GUARANTEED VOTES FOR ALL SHAREHOLDERS

How to reform UK share ownership

This document explains why the existing system of share ownership in the UK is deeply unsatisfactory for private shareholders, and how it might be rectified.

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FOREWORD

The problems of UK public companies in terms of corporate governance have been widely debated in recent years. The last major review of the UK stock market and the way it operates was undertaken by Professor John Kay at the behest of the Government in 2012. One of Prof Kay's conclusions was that there was excessive "intermediation" in the financial sector which raises costs and reduces "engagement" between investors and public companies.

One of the major problems which ShareSoc perceives is that private investors, who actually own a substantial proportion of the listed shares of public companies, are now mainly in nominee accounts. This distances them from the companies they own.

> "The nominee system disenfranchises the vast majority of private shareholders."

Shareholders Disenfranchised and Rights Undermined

The nominee system disenfranchises the vast majority of private shareholders* and undermines their rights as investors to have a say in the management of a company. As a result they now often see investment in publicly listed companies as speculation on a share price derivative rather than the purchase of a stake in a business they own.

Commercial Interests have taken Precedence

This situation has arisen because of the commercial interests of stockbrokers and other financial market intermediaries, while the Government has not ensured that the rights of individual investors are protected.

Rights not Exercisable

Although in theory investors via nominee accounts have rights to vote, attend meetings and receive information under the Companies Act, those rights are in practice not exercisable, and are not exercised, by the vast majority of private investors. In addition many rights that are otherwise available to shareholders who are on the register of a company are lost.

Shareholder Democracy Destroyed

Shareholder democracy has been fatally undermined by the historic changes to the way the UK stock market operates to the detriment of good corporate governance in companies as the voice of individual shareholders is lost.

Individual shareholders have a direct ownership interest rather than simply acting as agents for others as is the case with many institutional investors, so they are more likely to express concerns about management failings, excessive director pay and poor corporate governance.

Campaign Formed

ShareSoc has commenced a campaign to re-establish the traditional model where all shareholders in a public company have the ability to vote. We need to ensure that all investors can easily vote, can attend General Meetings without obstructive processes and are fully informed on the affairs of the company.

Nominee Accounts Must be Discouraged

The nominee system must be both reformed and usage curtailed, with most investors placed on the share register of the company. In addition, tax efficient vehicles such as ISAs and SIPPs must support direct share registration of investors rather than require the use of nominee accounts.

The Purpose of this Document

This document has been written to explain the nature of the problems that currently exist, how they have arisen, and how they can be rectified.

Roger W. Lawson

Deputy Chairman, ShareSoc

* Note that in this document the term "shareholder" is used to describe anyone with a direct or indirect interest in a certain number of shares in a public company, whether they are shareholders on the register of a company (i.e. members) or simply beneficial owners with someone else (typically a nominee operator) holding and recording their interest on their behalf.

1. Where We Are

Private shareholders (i.e. individual retail ones) held 10.7% of shares listed on the LSE at the end of 2012 (Source: the Office of National Statistics - see the Note below, although that figure may be an underestimate). That compares with 17.5% held by pension funds, insurance companies and other financial institutions. It is important to emphasise that there are many millions of people affected by the problems we discuss below, with probably over 4 million people holding shares in nominee accounts and as many as 10 million individual shareholders altogether. The problems such investors face are not uncommon ones.

Most private shareholders do not understand that there is more than one way to hold shares in public companies. Indeed if they now approach a stockbroker to open a new investment or trading account, they are almost always put automatically into a nominee account. A nominee account is one where shares are not held in the name of the investor but in the name of the nominee operator (who is typically the stockbroker or an associated company). The investor is only the "beneficial owner" of the shares who has rights to receive dividends under a contract with the nominee operator. But the investor is not on the share register of the company and will not be known to the company in any way - indeed the company cannot communicate with them except in limited circumstances and would have practical difficulties in finding out who they are. Neither can anyone else.

Nominee accounts are usually "pooled", i.e. there is no separate designation of who owns what within the pool and all the shares within the pool are registered in the single name of the nominee operator on the share register of the company. Only the nominee operator knows who is entitled to the proportions of shares within the pool.

Although there are other ways to hold shares (see later chapter), tax exempt vehicles such as ISAs and SIPPs must be held within nominee accounts which is another reason why nominee accounts are now so prevalent. Although many long-established companies still have many investors on their share registers for historic reasons (the investors may still hold paper share certificates), the trend is to nominee accounts because of the ease and speed of on-line trading, which must be on an electronic basis.

Unfortunately in legal terms, the nominee operator has the rights of the shareholder in the company because it is their name on the register of the company. The multiple beneficial owners represented by that name on the register have no rights (with some exceptions) such as the ability to vote at company meetings, to attend such meetings, to requisition resolutions or even to receive information from the company such as Annual Reports or Notices of Meetings. Indeed investors in nominee accounts have minimal legal rights under the Companies Act but are reliant on the contractual rights they have obtained from their nominee operator (e.g. stockbroker).

The 2006 Companies Act did enable beneficial owners to gain certain rights but these are limited in scope, in practice rely on the nominee operators to pass them on, and are difficult for investors to obtain.

Indeed it is unusual for stockbrokers, with a few exceptions, to even inform their retail clients about these rights, how they can exercise them, or provide on-line systems to support their exercise. In reality most stockbrokers have no interest in enabling their clients to act like normal shareholders who enjoy all the rights directly.

The end result of this system is that most retail investors are not sent information about company meetings (or Annual Reports), do not know how to vote, do not attend company meetings (they don't know how they can legally gain admittance), and are effectively disenfranchised.

They are not treated as shareholders and hence do not act like shareholders. This creates particular problems when companies run into difficulties or are the subject of corporate actions such as takeover bids. The retail shareholders often have no way of expressing their wishes, and this is a major difficulty when the retail shareholders form a significant proportion of the total shareholders. The figure above of the average interest of private shareholders in companies is only an average. In smaller companies (such as those listed on AIM) and in companies that are particularly attractive to retail investors, they can form a much higher proportion than 10%.

