unlike at present where the directors might have their own self-interest at heart on matters such as pay. A Shareholder Committee would be truly independent of the company board of directors and its executive management. Hence any advice they give is likely to be unbiased. But they would need to justify any such advice to the company board and to a general meeting of shareholders.

Shareholder Committees should themselves establish how members should be identified and selected. There may be different approaches for different companies – clearly larger companies with more diverse shareholdings may take a different approach to those where there are more concentrated shareholdings. Institutional shareholders would clearly need to identify people who could represent them on a Shareholder Committee – although they would not necessarily have to be employees of the institution.

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The success of such a system does depend on the engagement of shareholders and their need to act as “owners” which has been one of the things lacking in recent corporate history. The problem of “absentee landlords” who do not pay close attention to the interests of shareholders has corrupted shareholder democracy. For example institutions who manage funds on behalf of other investors but have no direct interest in a company may act very differently to direct shareholders.

One issue that might arise, and hence is worth mentioning, is the problem of becoming an “insider”. Committee members might become aware of “price sensitive” information. For example, although board pay is not likely to be a particularly price sensitive matter, the appointment of a new chief executive might be. Institutions may be reluctant to participate if they were barred from trading in the shares of the company as a result of becoming an “insider”. The solution to this is to establish a protocol or “Chinese wall” between Committee members and the trading arms of the body they represent.

This issue is already present in that companies do consult their major shareholders about important decisions, without such discussions necessarily becoming public knowledge. This whole subject probably requires further consideration because it is unclear at present how shareholder democracy can be supported if the board of a company, or any proposed Shareholder Committee, cannot discuss strategic options.

One person on the Committee should be a board director who can act as the communication channel between the board and the Committee, but they should not act as the Chairman of the Committee who should be appointed by the Committee Members from their number.

Note that the shareholders in General Meeting should approve any selection method that is to be used to appoint members of a Shareholder Committee.

It is important to emphasize at this point before moving on that the quality of people on any such Committee would be very important. No board, and neither will shareholders, respect the views of a body whose members cannot speak from knowledge and experience and promote their views in a logical manner. It should not be difficult to identify the kind of personal background that would qualify people to be Committee members, and document those parameters in corporate governance guidelines. We would like to see such Committees dominated by people with a broad knowledge of business affair rather than by those with academic or professional qualifications. We also suggest that anybody proposing someone for members of such committees should ensure that they had suitable training and mentoring (as ShareSoc would do for private investors).
The Role of Private Shareholders?

Individual shareholders are often long term investors who have a strong personal interest in the success of a company. They often have lengthy business backgrounds and are frequently very experienced investors in a wide range of companies. On the other hand, some will have limited experience of financial and stock market regulations and practice, plus they do not always have the right personal attributes to take part in Committee meetings. Also of course they might similarly be reluctant to accept becoming an insider of a company in which they hold shares. So any involvement of private shareholders in a Shareholder Committee would have to be carefully considered. The best solution would be if they could be represented by a person nominated by a recognized body such as ShareSoc who have taken on the task of generally promoting the interests of such shareholders. They could bring the views of individual shareholders to the table.

ShareSoc would have to ensure that anybody that they put forward as a representative was suitably qualified, trained and experienced to take on the role.

How They Might Work and Why They are Needed – Board Appointments

One of the reasons why it is very important to give shareholders more say in the appointment of board directors is because without that, shareholder “engagement” can ultimately be defeated. There are many examples of major shareholders disagreeing with the strategy of a company, or taking a dim view of the existing Chairman or Chief Executive of a company. One only has to look at the campaigns mounted by “activist” institutional investors or by private shareholder “action groups” in recent years to see that “engagement” is often pursued initially to no effect. A board can be immune to shareholder influence (directors who have been there a long time can be resistant to change), and most shareholders have insufficient votes by themselves to be seen as having enough influence. But they cannot easily communicate with other shareholders. Only the company can easily do so and they can “manage” the process by speaking to their shareholders individually and emphasizing the widespread support for their own views, whether there is or not.

The end result is that one of the few options for activist investors if their views are ignored is to escalate the matter to a full blown public dispute, and try to put an appropriate resolution to a General Meeting. That can be very damaging to the interests of the company, and consume a large amount of management time, much to their annoyance.
A good example recently of this “negative” approach to shareholder engagement was the attempt by Laxey Partners to encourage a more active discount management approach at Alliance Trust. Ultimately it was successful, but not without a public airing of the competing views with allegations from both sides that became quite forceful.

