

UK Shareholders Association
BM UKSA
London
WC1N 3XX

Rt. Hon. Jacqui Smith M.P.
Minister of State for Industry
Department of Trade and Industry
1 Victoria Street
London
SW1H 0ET

Phone: 0870-70-60-600
Email: uksa@uksa.org.uk
Web: www.uksa.org.uk

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The ESF Proposals for Dematerialisation and Shareholder Enfranchisement

Dear Ms Smith,

We welcome the proposals from the European Securities Forum (ESF) concerning the dematerialisation of share certificates and the enfranchisement of shareholders which was recently published under the title "Better, Quicker and More Efficient Investment Arrangements for the Individual Shareholder". Their proposals certainly contain many positive suggestions, and are in our view a step in the right direction.

We have campaigned for many years for improvements to the rights of shareholders and particularly on the problem of nominee accounts - some of our previous comments on this issue can be seen on our web site at: http://www.uksa.org.uk/Share_Certificates_Nominees.htm - and we welcome suggestions to improve the situation as we feel that such improvements are long overdue. As the report points out, the UK is falling behind other countries in having an efficient and secure share trading system, which protects the rights of shareholders and provides them with adequate information about company activities.

However we do have the following comments:

1. Share Certificates and Dematerialisation

We accept that there are numerous problems in terms of security and efficiency of trading with existing paper share certificates. The prime reason that many of our members have resisted their abandonment in the past is no doubt because the alternatives (Personal Crest membership or nominee accounts) both had major drawbacks.

Personal Crest membership is often more costly, and makes it difficult to trade through more than one broker, so tends to be only used by active traders (and private shareholders are often relatively inactive traders). Nominee accounts disenfranchise shareholders so they lose voting rights, miss out on company reports and have other disadvantages. At present we see nominee accounts as positively abhorrent and recommend our members not to use them, although of course this is impossible to avoid with such vehicles as ISAs.

UKSA—The independent voice of the private shareholder

The United Kingdom Shareholders' Association Limited
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The proposal that is being made to set up a new "electronic" form of shareholding (the "name-on-register" model as ESF call it) where shareholders would be fully included in the share register, have the normal rights of registered holders, and be identified by an "SRN", we therefore welcome.

We also accept that this mechanism should compulsorily replace all existing paper share certificates over a space of time (given adequate time for shareholder education and tracing of certificates), but subject to a couple of comments:

a - Some shareholders use their shares as security for bank loans and in that case at present the banks ask to hold the certificates so they can ensure the client does not dispose of the shares. There would need to be some way for banks to record a "charge" on the electronic share register which would inhibit trading in the shares until the charge holder released the charge.

b - We think that many older shareholders may still resist the removal of share certificates and therefore we recommend that the new system does provide for the issue of an "SRN Register Copy" in paper form stating the number of shares acquired when they are purchased. This could look very like an existing certificate (in fact could look similar and even be similarly named), but would not be essential for trading of the shares and clearly would be no legal evidence of ownership (but neither is an existing certificate necessarily). It could be combined with the existing contract note, or dispensed with at a later date when everyone was used to the new system.

2. Shareholders Rights and "Opting In/Out"

We also accept that currently many shareholders might not wish to receive the full Annual Report & Accounts, interim statements and other shareholder communications and that companies currently incur needless expense in distributing such items, particularly to smaller shareholders. We certainly have no problems with the existing system of producing a "Summary" Annual Report for some shareholders, but we are opposed to any system of removing such communications altogether based on an "opt-in" arrangement.

This would be even more retrograde if such matters as proxy voting forms were not circulated, or some alternative electronic voting mechanism not provided.

There are simple practical problems with an "opt-in" system. For example, is a new shareholder always going to be sent an "opt-in" form immediately after purchasing shares? If so that would add considerable expense for companies. But if not, and such form is delayed then shareholders might not receive communications they both wanted and needed.

We also feel that it would be very easy for companies to encourage shareholders to not "opt-in" and hence ultimately remove many shareholders from involvement in the affairs of the company. In other words, shareholder democracy would be undermined and ultimately the shareholders could be disenfranchised. This surely moves contrary to the spirit of the times, where more involvement of shareholders and supervision of the activities of the company's managers are seen as a good things in order to limit abuses of power.

Our proposal would simply be to provide shareholders with an "opt-out" mechanism for shareholder communications in general. But they should still receive voting forms in all cases (and be given an internet web site reference where they can see the full documents if they desire, or a way to request copies by telephone).

But we would also permit shareholders to receive such proxy voting forms electronically if they were registered to do so, and provide some mechanism to vote electronically also (as is already commonly provided to shareholders in the USA and is provided to Crest members also).

Note that we would be absolutely opposed to the provision of information and access to voting rights being "dependent on the decision of the issuer" as is proposed by ESF. We feel these are matter for company law, or associated regulations, if uniformity and consistency are to be maintained so that shareholders know where they stand, and so that unethical company managements do not exploit lax arrangements to reduce shareholders rights in the name of saving money.