The difficulties that retail investors now face in voting their shares, even when they know they should be able to, has meant that the directors of companies can often assume they will not vote. Turn-outs from institutional investors have been rising but there still often problems in smaller companies where private shareholders often hold a larger stake and this gives enormous power to the directors to push through such actions as de-listings when they so desire.

Retail investors are often more committed long-term holders than institutions and therefore more likely to act as "owners" if given the chance. Unlike institutional shareholders who often have to buy and sell shares to meet the requirements of index tracking, or imposed investment policies, retail investors make their decisions independently. This can be helpful to ensure a healthy market for public company shares but is effectively now being undermined by the nominee system. Retail investors cannot engage with company management or even express their views on contentious matters due to the iniquities of the nominee system.

Note: the figure given above of 10.7% of shares of shares held includes those held directly and indirectly via nominee accounts, i.e. they are the direct owners or beneficial owners. It excludes more indirect holdings via pension funds, insurance companies and other institutions. See this page of the ShareSoc web site for more background information on retail share ownership: www.sharesoc.org/market_statistics.html .

2. How Did We Get Here?

Fifty years ago almost all investors held a paper share certificate issued by the company (or the company's registrars) in which they had invested. The UK system of a share register that recorded who the investors were in all companies was established many years before as a way for all investors to know who owned companies and to enable companies to know who owned their shares. It also was used by companies as the basis for the distribution of dividends (typically via paper cheques of course) and for the distribution of information to shareholders. The register simply contained the names and postal addresses of the shareholders who were entitled to dividends, and to attend and vote at General Meetings of a company.

It is worth emphasizing that the Companies Acts have consistently provided that company share registers are open to all, not just to the shareholders. The more recent Data Protection legislation is overridden in that regard and the requirement to have a "proper purpose" which was added recently only limits it in minor ways. In essence anyone has been able to obtain a copy of the share register and write to the shareholders expressing their concerns about the company or its directors, ask for support for changes, ask for support for submitted resolutions at General Meetings, and canvas for votes. This was a very valuable function to ensure shareholder democracy was effective and that directors of companies could not simply run the business in their interests rather than that of shareholders. Only in recent years has this been undermined by the prevalence of nominee accounts and the rising cost of postal communications.

So share registration used to be a very simple system, and even in the modern digital era is still in operation for many shares in many companies - for example in most private companies (those not listed on public stock markets). Indeed many retail investors still hold paper share certificates and receive dividends and notices from a public company via post.

"Share registration used to be a very simple system".

The UK Companies Act, which was last substantially revised in 2006 and which governs how UK registered companies must operate, assumes to a large extent that these arrangements still apply. Some changes were made at that date though to enable electronic communication and provide some provisions to cope with the growth of the nominee system (see below), but in essence to be sure of having all the rights available you still need to be listed on the share register of a company.

Electronic Share Trading and the Crest System

Share registers became electronic, typically maintained by third party registrar companies for a fee, as early as the 1960s, but company law and trading systems did not keep up. However in the 1980s it was recognised that share trading and settlement should be electronic and a project called Taurus was launched by the London Stock Exchange.

The Taurus system proved to be a fiasco and was financially disastrous. It was abandoned in 1993 and subsequently two systems were introduced - SETS for trading and Crest for settlement - the latter went live in 1996. Crest is now owned by Euroclear and the principles of its operation have remained basically unchanged since.

Crest was primarily designed to support the share trading of major institutions and all shares traded on the main London market and AIM (with a very few exceptions) are recorded in Crest and settlement takes place via that system. So large institutional holders are typically "Members" of Crest and hence recording of transactions and settlement can be expedited - their individual shareholdings are recorded in the Crest system only in electronic form. Likewise stockbrokers and other asset managers can interface directly to the Crest computer system via special software. Registrars are also integrated electronically into the system so that their records are updated. Electronic trading has enabled much reduced settlement times which have therefore come down over the years, and it has also enabled enormously larger volumes of shares trades to be handled at lower cost.

But the Crest system had one major drawback. It was not designed to cope with the needs of retail investors. As a result there are substantial delays when trades involving paper share certificates are involved, and there is a frequent need to "dematerialise" paper shares into electronic form (or "rematerialise" them into paper form) to meet the needs of particular transactions or investors. For example, if one private individual wishes to sell to another some shares he holds as an "off-market" transaction, the Crest system does not support that so it has to be done via paper. See the next Chapter for a summary of the different ways private individuals can now hold shares.

But there was a system introduced some years later that enabled private individuals to become "Sponsored" or "Personal" Crest Members that gives them indirect access to this system. It unfortunately has not proved particularly popular, and is not supported by most stockbrokers for reasons that are given later.

There was a move to introduce a fully electronic share registration system into the UK some years ago, and a Working Group spent more than two years working on it. This would have scrapped all paper share certificates in publicly listed companies as has been done in other countries under the somewhat misleading and negative term of "dematerialisation". It would have given some cost savings and major advantages to retail shareholders. But ultimately the Government failed to give their backing to the project, perhaps because some stockbrokers opposed it and there was concern that the typical elderly private shareholders might prefer to retain their paper share certificates. This unfortunately was simply a misconception on their part of the security of paper. Even a public consultation at the time found a majority in favour and the views of shareholders might be even more supportive now that most private shareholders are electronically "enabled", i.e. use the internet for shopping, banking and other purposes.

On-line Trading by Retail Investors

Retail investors were using Personal Computers to trade stocks as early as the mid-1980s in the USA, but it really took off in a big way in the 1990s due to the spread of the internet. The trend to broadband access also encouraged this move. So many retail investors no longer talk to a stockbroker over the telephone to initiate a trade - they simply interface directly to a web based software platform run by a stockbroker, a bank or some other financial institution. Hence some of these organisations, who might offer other investments as well, are now commonly called "platforms".