That of course is an extreme example of where the board might not have been representing the views of some shareholders as they wish. But even more problematic is engineering a change of Chief Executive or Chairman. A person already in those roles may have a very dominating influence on a board, from a long standing involvement in the company and his personal relationships with the other directors. In theory one could approach the Senior Independent Director, or the Nomination Sub-Committee and express one’s concerns but a single shareholder speaking out is likely to have little impact.

One of the problems is that the directors appoint themselves via the nomination board sub-committee. This creates problems with the “independence” of directors and the diversity of boards – two problems that are well known. Non-executive directors do not frequently challenge the executive directors, as was very evident when looking at the recent history of banks and their involvement in risky business and investment strategies. Non-executive directors are keen to retain their positions and they realize that their continuance on the board depends on the views of the nomination sub-committee – in other words of other directors. So a culture of “conformance” results. Likewise nomination sub-committees tend to select new board members who they know will “fit-in” with the existing board and not dispute their past decisions. So boards tend to become in-bred with similar backgrounds. If shareholders perceive that substantial change is required, this can often be defeated as a result.

Obviously it would be wrong to ignore the views of existing board members, or the current consultants they might employ to review board appointments, but the existing system is a recipe for conflict with shareholders rather than consultation. The use of Shareholder Committee to ensure that the broader views of shareholders were taken into account in the appointment of new directors, or any general restructuring of the board, would solve many of the perceived problems.

It is worth quoting from the Tomorrow’s Company report mentioned above where they discuss the view that company Chairmen and Non-executive Directors may feel they sense the needs of the company and know the dynamics of the board better than a Shareholder Committee ever could. What the report says is: "It is true that chairs and NEDs are closer to the board members, knowing them better and seeing them in action at close quarters. But it is precisely this closeness that becomes the issue, exposing boards to the risk of group-think, a lack of objectivity, an excessive sense of loyalty to established colleagues, and a tendency to recruit ‘people like them’."
In essence a Shareholder Committee would take over the role of the existing board nomination sub-committee and operate in the same way. It would take advice from the company executives, board members, and recruitment consultants as needed.

Chairmen of companies might complain that their role might be undermined if they did not have the current level of control on board composition, but that might be a good thing in some companies as it would prevent the excessive dominance of boards by their Chairmen. In any case the Chairman could make his views known to the Shareholder Committee on any board changes.

The key here is to evolve into a more consultative approach and restore more power to the shareholders who after all are the owners of the company. But it is not so abrupt a change as some might perceive.

"The key is to restore more power to the shareholders who are the owners of the company."

How They Might Work and Why They are Needed – Board Remuneration

It would be wrong to suggest that the pay of all directors in all public companies is excessive. But it has clearly been growing much faster than the pay of other employees in some companies. Indeed it has reached levels where some people think it has become socially divisive. A good report on this has been produced by the High Pay Commission (see http://highpaycommission.co.uk/).

So far as shareholders are concerned, their main concern is that the pay of directors can actually reach the point where it reduces the returns to shareholders – for example by reducing the available cash distributable via dividends, or diluting their share interest by excessive grant of “free” or low cost shares via LTIPs or via share options. In addition, if pay at the top of a company rises, then it does tend to have some impact on the pay of senior management generally (even if not at the bottom of the company) which can divert profits to employees as opposed to shareholders. Or shareholders might believe that a very wide disparity in pay within an organization can undermine social coherence – it encourages employees to think that the senior management are solely motivated by their own personal financial interests rather than the good of the company as a whole. Indeed some directors can obtain so much wealth via remuneration in so few years, that they might be assumed to be motivated to take a very short term view of a business whereas other employees and shareholders have longer term interests.
Why has director pay been increasing so rapidly in the last few years? One reason is the problem already covered where shareholders have lost influence over the board. Pay is now set by a Remuneration board sub-committee, after they have typically taken advice from remuneration consultants. They have little motivation to reduce recommendations and boards tend to take the view that they should all be in the top quartile of comparator companies – so as to enable them to attract the best people. As a result there has been repeated “leap-frogging” of pay levels, or as one writer recently called it – a “trickle-up effect”.