We would also be opposed to any presumption that a shareholder who had "opted out" meant that he did not wish to receive other communications from third parties (ie. that effectively his name might be removed from the public register). UKSA has in the past sent letters to shareholders pointing out the mismanagement of companies and it would not be wise to encourage companies to promote "opting-out" so that they knew other people could not contact shareholders. The preservation of public access to shareholder registers (as it is to electoral registers) is a very important aspect of maintaining shareholder democracy.

3. Enfranchisement of Beneficial Owners within the Nominee Structure

UKSA has long complained about the erosion of shareholders rights by the use of nominees. This not only adversely affects the rights of the individual shareholders who have their holdings in nominee accounts, but it increasingly makes it very difficult for shareholders in general to oppose unreasonable corporate actions. With on-line trading now prevalent (which typically use nominee accounts), if you look at some company share registers, the majority of holdings are in nominees. Writing to shareholders becomes impossible as the nominees do not forward such communications to the beneficial owners. Of course this can often be to the advantage of company management or one or two dominant shareholders, but it certainly undermines the basic principles of company law, including the one vote for one share concept. Anyone in a nominee not only gets no information on what a company is doing, they lose the right to vote.

The proposals from ESF can be seen as a move in the right direction in that they are obviously trying to introduce mechanisms for investors in nominee accounts to re-establish their rights. However we can see several detail flaws in their proposals:

a - The ability for companies to request that nominees provide details of beneficial share owners upon request so that they can send communications to them, appears to be at the option of the company, ie. it will not be a legal right for all companies to do this and send all communications to such "shareholders". In our view this relies on the goodwill of companies and their willingness to incur the expense, which they will not do if the result might be unfavourable to them. For example, will boards dominated by major shareholders wish to do so? I doubt it.

b - There presumably will be no right for third parties to request details of shareholders so they can also communicate with them (as there is on the company share register). This right is one of the few things that can help to protect shareholders interests and which is obstructed by the nominee system.

c - The nominee operator also "will have the choice of which level of services they offer to their customers" according to the ESF proposals. It is not clear how this might be reconciled with the companies desires to communicate to their beneficial shareholders, and certainly we would be opposed to any discretion in this regard. We might be happy with an "opt-out" mechanism for some nominee shareholders, but we think that there should be clear rights rather than each company, nominee or broker making up their own mind how they service the beneficial shareholders.

Note that we would much prefer to see an approach adopted to this problem that is similar to that existing in the USA. In that case, the nominee operator has the legal obligation to distribute all company reports and announcements to beneficial shareholders including proxy voting forms.

They also have an "opt-out" system in place, but there are regular reminders about the ability to opt back in. Of course, again we would prefer an "opt-out" system rather than an "opt-in" system for company information. We should be encouraging more knowledge in individual shareholders, rather than discouraging it.

And incidentally we would like to see positive discouragement of the use of nominee accounts as an alternative to use of the proposed new "name-on-register" model accounts for individual share trading. Nominee accounts should be reserved for those situations where it is clear that the shares are being managed as part of a portfolio on behalf of the investor by a fund manager or broker, and where the shareholder has little interest in their individual holdings.

4. More Emphasis on Electronic Communication and Voting Required

One aspect of the subject of shareholder communication and voting that we feel is inadequately covered in the ESF report is the issue of the use of electronic communication and voting services to reduce costs. Clearly the internet (web sites and email services) provide the ability to delivery information at much lower cost than via paper/post. We feel that such technology could now reliably deliver, or make accessible, such information as Annual Reports and Accounts to the vast majority of shareholders at minimal expense. Shareholders might be encouraged to use such services (if they were available which they are not at present), by suitable financial incentives.

This would be a better solution, in terms of maintaining shareholder democracy and rights, than encouraging people not to receive information from companies at all.

5. Summary

In summary, although we acknowledge that the ESF proposals have some good aspects, they do not go far enough in our view to solve the problems of nominee accounts, and are deficient in detail. We feel that too much attention has been paid to the needs of the financial services industry (as one might expect from the composition of the ESF) rather than the needs of shareholders, and the greater good of the business community.

We would ask that before any proposals such as those of the ESF are incorporated into the revisions of Company Law that are currently under review, that a forum be set up under the behest of the DTI that would contain all interested parties to discuss these matters. We would of course be happy to contribute to any such discussions.

Note also that we would be happy to support the proposals to do away with share certificates, and help to educate the public on the need for that, if we felt that we could support the details of proposals in this area.

Yours sincerely

Roger Lawson
Communications Director

cc. Werner Frey, ESF
David Blundell, Chairman, UKSA
Angela Knight, APCIMS

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www.uksa.org.uk/Dematerialisation_&_Nominees_Letter_Jacqui_Smith.pdf