Obviously paper share certificates are an anachronism in this world because most brokers will need to see the certificate before they are willing to sell the shares it represents. Therefore almost all on-line trading accounts were initially implemented in the UK via the use of nominee accounts (see next chapter).

Likewise most new retail stockbroking accounts are now established as nominee accounts with the broker rarely mentioning any alternative (if they support them at all), even if the client wishes to trade via the telephone.

3. The Different Ways to Hold Shares

There are three primary ways that investors in public companies can hold shares in the UK:

1. Via a paper share certificate. In this case the named shareholder is on the share register of the company (i.e. is a "Member" of the company) and has all the rights given by the Companies Act or granted under the Articles of the company. Note though that title is primarily evidenced in law by the shareholder's name being on the register of the company and the holding of a paper share certificate may be incidental. Paper share certificates may be prima facie evidence of title but they are not as secure as electronic systems, incur delays in trading/settlement and have other disadvantages.

2. As a Personal or Sponsored Crest Member. In this case the shareholder will have an account within the Crest system but it is managed and controlled by the stockbroker who has a contractual relationship with the retail investor. But the big advantage is that the shareholders name is on the register of the company so there is no question of the ultimate ownership, i.e. it is in the investors name not that of the stockbroker. In fact the investors position is the same as if they held a paper share certificate in most regards. They have all the same rights under Company Law, will be sent all notices issued by the company, all dividends will come directly to them, they can attend (without notice) and vote at all company General Meetings and otherwise exercise their rights as Members of the company. Only a few stockbrokers offer Personal Crest accounts, and although some offer them at no extra charge, others impose administration or other fees. In general the use of such accounts by investors with smaller portfolios is deterred, particularly as they take more time to set up than nominee accounts due to the need to obtain a Crest account.

3. Via a Nominee Account. In this case the retail investor does not hold shares that are registered on the share register. The nominee operator (typically a stockbroker) holds the shares in their name. Only they have the rights as Members of the company. Typically neither the company, the company's registrar, nor Crest, know who the actual investor is so cannot communicate with them directly. The investor is simply a "beneficial" owner whose contract with the nominee operator defines their rights to receive dividends applicable to the shares, and other rights available on the shares.

Most nominee accounts are actually "pooled nominee" accounts. In other words, the shareholdings of multiple individual investor accounts with a stockbroker are intermingled with only one entry on the share register of the company summating all the individual holdings. And of course only the single name of the stockbroker is present on the register.

Stockbrokers argue that the pooled nominee system simplifies their work and enables them to lower costs, but it creates major legal difficulties because there is no direct connection with the retail investors account and his claim on the assets therein, to what is held in the records of the share issuing company.

The advantage of nominee accounts to the stockbroker are two-fold. The first is that dividends go directly into the nominee operators cash account and are not paid out directly to investors. As stockbrokers pay little interest on cash balances held in the name of investors and can obtain a much higher rate themselves, this results in substantial profits to the brokers. Often stockbrokers made a substantial proportion of their overall profits from this "margin" arrangement. This is one reason why stockbrokers dislike Personal Crest Accounts because in that case dividends get sent directly to the investor.

Secondly the nominee system enables stockbrokers to lock their clients into their services. The clients cannot trade their investments through any other broker (as they can for example with paper share certificates), and moving an investment portfolio from one broker to another is both difficult and costly. In addition, nobody else can communicate with the investors because only the broker knows who they are. This destroys shareholder democracy at a stroke and brokers will generally not forward any communications from third parties, and even from companies with the exception of some "corporate actions", to their clients.

The Crest system and company registers also support "designated nominee" accounts where both the nominee operator and the individual beneficiary are recorded but it is claimed that this is more costly and hence is little used by stockbrokers. Such accounts also rarely record the beneficiaries directly and may simply refer to another pooled account.

Pooled accounts can also used to facilitate stock lending by the nominee operators for their financial benefit, and unknowingly to the beneficial owners (and potentially contrary to their interests).

Retail investors are normally put into pooled nominee accounts without being given any option, and without any understanding of the implications of using such accounts.

"Nominee accounts have grown to be the dominant way that retail investors hold shares in the UK because of the interests of stockbrokers rather than their customers".

In summary nominee accounts have grown to be the dominant way that retail investors hold shares in the UK because of the interests of stockbrokers rather than their customers. The introduction of electronic platforms has enabled stockbrokers to promote the use of nominee accounts while ignoring the offering of the alternatives. Meanwhile retail investors are typically ignorant of the implications for their rights as "shareholders" in a company (which they are not in reality if they are in a nominee account) and the loss of valuable legal rights.

ISA and SIPP Accounts

Because of the tax advantages many retail investors hold direct share investments in Individual Savings Accounts (ISAs) or Self Invested Personal Pensions (SIPPs).

ISAs for example are often recommended to new stock market investors as an appropriate way to begin investing because it enables £15,000 (in the 2014-15 tax year) to be invested with no income tax paid on dividends and no future capital gains tax however large the investor's portfolio becomes. But there is a presumption in the ISA regulations that such accounts will be managed by financial intermediaries and be held in nominee accounts for investors (even if Personal Crest or Certificated shares were permitted, it would cause technical difficulties because dividends would be paid directly and not retained within the ISA "wrapper"). In general the same rules apply to SIPPs also. These arrangements again tend to presume that any new investor who approaches a stockbroker will be placed into a nominee account.

If investors hold their shares in ISA accounts then they can potentially exercise their voting rights via the nominee operator as provided in the 2006 Companies Act. Indeed the ISA Regulations specify that holders of such accounts must be able to vote the shares held therein. However most of them are not aware of this fact, the nominee operators (e.g. stockbrokers) do not advertise the fact, and in general do not provide system that enable investors to easily do so.

IT IS OBVIOUS THAT EXISTING SHARE TRADING AND RECORDING SYSTEMS ARE DESIGNED NOT FOR THE BENEFIT OF RETAIL INVESTORS (AS CONSUMERS OF THESE SERVICES) BUT FOR THE BENEFIT OF THE FINANCIAL INTERMEDIARIES WHO OPERATE THEM. NOMINEE ACCOUNTS ARE EVIDENCE OF THIS FACT IN EXTREMIS.