Annual General Meeting resolutions to approve Remuneration Reports were introduced a few years ago in the UK to try and establish some control over pay, but to little effect. Such resolutions are only advisory and are voted on in retrospect (which is rather equivalent to shutting the stable door after the horse has bolted). Despite the sharp growth in total pay, very few such Resolutions are voted down. Perhaps that’s not surprising because in the case of major institutions, the board will know who voted against such a Resolution and that might lead to a significant freezing in the relationship between the board and that investor (for example access to the board by the institution might become more restricted).

Of course there are good reasons why Remuneration Sub-Committees do not work to control pay (Ruth Bender of Cranfield Business School has written widely on this subject if you want more background including a very revealing paper entitled “The Platonic Remuneration Committee” available on the internet). One problem is that such sub-committees now have members who are directors and whose pay tends to reflect the pay of other directors. So it is hardly in their own personal interests to exert downward pressure on pay levels. In addition, as their retention as a director tends to depend on the views of their fellow directors, they will hardly want to stand out against the views of other directors on what the latter’s pay should be.

A Shareholder Committee would simply act in the same way as the existing board Remuneration Sub-Committee. In other words, it would take advice from the board and from Remuneration Consultants before putting recommendations to the board (and subsequently to the AGM perhaps). It might be possible therefore to enable a Remuneration Resolution that defined future pay to the AGM, but clearly there would need to be the ability to change remuneration, or to set it for new appointments, during the year.

Moving pay determination into an independent forum such as a Shareholder Committee is not the only change that might be required to bring pay under control, but it would certainly be a major step in the right direction.

One difficulty at present is the complexity of pay arrangements such that the total remuneration package, and how it relates to levels in other companies, can be very difficult to both determine and to comprehend. This might have to be solved in other ways.
A Shareholder Committee could also recommend the appointment of auditors and their remuneration. The role of auditors has come under scrutiny of late because of their failings to identify significant accounting abuses, particularly in the USA which led to onerous legislation being introduced. However their role in the UK banking crisis has also been criticized for allowing banks to operate with apparent imprudent levels of reserves, to produce accounts which most people had difficulty in understanding and failings in their valuation processes on complex financial instruments. In smaller companies (and an example was AIM listed Aero Inventory), there seem to be more basic and quite common failings in the scrutiny of accounts and the reliance on the opinions or statements of directors - which of course is why shareholders and not directors might be best to scrutinize such matters.

The role of auditors in sometimes acting as consultants to companies on non-audit matters has also been questioned (there is a suggestion that such revenue might bias their audit role), and the lack of apparent competition between audit firms and the low level of switching which builds an incestuous relationship between audit firms and their clients has been criticized.

Even more than with Remuneration Resolutions, the impact of the need for shareholders to vote on a Resolution to approve the appointment of auditors has been minimal. It is a very exceptional case where there is any significant vote against the board’s recommendation on auditors, and we cannot recall a single instance where such a resolution has been voted down. For example PIRC recommended recently to vote against the appointment of PwC at TUI Travel, for possibly good reason, but the result was only 7% against with 6% abstaining. Introducing an independent body into the audit relationship will surely avoid some of these problems.

However, the discussions about audit matters can take a very technical slant and a Shareholder Committee might not have many financially qualified members on it. We therefore propose that a Shareholder Committee only gets involved in reviewing the work of the Audit function if there are concerns about the financial accounts of a company, or an obvious need to consider a change of Auditor. In other words, there is no proposal to change the role of the board Audit Sub-Committee in essence, but the Shareholder Committee should have the ability to review the work of the board Audit Sub-Committee and the role of the auditors, and recommend a change of Auditor if necessary.

This might enhance the accountability of auditors to shareholders, which has been seriously undermined by the Caparo judgment and other trends in UK audit law. Again though it is important to emphasize that the role of the Shareholder Committee would be advisory on the board and to the shareholders convened in General Meeting.
What Might be the Objections?

Some of the possible objections to Shareholder Committees have already been mentioned above. Such as the impact on the role of company Chairman – it might weaken their position – the difficulties some institutions might have in getting involved and the problem of recruiting competent individuals to become members of such committees. It has been pointed out that those institutions that typically have the largest stakes in UK companies might need to be represented on hundreds of Shareholder Committees, but this would not be essential, unless they had a particular interest in being so represented. What matters is that there are simply sufficient nominees from a broad spread of investors to be representative of them and of their interests.

The issue of recruiting sufficient competent individuals, and resolving conflicts of interest, do not seem impossible of solution to us, and the overall benefits of Shareholder Committees seem to strongly outweigh the possible disadvantages in a reduction in the power of boards and their Chairmen.

