UK Shareholders' Association

Responsible Investing
— for the individual and society

Responsible Investing – for the Individual and for Society

Contents

Note to readers: document format

A number of printed copies of this document have been produced in A5 format. The page numbering here differs from that in the A5 booklet, but the contents are the same, apart from changing the numbering of the objectives in the Manifesto so that they run from 1 to 12, rather than restarting at 1 in each of the 3 sections.

More information on UKSA will be found at www.uksa.org.uk

Comments on the material and issues raised in this booklet are welcome. Please write to the address below or e-mail to ResponsibleInvesting@uksa.org.uk

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INTRODUCING THIS BOOKLET

This booklet has been produced to raise public awareness of the issues raised and contribute to public debate about them. We call for changed attitudes, but we also call for some specific reforms which may need legislation, some of which may appear quite radical.

Part One describes how we, the United Kingdom Shareholders' Association, see the responsible private investor.

Part Two describes what needs to be done to give him and her the power to exercise their responsible attitudes to better effect.

Part Three is UKSA's *Claim for Private Shareholders' Rights*. This is our manifesto. Unlike those issued by political parties, this is not a manifesto stating what we say we will do. It is a manifesto of what we believe needs to be done.

The authors, Derek Miles and John Hunter, are members of UKSA and private investors of long-standing, with direct experience of what is described in this booklet. Their words are their own, but they have collaborated with others on this booklet for the UK Shareholders' Association, which fully endorses its central message.

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UKSA is the leading independent organisation which represents the interests of private shareholders in the United Kingdom. We campaign to protect the rights of shareholders in public companies, and to promote improved standards of corporate governance. Our educational activities, regional meetings, company analyst-style meetings and the resources of our website, help to inform the public on investment management. UKSA is a not-for-profit organisation which is financially supported primarily by its individual members.

PREFACE

The time is long overdue to make the case for the private investor. This booklet attempts to do so.

First, let us proclaim his virtue – and hers. Collectively, they have certain qualities not always present in other shareholders. He and she are the ultimate shareholders in for the long term. They think like owners and have an owner's loyalty. They may have long experience of the company. They often have valuable business and investing skills quite the equal of those at the disposal of institutional investors. They have no conflicts of interest and no commercial interest other than the preservation, enhancement and enjoyment of their investments.

In making this contribution to their own financial well-being and that of their families – which is a virtue in itself – private investors are behaving responsibly in a broader sense: for the good of society as a whole. One would have thought such a responsible attitude would be encouraged and similar attitudes inculcated throughout society, but the opposite has happened.

Individual savers and investors have been treated disgracefully in recent years, disenfranchised and ignored, viewed only as fodder for the extraction of value by the financial services industry. It is notable that in virtually all the official inquiries into the failings which the credit crunch exposed, the term 'investor' was taken as synonymous with institutional investors only. Individual investors and savers are still being ignored. Those in positions of authority bemoan their inability to persuade, cajole or bully institutional investors to behave like the owners they are supposed to be but fail to be, while seemingly blind to the opportunities for improving corporate governance and the long term performance of British business offered by the private investor, if only he and she were empowered to do so.

The central message is this. The diminishing freedom available, to individuals choosing to invest in public companies to manage those investments, is close to scandalous and must be challenged. Instead of succumbing to the desire of company directors for autonomy, or to the unbridled desire of stock exchanges for ever-greater turnover for the sake of profit, or to the equally avaricious nature of much of the financial services industry, or to the quiescent role of a mere 'consumer' (i.e. a buyer of goods or services) ascribed to them by the regulators, private investors need to assert themselves.

All these and other matters requiring reform are addressed in this booklet. The tide that has been flowing against the private investor needs to be turned. In this general election year, there are few issues which matter more to the long term health and prosperity of our nation.

Part One:
THE NATURE OF RESPONSIBLE INVESTING

1. Private Investors: Leaders or Lemmings?

In this booklet, we shall argue that a market economy is more likely to thrive if ownership of businesses is diffused among large numbers of private shareholders than if it is concentrated in the hands of a few institutions.

What is a market economy? What indeed is a market? David Howell[1] suggests it started as *"the meeting place, the agora, where citizens met and mingled and built up the cement of trust and the customs and habits of association which held life together."* This implies that widespread participation in market activities by individuals as well as corporate groups is desirable if a society is to be cohesive and successful. Where institutions dominate and hunt in packs, as they often do, the market will lack a sufficient body of iconoclasts who take a contrary view.

Private shareholders are often seen as lemmings, likely to throw themselves off the nearest cliff because they lack the collective wisdom of established investment institutions. To set against this, their very individuality and range of views can stabilise markets and lead them critically to examine and reassess whatever happens to be the fashionable view at the time.

Let us be clear that we are discussing *investors* rather than *speculators*. Of course, some people regard stock exchange investment as another branch of gambling, or purchase shares because they like the name of the company, the look of its premises, or even the look of its chief executive. Others base their choices on tips from relatives, friends or the daily newspaper, but without any real attempt to understand and test the reasoning that lies behind the recommendation. These people are really gamblers rather than investors and they might have more fun (and lose their money no more quickly) by going to a horse race or joining a poker school. UKSA was not formed to look after gamblers.

Thus this booklet aims to focus on the interests of people who have a serious approach to investment, and recognize that they have a responsibility to look after their own interests in an intelligent way.

We see investors as individuals who essentially are responding to the most basic financial impulse of all, i.e. to save for the future, because the future is unpredictable. Indeed it has become even more unpredictable in recent years, with the demise of final-salary pension schemes for all but a lucky few. In the words of Niall Ferguson[2] *"They appreciate that the world is a dangerous place, and not many of us get through life without having a little bad luck. Some of us end up having a lot."* If they are to save effectively, they have to try to assess the relative likelihood of the various uncertainties to which their savings will be subject.