4. The 2006 Companies Act

Prior to the 2006 Companies Act there were enormous difficulties for any shareholder in a nominee account to exercise their normal rights as a shareholder (i.e. in the same way as if they were on the register). Although potentially they might ask their nominee operator to act as their proxy and vote on their behalf, if it was a pooled nominee account the nominee operator might receive multiple and conflicting instructions from their various clients. So one change made in 2006 was to enable someone submitting a proxy vote to split their vote in differing ways.

Likewise there were difficulties for investors to obtain information such as the Annual Report, the notices of General Meetings, and of corporate actions. These all were sent to the nominee operator but in the case of Annual Reports they would only receive one copy when they might have thousands of clients holding the shares in a company. The 2006 Companies Act also solved that problem in that it required companies to send information to persons nominated by the nominee operator to receive such information in the case of publicly listed companies (but not AIM companies). It is also possible for nominee operators to supply a "letter of representation" to one of their clients that will enable them to attend a General Meeting of the company and be recognised as a representative of the nominee operator (who is on the register remember) for the number of shares held by the nominee operator's client.

A Major Defect in the 2006 Companies Act

So the 2006 Companies Act was a big step forward in some respects. However, there is one major defect. Apart from the fact that nominee operators (e.g. stockbrokers) can charge for the provision of these services, they have no legal obligation to provide them and most do not.

Only a few brokers offer free voting facilities on an automated basis at present (along with information provision also because unless you receive the documents issued by the company you may not know how to vote) - the ones we know of are Brewin Dolphin, Killik & Co., Natwest Stockbrokers, TD Waterhouse and The Share Centre. Others may offer the facilities upon request, and/or subject to a charge. In reality the vast majority of retail investors in nominee accounts do not know they can vote or how to vote.

Other Defects in the 2006 Companies Act

Another problem is that only certain rights in respect of nominee accounts are covered by the 2006 Companies Act - namely mainly voting and information rights. However the right to vote by a beneficial owner (to be appointed as a proxy) in Section 145 of the Act has been implemented by very few companies because of the practical difficulties of operating such an arrangement. So investors have to rely on their contractual agreements with their nominee operator (and their ability to vote).

Note also that shareholders on the register have a number of other rights as "Members" of the company, for example the ability to challenge a poll, or apply to a court to object to a change from a public to a private company, which are in practice lost by beneficial owners. An example of where shareholders rights were frustrated as a result is given in Appendix C.

Practical difficulties of exercising rights

The 2006 Companies Act does provide ways for investors to obtain proxy voting rights and rights to attend and vote at General Meetings of companies (if the nominee operator passes on those rights). But even if those rights are passed on there are lots of practical problems that arise because of the slow paper based processes that are involved. For example, a nominee operator cannot issue a "letter of representation" enabling them to attend a General Meeting to an investor until near the "record date" for a meeting because otherwise they have no certainty that the investors still has a beneficial interest in the shares of the company concerned. The letter of representation then has to be posted to the investor and there is a high probability it will not arrive before the meeting is to take place - that is particularly the case if the investor is located overseas.

"The 2006 Act was not designed to support the modern electronic world of communication".

In reality the additional rights put into the 2006 Companies Act at a relatively late stage in the passage of the Bill through Parliament are difficult to support in practice, and create lots of complexities that Registrars have difficulty in supporting and which few other people understand. The Act was not designed to support the modern electronic world of communication. It's a hybrid of an old-fashioned paper based system upon which has been grafted more complexity to try and support the use of nominees. The end result is an inelegant and complex system.

Lack of Obligations Imposed on Nominee Operators

A further difficulty, and a major omission from the 2006 Act, was the failure to require nominee operators to distribute information from companies, or other people, to their clients. There are obligations to distribute corporate action information (for example, advising of bids) to investors in nominee accounts, but there is no general ability by companies to send information to the clients of nominee operators. For example, if companies have encountered major business problems (such as BP in the Gulf of Mexico oil spill), they cannot send information on that to their shareholders in nominee accounts. Nominee operators have no obligation to distribute any information to their clients from companies and generally will not do so on the grounds of administrative cost (although obviously nowadays most such communications could be sent via email). In addition third parties cannot get such information sent (even if they are willing to pay the associated costs), or obtain the contact information of the investors so they cannot canvas for proxy votes or make representations about the affairs of the company as they would be able to do if shareholders were on the register. This totally undermines shareholder democracy.

In practice shareholders in nominee accounts are not shareholders in law and are not treated as such. They are in limbo so far as most of the established legal and corporate democracy practices are concerned.

No Coverage of AIM Companies

The failure to include AIM Companies in the Regulations that were introduced with the 2006 Act is also a major deficiency that seriously affects private shareholders. Not only are private shareholders significant investors in AIM companies, and often hold a substantial proportion of the shares in such companies, but it is an area where shareholder democracy is very important to counter dominance by insiders.

Even if stockbrokers wish to support shareholder information rights and voting, they are thwarted by the fact that AIM companies are not required to provide information to the beneficiaries of nominee accounts.

IT IS IMPORTANT TO POINT OUT THAT MOST RETAIL INVESTORS ARE TOTALLY IGNORANT OF HOW THEY ARE DISENFRANCHISED

The only information source for most retail investors are the stockbrokers or platform operators they deal with, and those organisations have little interest in educating investors on those matters. Indeed many claim that investors have little interest in such matters because they mainly "just want to make money". But that was not the case when investors were mainly on the share register of a company. It is surely a truism that if shareholders are distanced from the companies in which they invest, and are not offered a simple and easy way to vote, then the principles originally laid down for the way in which public companies should operate are undermined.