Indeed the whole point of these proposals is to slightly adjust the power of shareholders versus the power of boards, where the latter seem to have lost sight of the foundations of shareholder democracy.

The increased fragmentation of shareholdings, the use of nominee accounts (that disenfranchises most private shareholders and generally leads to low voting turn-outs), and the fossilization of Annual General Meetings has put much more power into the hands of board directors then the original limited company legal structure anticipated. Directors now have control over the communication channels to shareholders whereas the latter cannot communicate with one another easily. This needs rectifying by the introduction of new concepts and systems and a Shareholder Committee system would be one aspect that would assist.

Complementary to the Stewardship Code

It could be argued that the engagement of shareholders with companies will be enhanced by the introduction of the UK Stewardship Code (refer to this web page for details: www.frc.org.uk/corporate/investorgovernance.cfm) and that it might be premature to introduce further changes until the impact of that Code has become obvious. However there are two points to make on this:

We see the Stewardship Code as complementary to the use of Shareholder Committees. The Stewardship Code is designed to encourage institutional investors to monitor companies in which they invest, to use their votes, to act collectively with other investors when necessary and more generally “engage” with company management. But without the presence of a Shareholder Committee, the extent of influence any investor might have is quite limited.
Certainly on matters of board appointments and pay, even if investors are adhering to the Stewardship Code, it does not mean that companies will be paying attention. In addition of course the Stewardship Code does not provide for any real engagement by private shareholders or smaller institutional investors as there is no obvious “platform” to enable their engagement with company management.

In reality, a Shareholder Committee would support the role of the Stewardship Code in improving the engagement of shareholders with the companies in which they invest.

**What Should be Done to Implement Shareholder Committees?**

Any company could adopt a Shareholder Committee tomorrow if they so wished. A board of directors can take advice from anyone they choose including a committee of shareholders. But a large public company might not wish to do so without wider support for this approach – for example the presence of board sub-committees for nominations and remuneration is part of the Combined Code so removing them instantly would be problematic.

So it requires a lead from the Government or from standards bodies such as the FRC (and the FSA who have responsibility for the Listing Rules which reference the Combined Code). Alternatively it could potentially be imposed by a Resolution from shareholders - Company Law enables any shareholder to requisition such resolutions if they can garner sufficient votes.

Note that the board of directors would continue, as at present in UK Company Law, to prepare the required Resolutions to put to General Meetings of a company, based on the recommendations of the Shareholder Committee. Therefore they would of course need to support those recommendations – but this could be made an obligation under the Combined Code. We would certainly recommend that it be introduced gradually as a requirement so that experience could be obtained before it was widely introduced, and so that good practice for the role and membership of such Shareholder Committees could be established.

Note that we have not attempted to cover all the details of how Shareholder Committees would operate in this document. For example, how members would be selected, whether they were paid, whether they would report formally to shareholders or the board, and many other aspects. It would be best to establish such matters by debate among shareholders and companies so as to ensure a good practical system was established and to counter problems or objections that any parties can foresee.
A working group to establish some recommendations under the auspices of one of the bodies mentioned above would be one approach to take matters forward. But we also suggest that a wider political consultation on this matter be undertaken. The role of public companies, and the way they are governed is of wide interest not just to the financial community but also to the general public. Most people are employed by limited companies of which most are listed public ones, and pensioners are largely dependent on the wealth that such companies generate.

**In Conclusion**

We hope that you have read this document with an open mind and can see the advantage that a Shareholder Committee might bring in improving the oversight of a public company. We see it enabling companies and their shareholders to move from a confrontational approach to a more consultative one, with less need for public disputes and quicker resolution of issues as a result.

Some companies have suffered from damaging boardroom battles when trying to change underperforming CEOs or Chairman (Marks & Spencer was an example). A Shareholder Committee could assist the directors of a company and their Chairman as such a Committee would provide a good and independent “sounding board” on a lot of matters. In addition it would enable a sharing of responsibility and a wider consensus to be easily achieved on the basic matters of board appointments, board remuneration and auditor appointment.

But if you think we have overlooked anything in these proposals then please let us know. Likewise if you have any questions then please contact us.

Send an email to sharesoc@btconnect.com if you wish to contact us on this matter or contact us via post or telephone (see the last page for contact details).
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 its commercial activities. Associate Membership of ShareSoc is free and is open to everyone with an interest in stock market investment (go to www.sharesoc.org/membership.html to register). 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).