

BIS Paper on the Shareholding Model

The Government BIS Department have published a "Research Paper" on the Intermediated Shareholding Model - see <https://www.gov.uk/government/publications/shareholding-the-role-of-intermediaries> . For those who wish to understand the existing problems that arise from the use of nominee accounts and the complexities of the support of shareholder rights and voting arrangements at the general meetings of public companies, this is really essential reading. For those who only have a passing interest in such matters (as is the case for many private investors who simply wish to make money from their investments apparently), you may find the complexity mind-boggling.

ShareSoc directors and our members participated in the underlying research for this project via interviews and surveys, but much wider consultation was also undertaken. The result appears to be a very accurate description of existing processes and the views of the various market participants, i.e. not just investors (both private and institutional), but also brokers, registrars, Euroclear (the operator of Crest) and others.

Here's some of the conclusions and particularly interesting points that come out of the Paper for those who don't wish to read the full 160 pages:

One finding was that private investors often held shares in different forms, i.e. as paper share certificates, in nominee accounts or as Personal Crest Members - although the latter number has fallen to 20,000 from the 40,000 reported in 2001. Around half of equity investors held shares in certificated form. Those who held them via nominee accounts were typically in pooled nominees - there is very little usage of "designated" nominee accounts. Few brokers now offered Personal Crest Membership and the Paper does not identify why it is not more widely used (see pages 79-80 for discussion).

To quote from the Paper: *"Brokers argued that pooled nominee accounts are cost effective and enable them to keep costs down for clients. They also saw themselves as 'protecting' their clients from unwanted information from the companies in which they hold shares, although there was no mention of this from investors themselves"* (page 15), but it is clear from later in the Paper that retail investors had great difficulty in understanding what rights they had, or how to exercise them. The paper says *".....it is important to stress that while brokers were willing to pass back rights 'on request', very few brokers were found to be actively encouraging clients to take-up information rights"* (page 73).

Investors, particularly institutional ones, had great difficulty in ensuring their votes were cast or in identifying whether they actually had been. The complexity of the voting chain and lack of audit trail was a major concern. There was general opacity around voting, voting rights and fees in the investor chain. But there was low interest in large numbers of investors in exercising shareholder rights among both types of investors. But as it says in the Paper: *"In both communities, investors had become systemically distanced from the companies they invested in over time"*.

One aspect of the Paper is that it gives some interesting data on the latest numbers of individual investors in the UK (we will add this information to the ShareSoc web page that gives some past data here: http://www.sharesoc.org/market_statistics.html). Apparently 20% of a representative sample of UK adults held publicly listed shares, either directly or via an ISA or SIPP - that implies about 12 million individuals in total. The Paper gives some interesting data on the demographics and share trading styles of investors. ShareSoc members are clearly more knowledgeable in general, more active investors and happy to trade shares without advice than others.

For example 93% of ShareSoc members were aware that using nominee accounts means they do not automatically get shareholder rights while only 44% of other investors were aware of this.

The Paper says that *"Whilst UK company law mandates transparency with regard to institutional investment, the reality is somewhat more opaque"*. (page 98). This applies just as much to institutional investors as it does to private investors due to the use of pooled omnibus accounts in both cases.

This of course thwarts investors from finding out who their fellow investors are and hence obstructs collective representation to companies.

The proxy voting and poll arrangements for general meetings are apparently not fit for purpose in that rules regarding "record dates" tend to ensure there is under voting. It is clear that they certainly do not ensure an accurate vote even if all investors have tried to vote.

There was one possible misleading comment in the Paper where it is reported that a broker suggested that designated nominee accounts would generate a lot more transactions, and hence cost, than a pooled nominee account (page 78). This is surely questionable because the principle of "best execution" means that client orders cannot be delayed so that would only be true where a number of discretionary managed client accounts were pooled and blocks of shares were traded and then parcelled out among clients.

The comment in the Paper on page 76 that *"there was limited evidence to suggest brokers generated substantial revenue from pooled nominee accounts"* is surely wrong though. Although some publicly listed brokers do not separate out their interest income from customer deposits, the Share Centre who are one of the largest execution only brokers do so. In their last published accounts (for 2014), they show income of £1,828,000 from that source in comparison with total income of £15,020,000 (page 52). In other words, it represents 12% of their income and their pre-tax profits for the year were only £792,000 so removing it would have wiped out more than their profits. Although interest income has reduced because of the restriction to only being able to invest in short term deposits, one has to bear in mind that market interest rates are at a historic low (the lowest since Babylonian times according to one expert). Interest rates will no doubt return to more normal levels in due course and brokers will then get a major boost to profitability from interest from client deposits, as they have done in the past.

It also says on page 76 that there are *"FCA regulations against retaining client funds beyond thirty days"*. That is surely very misleading. There are regulations that prevent brokers from investing client funds on longer terms (i.e. they must be on short term deposit), but there is no obligation to return cash to clients unless they specifically request them which most do not. Only if they do so are the funds promptly returned. It is undoubtedly the case that there is a strong financial incentive for brokers to promote the use of nominee accounts.

The Paper does not of course propose any remedies for all the failings it makes plain - that may come out of the BIS in due course. But it makes it clear why we need a better alternative to nominee accounts that is readily available and a good electronic form of holding shares to replace paper share certificates, as ShareSoc has been campaigning for (see <http://www.sharesoc.org/shareholder-rights.html>). Plus of course why ISAs and SIPP's should not require the use of nominee accounts which are currently mandated by almost all brokers (this writer does not know of any who do not) although legally that was not the original intention.

In conclusion though this Paper is certainly a very valuable contribution to knowledge about how current public company shares are traded, and the existing defects in current systems.

Roger Lawson 17/1/2016 © ShareSoc www.sharesoc.org