It is also important to emphasize that it is not just individual retail investors who are affected by these problems. It is smaller institutions and overseas investors who often have difficulties in voting, or getting their votes in on time due to the difficulty of establishing and executing their voting rights (and it's worth pointing out that overseas investors now hold more than 50% of the shares of UK listed companies).

5. The Other Legal Problems of Nominee Accounts

There are a number of practical difficulties, and potentially complex legal problems, associated with the use of nominee accounts (other than those covered in the previous chapter).

In theory, shares in a nominee account are held in trust (and usually "title" is recorded in a separate but associated trust company to that of the nominee operator). So if a stockbroker goes bust the clients should not lose their investments or cash. In reality it can be very different.

One of the largest examples was that of Pacific Continental who were stopped from trading by the FSA and subsequently went into administration in 2007. The administrator immediately froze all client accounts (including open trading positions) and then attempted to sort out the records that could be obtained. It proved impossible to reconcile the claimed holdings of clients with those on the share registers of companies (i.e. within Crest for UK holdings). Although the Financial Services Compensation Scheme (FSCS) was invoked and claims subsequently assigned to the FSCS in 2012, compensation was limited to £48,000 per client and it seems likely that less than 10p in the £1 will be recovered above that. As the liquidator said "*the Joint Liquidators have been unable to distribute to investors any shares purchased by the Company (and held by PCS(UK)'s nominee company), as it is not possible to determine from the Company's records the true entitlement of each client*". More information is available from the Smith & Williamson web site.

" it is not possible to determine from the Company's records the true entitlement of each client".

Another even larger example was that of Lehman Bros who acted as a "prime broker". Ultimately the company collapsed amid allegations it was using client assets to shore up its own financial position. Now client assets were generally protected in the USA, but this is what one internet blogger has said happened in the UK: "*None of this applied in London, where Lehman Brothers International operated under a much looser regulatory and insolvency law framework that has tied customer assets up for years in liquidation proceedings. It did not help that in a number of cases where Lehman Brothers International was contractually bound to segregate client assets in London, it had failed to do so*."

It is worth pointing out that stockbrokers regularly go bust and the ones most likely to have poor quality administration and accounting systems (and hence suffer from the "reconciliation of clients assets to real holdings" problem) are those most likely to do so. Investors who hold more than £50,000 of investments with a stockbroker (a relatively small amount for many private investors) are at substantial risk if their holdings are in nominee accounts.

Legal Uncertainties and the Unidroit Convention

There is considerable uncertainty about the legal framework under which intermediated securities are held. Although there is an assumption that the arrangement is trust-based, to quote from the recent public consultation by the Law Commission on the Fiduciary Duties of Intermediaries: "some areas of uncertainty remain".

In 2009 UNIDROIT produced a Convention on the underlying law of intermediated securities also known as the Geneva Securities Convention and the UK Government was advised to sign up to the convention but has not done so. Only one country (Bangladesh) has done so at the time of writing. The convention would have brought some clarity to the rights of holders of intermediated securities.

There are 48 Articles in the Convention in all but the key points that it covers for investors are:

1. That investors should be able to exercise the intrinsic rights associated with the securities via the intermediary.

2. The intermediary should pass on information related to securities to investors to enable them to exercise their rights.

3. That securities must be "allocated" to account holders and protected against claims on the intermediary in case of insolvency. In general the provisions of the Convention prejudice the use of "pooled" nominee accounts which are a major legal risk to investors ownership claims.

In July 2014 the Law Commission reported on the results of the aforementioned consultation and this is what it said on intermediated securities:

"Given the importance of this area, we think that there is a need for a clear statement of legal principles. In our advice to HM Treasury in 2008, we recommended that the UK should ratify the UNIDROIT Convention, to provide a clear harmonised system reflecting current market practice. We continue to think that there is a need for the UK to work at a European and international level to bring clarity to the law and to reduce the practical difficulties caused by the intermediated system. We accept that a UK-only solution would be unworkable. However, this does not mean that the UK should simply leave the issue to the European Commission."

And: ***"We recommend that the Government should review the current operation of the system of intermediated shareholding, with a view to taking the lead in negotiating solutions at a European or international level."***

6. How to Fix the Problems

The previous chapters of this document have described the problems associated with the existing prevalence of nominee accounts and the provisions of Company Law. What follows is a discussion of how matters might be improved so as to ensure ALL shareholders are properly enfranchised (i.e. given a vote and a right to attend General Meetings of companies without hinder).

It is suggested that any new arrangements should properly support modern electronic communication, be more secure and lower cost (for both market participants/intermediaries and investors). Any new systems should surely attempt to simplify the processes faced by retail stock market investors.

There is also the need to support the upcoming CSDR regulations mandated by the EU Commission which will force the dematerialisation of all securities, although the imposed timescale for implementation is currently uncertain.

It is also necessary to support the recommendation in the Kay Review of UK Equity Markets which has been supported by the Government. Recommendation 17 stated that "*The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register*", but little progress has been made on doing so. So our first two recommendations are:

PRINCIPLE 1. THAT A MODERN LOW COST SYSTEM OF ELECTRONIC SHARE REGISTRATION SUITABLE FOR DIRECT USE BY RETAIL INVESTORS BE ESTABLISHED AS PART OF ANY DEMATERIALISATION INITIATIVE; and

PRINCIPLE 2. THAT THE IMPLEMENTATION OF A COMPREHENSIVE ELECTRONIC SHARE REGISTRATION SYSTEM TO MEET THE CSDR DEMATERIALISATION REQUIREMENTS BE EXPEDITED.

In our suggestions, we assume that there will still be a need to support the use of nominee accounts to cope with the needs of those individuals (or organisations) who require "blind trusts" (e.g. politicians) or who do not wish to be informed about the affairs of the companies in which they are invested. However the use of nominee accounts has expanded way beyond those purposes in recent years. This should surely be changed. So these are two of our key short term recommendations:

PRINCIPLE 3. THAT RETAIL CLIENTS ARE ALWAYS FULLY INFORMED ABOUT THE LOSS OF THEIR RIGHTS BY THE USE OF NOMINEE ACCOUNTS AND ARE ALWAYS OFFERED AN ALTERNATIVE WITH FULL DIRECT RIGHTS (AN OPT-IN NEEDED FOR NOMINEE USAGE); and

PRINCIPLE 4. THAT ANYONE USING A NOMINEE ACCOUNT IS NOT DEPRIVED OF THEIR RIGHTS AS A SHAREHOLDER IF THEY CHOOSE TO TAKE THEM UP AND THAT ALL NOMINEE OPERATORS MUST PROVIDE WAYS FOR THEM TO DO SO AT NO CHARGE.

The mandating of the use of nominee accounts by ISA and SIPP providers has encouraged the growth of the use of such accounts, so our next principle is:

PRINCIPLE 5. THAT THE GOVERNMENT SHOULD ENSURE THAT ANY TAX BENEFICIAL ACCOUNTS ARE CAPABLE OF CONTAINING DIRECT HOLDINGS AND SHOULD NOT REQUIRE THE USE OF NOMINEE ACCOUNTS.

The inability of other shareholders to communicate with beneficial holders who hold shares via nominee accounts has made it exceedingly difficult to communicate concerns about the management or operations of a company to all shareholders or obtain proxy votes in support, so this is another principle that is important to restore shareholder democracy:

PRINCIPLE 6. THAT IT SHOULD BE POSSIBLE TO COMMUNICATE WITH ALL BENEFICIAL HOLDERS OF SHARES IN A COMPANY AT LOW COST IN A SIMILAR WAY TO THE CURRENT PROVISIONS ON PUBLIC ACCESS TO SHARE REGISTERS.

To support the above might require significant changes to both Company Law the Regulations (for example in the ISA and SIPP Regulations), so our last principle is:

PRINCIPLE 7. THAT THE COMPANIES ACT AND ASSOCIATED REGULATIONS BE REVIEWED WITH VIEW TO UPDATING THEM TO BE MORE APPROPRIATE TO THE WAY THAT PUBLIC COMPANIES OPERATE AND THEIR SHARES ARE NOW TRADED.

The required approaches to implementing the above principles are covered in the following chapters.

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7. A Modern Share Registration System

There is surely nothing wrong with the basic principles of UK share registration that were established many years ago. Namely that the real owners of a company, which is otherwise an impersonal entity, should be recorded on a register held by the company (or in practice in the case of public companies by "registrars" under a management contract with the company).

The register serves a number of purposes: 1) the recording of ownership represented by "shares" in the company as those shares are issued, or when cancelled; 2) a record of who is entitled to dividends; 3) a record of who has voting rights in the company, rights to attend General Meetings and other rights as may be granted by the Articles of Association or by Company Law; 4) a means whereby the company can inform the shareholders about the affairs of the company and invite them to vote and attend General Meetings; and 5) a means whereby shareholders and other interested parties can communicate with the shareholders.

A share register therefore has typically contained the full name and postal address of the shareholder, how many shares are held and the class of shares plus minor other information. In the era of postal communication when letters were deliverable at low cost overnight and most shareholders were based in the UK for UK registered companies, it proved to be a practical system.

But with many shareholders (the majority by value) in UK listed companies now based overseas, and with the slow, expensive, unreliable and increasingly expensive postal service, it is surely necessary to record email addresses for as many shareholders as possible. It should be the default that communication is via email address and those addresses should be available to the company and to any third party, with appropriate opt-out provisions. The principle of electronic communication was of course already established in the 2006 Companies Act but the share registration provisions and associated Regulations were not updated to match.

The share register should also record how shareholders wish to be paid dividends and whether to themselves or a third party (for example if ISAs are to allow for direct holdings, then dividends might need to be paid into an "associated" bank account rather than directly to the shareholder). The "designated nominee" system already enables the separate recording of the beneficial ownership from the "operating" ownership of shares so that might be one simple way to solve this requirement.

Some might say that recording all individual ownership of shares as against the existing "pooled" nominee system creates very large share registers but the cost of computer storage is now so low that this is a trivial consequence.

At present we unfortunately have a system ("pooled nominees") which was devised to minimise cost while ignoring the legal consequences and the undermining of shareholder democracy/rights.

8. Dematerialisation and the CSDR

A modern share registration system as described in the previous chapter can support the recommendations in the Kay Review and meet the requirement of the CSDR regulations, i.e. remove the support of paper share certificates and the expensive settlement process, for UK publicly quoted companies. The latter means those companies in the existing Crest system.

There should be no need for retail shareholders to have a sponsor as required by the existing Personal Crest Membership if they wish to have their name on the register, and all stockbrokers and other market participants should support a new "Name on Register" registration, clearing and settlement system as has been proposed by the ICSA Registrars Group.

It is important that such a system enables the direct, off-market, transfer of shares between any registered holders without going via brokers or market makers so as to avoid unnecessary costs being imposed on investors.

The UK is actually falling behind many other countries in regards to the modernisation of its systems. For example, consider the Australian Chess system which is described in Appendix B.

9. Actions Required on Legislation & Regulation

There are a few simple things that need to be done to implement the principles previously laid down. These are:

1. **Investors should be informed about nominee accounts.** Regulations should be imposed that require all stockbrokers (including platforms, wealth managers and others acting as agents for investors in the purchase or sale of listed company shares) to warn prospective clients about the potential loss of rights and the legal risks associated with nominee accounts if the client is offered such an account. The client should specifically need to opt-in to confirm that he is aware that he is accepting this and has read the warning. The form of this warning and the opt-in question should be defined in those regulations so as to ensure it is not perceived as trivial or normal and the availability of other alternatives should be explained (whether offered by the broker or not).

2. **An obligation to provide enfranchisement.** There should be an obligation on all brokers to provide voting rights and letters of representation upon request and at nil cost to all their nominee clients. Clients should also be offered information rights advising them of the availability of Annual Reports, of dates of General Meetings and all other corporate actions and communications issued by companies unless they specifically opt out. Brokers should also be encouraged to provide automated systems for the collection of votes from their nominee clients (i.e. the clients should be prompted for their votes and provided with a system to easily record them rather than having to rely on sending emails or paper letters to get their votes recorded).

3. **Extension to AIM Companies.** The Companies Act Regulations that provide some rights to beneficial owners should immediately be extended to AIM companies.

4. **Allow direct holdings in ISAs and SIPPs**. The Government should change the ISA and SIPP Regulations so as to support the direct holding of shares in addition to the use of nominee accounts - whether in an existing Personal Crest Account or any new electronic "Name on Register" system. Any dividends paid on the shares should be routed to an associated bank account.

5. **All investors should be on the share register.** The principle should be introduced that all shareholders (both direct and indirect) be on the share register of the company (i.e. the publicly accessible register includes sub-registers of any beneficial owners) and such registers include email addresses where available and if requested by third parties are supplied in a standardised format defined by regulations.

6. **The Companies Act needs revision.** That the Companies Act and associated Regulations be reviewed to meet the requirements of the above changes, and to ensure ALL rights are included in the provisions for indirect holdings, without the need for companies to amend their Articles.

7. **Simplification is essential.** That the whole process of the provision of rights to indirect holders be simplified in law so as to remove complexity and the associated practical difficulties of those rights being exercised.

10. Conclusion

We hope we have shown in this document that there are major deficiencies in the existing arrangements for the registration of the ownership of public companies. Over time, technology changes and new market arrangements introduced by financial intermediaries have undermined the principles that ensured effective control of public companies by their owners. Company law has failed to keep up with those changes such that we are now left with an ineffective and exceedingly complex system. In practice, individual investors cannot and do not exercise their rights as shareholders.

Our conclusion is that substantial changes are required to ensure that all shareholders are enfranchised and that **guaranteed votes for all** are provided.

A modern new electronic system of share registration should be developed with the supporting legal system being designed around how that operates.

Such changes are only likely if the UK Government takes the initiative on this issue because as has been explained in this document, it is not in the interests of many existing financial market intermediaries to do so. We therefore suggest that the Government adopts the Principles set out in Chapter 6 and forms a body to advise how they should be implemented.

Appendix A - A Survey of Share Ownership and Voting

In January 2014 ShareSoc issued a survey to our Members covering their voting and attendance at General Meetings and the prevalence of the use of nominee accounts. In addition an identical survey was made publicly available that members could forward to other people and it was also mentioned on some financial bulletin boards. The results of the two surveys were similar in many regards - any differences are noted below.

Nominee account usage. 89% of ShareSoc Members held some shares in a nominee account, with an even high percentage in the Public survey. 17% of ShareSoc Members use a Personal Crest Account but only 8% of the Public respondents. There was a remarkable high percentage of paper share certificates still being held - 52% among Members and 38% in the Public held them (the overall percentage adds up to more than 100 because many people hold shares in more than one way). It is also clear that many people use more than one "platform" or broker to trade or hold shares (only 40% of Members use only one).

Recognition as a shareholder. 84% of ShareSoc Members were aware that shares held via a nominee account meant that they would not be recognised by the company as a shareholder, but only 73% of Public respondents were aware of this.

Voting of Shares held directly. Where shares are held directly (i.e. via a Personal Crest Account or paper share certificate so the holder is on the register of the company), 34% of Members said they Always or Often submitted a proxy voting form. For Public respondents it was only 19%. Only 7% of Members never bother to submit a proxy form.

Voting of Shares held via nominees. The figure for voting of shares held indirectly fell to 14% for "Always" or "Often" for ShareSoc Members and rose to 42% for "Never". The breakdown of answers is given in the table below (the question posed was "for shares held via a nominee account do you submit proxy votes for General Meetings?"). Public respondents were even less likely to vote nominee account shares. This demonstrates the great difficulty investors in nominee accounts face in voting their shares, or simply the ignorance of how to do it and the lack of support via brokers.

Answer	0% 100%	Number of Response(s)	Response Ratio
Always (or attempt to do so)		39	9.7 %
Often		16	3.9 %
Sometimes		49	12.2 %
Rarely		72	17.9 %
Never		168	41.8 %
No Response(s)		57	14.2 %
	Totals	401	100%

Provision of voting and information rights in nominee accounts. The responses to a question on whether the main stockbroker used provided information and voting rights gave only 18% among ShareSoc Members although there were a considerable number of "Don't Knows".

ISA Account Rights. Indeed only 38% of Members and 31% of Public respondents were aware that the ISA regulations required nominee operators to provide voting rights.

Attendance at AGMs. Personal attendance at Annual General Meetings was lower than proxy voting numbers (somewhat to be expected as respondents are geographically spread and may not have the time to attend such Meetings). Only 16% of Members who held shares directly answered "Always", "Often" or "Sometimes" to that question, and 6.3% of the Public. These numbers fell to 14% and 8% respectively for shares held indirectly via nominee accounts.

Shareholders feel disenfranchised. 74% of Members and 70% of the Public confirmed that they felt disenfranchised by the existing nominee system and proxy voting arrangements.

Profile of respondents. It was clear from the responses to a question on the number of shares held, the age profile of the respondents, and the number of platforms used that many of the responses were from more experienced and sophisticated members. Voting levels might be even lower for smaller investors.

Voting apathy and voting difficulties. For those shareholders who responded "rarely" or "never" to the question on voting, they were asked to comment on why they did not. The answers were typically of the form "the size of my holding is dwarfed by institutional shareholders so there is no point in voting", "I only vote on important matters", or "got out of the habit". There were also a large number of individual comments on the difficulties of voting, particularly where nominee accounts were in use - "too much hassle" was a typical one.

Summary. The results of this survey demonstrate that the nominee account system dramatically reduces the number of investors who submit proxy voting forms for the companies in which they hold shares. Even among ShareSoc Members, who are more likely to understand how to exercise such votes, they are often unable to do so because only 18% use a broker who provides information and voting rights. There is also general ignorance of the obligation of ISA operators to provide voting rights.

Note: there were responses from 401 ShareSoc Members and 109 other "public" responses to the aforementioned survey. Copies of the full reports on the results of these surveys and the details of the questions posed are available from ShareSoc.

Appendix B - The Australian Chess System

The basic principle behind the Australian settlement system (CHESS) is that all trades are settled electronically with no share certificates or signed transfer forms having to pass hands. This dramatically reduces the chance of trades failing due to lost certificates or ignored transfer forms, and also materially speeds up the process of transferring shares. What makes the system attractive, apart from the fact that it has been in place in Australia since 1994 and is fully tested, is that it maintains the basic principle for shareholders of own name registration which allows for direct communication between companies and their shareholders, particularly private shareholders.

Below we quote directly from the ASX's manual on the CHESS system, underlining the system's key concept of 'name on register'.

"*The CHESS subregister is recognised as forming part of the legal register of holders for a financial product, upon which each individual holder's holding and registration details are maintained. This is in contrast to the depository nominee approach to electronic transfer, common in foreign settlement systems, in which holding records are maintained as sub-accounts within the registered holding of a 'super' nominee*." (For 'super' read broker).

Whilst some shares are held in nominee names in Australia, and indeed there are some limited legacy holdings still in certificated form, the new system is primarily aimed at sustaining the own name concept of share ownership in a dematerialised structure. This reinforces the fact that it would be simple for the UK to similarly embrace the concept.

The basic structure is that securities are registered in two ways, both of which ideally entail the registration of the underlying shareholder as the direct owner of the shares. The first registration type is that of a CHESS sponsored shareholder where the involved broker, who has to be a CHESS member in its own right, sponsors a client who then appears directly on the register of the company in which they have bought shares. The second registration type is where a new buyer requests that the broker registers them directly on the company register as the legal owner in a process known as issuer sponsorship, i.e. where the company itself sponsors the new shareholder. CHESS effectively operates a sub-register from which details input when a trade has been carried out - details of the shareholder etc. - are uploaded to the company's register. If you are a broker or an issuer sponsored holder you are given a unique reference number which identifies you on the company register. However, as a CHESS/broker sponsored shareholder you will have just one reference number to cover all your holdings, if you are an issuer sponsored shareholder you will have a reference number for each of your holdings provided by the relevant registrar.

The difference between the two is that if your shares are CHESS/broker sponsored you have to deal in the particular share through the original broker, with an issuer sponsored holding you can trade with any broker you choose.

However when an issuer sponsored holder sells, their shares have to be converted into CHESS registration form before the transfer of ownership can take place, a straightforward and swift process. Settlement is T+3. In terms of the present UK system the two types of Australian registration are not dissimilar conceptually from CREST personal membership and certificated holding.

Once registered under the CHESS system the issuer sponsored shareholder is sent an account statement from the relevant registrar which shows their holding in the company. That is updated after any trade in the particular share by that client. The broker sponsored investor will receive one account from the broker which will show all registered holdings. The purpose of this short explanation of the CHESS system is to show how it operates at the investor registration level not at the exchange operating level. Suffice it to say that operationally the system has a number of linked stages from when the investor places their order to where funds are transferred from the buyer to the seller's account through the client brokers and the new holder is placed on the particular company register.

Appendix C - Problems in the 2006 Companies Act

If you hold shares via a nominee account, does that mean that in law you are a member of the company with all of the rights and protections provided by Company Law (i.e. under the Companies Act 2006)? The simple answer is no!

This legal position was reinforced by a High Court judgment in the case of Eckerle and others versus Wickeder Westfalenstahl GmbH. Mr Eckerle (who was represented by ASB Law) opposed the re-registration of the latter company from being a public company to a private company. There is a little known provision in the Companies Act that enables a holder of more than 5% of the shares in a company to oppose such re-registration as being prejudicial to the financial interests of a minority, by application to the Court.

The defendants (represented by Orrick Herrington & Sutcliffe) simply argued that the plaintiffs had no legal standing in law because they were not "members" of the company (i.e. not shareholders on the share register), and that claim was upheld by the court. Therefore the application was rejected.

Wickeder Westfalenstahl was a company registered in England but formerly traded on a German stock exchange. As is common in Germany, all the shares in the company were actually held by a bank as trustee with the interests of individual shareholders being recorded by them, i.e. they acted as the nominee operator and simply recorded the "beneficial interest" of individual shareholders in their trust records.

The lawyers for Mr Eckerle argued that he was enfranchised by the Company's Articles of Association and section 145 of the Companies Act. However, the Court determined that the Articles of Association could not be interpreted that widely. This left Mr. Eckerle without redress as a minority shareholder.

Mr Justice Norris stated that this was not a particularly comfortable decision for him to make as it deprived the claimants, as indirect investors, of the sort of protection which those who formulated the Act thought ought to be extended to minority shareholders.

Now you might think that this is of academic interest, or unlikely to be something that will concern you. But that is not the case, for anyone who invests in smaller quoted companies.

For example, consider the events at VSA Capital Group which was an AIM listed company and the subject of a delisting proposal. The directors narrowly won the delisting vote, mainly because a number of shareholders in nominee accounts seemed to have difficulty in voting, or their votes were delayed and hence not counted. In many respects, the vote was questionable. Now another provision of the Companies Act (Sections 342/343) enables any shareholder (or group of shareholders) with more than 5% to apply for an independent review of a vote. But obviously in this case with shareholders mainly in nominee accounts, they had no legal standing to do so!

Would the nominee operator do so on their behalf? Probably not because although they might have a legal responsibility to vote as requested by the beneficial owner (as applies to ISA accounts for example), they have no duty to take wider action.

So in essence, the nominee system not only makes it difficult for shareholders to vote (and act as owners of the company which is what in essence they are), but it also fatally undermines the rights of shareholders.

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**).

ShareSoc

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