Even the apparently low-risk option of putting money into a fixed interest account or long term bond will prove dangerous in an inflationary environment.

Why does the behaviour of individual investors matter for society as a whole? The essential point is that the diversity resulting from a range of individual views is more likely to bring to light the dangers of foolish strategies than is the collective standpoint of large institutional investors who tend to hunt in packs. It has truly been said that money managers do not suffer from being wrong, so long as they are wrong with everyone else. Punishment is reserved for those who are wrong on their own. For example the recent myth that an 'efficient balance sheet' is one loaded with debt has recently led many otherwise successful, but cyclical, companies either to their doom or to a need for a deeply discounted rights issue to enable the shareholders to retain a shred of value in the enterprises which their directors have debauched.

2. The Responsible Investor

We see a responsible investor as a person who invests only in an area about which he or she has gathered objective information and properly understands. Inevitably responsible private shareholders come in all shapes and sizes. Some operate as dealers, making short term profits here and there but having no long term commitment to the companies in which they invest. This group is serious, and sometimes financially highly successful, as a result of the attention that its members devote to their operations, but their focus is by definition on the short term. By and large short term investors do no real harm and no real good to the companies in which they invest, although larger institutional funds, so-called vulture investors, can do considerable harm by short selling and putting a company 'in play' and so destroying businesses, especially those that are quietly pursuing longer term strategies to build shareholder value. Of those who seek long term investments, we believe that anyone who is not able, or is not prepared, to devote enough time to really understand the principles of how to value a business would be unwise to embark prematurely on direct investment in companies.

UKSA is a special interest group bringing together people who have some money, some time, a definite interest in pursuing the direct investment route and a general interest in promoting the prosperity of businesses based in the United Kingdom. We respect people who do not share our willingness to devote a considerable element of spare time in attempting to understand the mechanics of investment and the economics of individual businesses, but who wish to invest as safely as possible in a medium that gives them exposure to the stock market through some form of collective investment instead. We believe that a number of investment trusts can be worth considering by such investors, providing there is evidence that the managers are competent and trustworthy and the management charges are relatively modest.

For those who are less confident about their capacity to make a choice, there is much to be said for a cheap tracker fund, which simply follows market movements without attempting to outguess its competitors on market timing or the strengths and weaknesses of individual companies.

Although we respect investors who take the simpler and more basic route to investing their assets, we wish to make it clear at the outset that this booklet is concerned with the role of those whom we see as serious and committed private investors in individual British businesses. If their knowledge and experience were properly harnessed, we believe they would have much to offer in improving the standards of corporate governance for the benefit of all.

After the events of recent years, with boards of directors exposing their businesses to excessive risks through investment in derivative instruments that they clearly did not properly understand and making the problem worse by operating with excessive gearing (i.e. high levels of borrowing laughably referred to as seeking 'efficient balance sheets'), few would argue that there is no scope for improvement in this area. We therefore focus on the scope for private investors to make a constructive contribution to improved governance and ways in which such an outcome could be encouraged through administrative and other reform.

3. The Caring Investor

By private shareholders, we mean investors who choose to invest directly in companies rather than through collective vehicles such as pension funds. Such private investors have a direct, albeit usually heavily diluted role in choosing boards of directors on whom they rely to look after their investment. They usually take at least some interest in the proper governance and allocation of funds by the companies in which they invest, because they want to see them run properly.

It is evident that private investors are savers primarily seeking benefit for themselves and their families, but wittingly or unwittingly they also make an important contribution to society, especially one which has taken on very significant debts in recent years. Their savings are directed towards providing capital for businesses to grow, whether directly (including through rights issues and open offers), or by purchase of investments in the stock market which is itself a process that ultimately results in more money becoming available for reinvestment directly into industry.

From the standpoint of corporate governance, private investors have no conflicts of interest and are without commercial pressures from employers, so they enjoy the luxury of being able to take a more objective position than those who are required to demonstrate short-term results.

This is starkly relevant when considering 'the derivative threat' to consistent and effective corporate governance, arising from the increasing use of investment means designed to offer various forms of exposure to equity shares but without the sense of responsibility that comes with the traditional 'one share one vote and one dividend' commitment to responsible stewardship. We recognize that the growth of this phenomenon makes it very difficult for boards to take a long term view and, while we admit that there are no easy solutions, it is essential that some means are found to limit the power of such predators to damage the long term prospects of sound companies and, by implication, the foundation on which our long-term national prosperity rests.

Above all we believe it places greater weight on the need for governance to be grounded in an underlying morality. We all know institutions that, despite the pressures placed on them, have an honest care for the companies they own and the savers they represent, but others seem to see their investors as sheep to be sheared. We believe that responsible private investors looking after their own personal interests have a greater motivation to watch carefully over their investments than institutions acting merely as virtually unaccountable agents.

If you put your full faith in the institutions, as you are currently, by implication, urged to do, do you think this will lead to more honest institutions? Or do you worry that your money is placed in the equivalent of an unlocked bank vault, which is out of your sight but open to plunder by the unscrupulous? We fear that a structure based on conventional shareholder governance allied to derivatives is just this to a venal or even just an adventurous hedge fund manager, and the opportunity will attract more of this kind.

Thoughtful and serious private investors, we believe, should be seen as truly independent investors, in that they are in a unique position to offer constructive alternative strategies to the companies in which they invest, based on knowledge and commitment coupled with serious thought and analysis. They can be seen as the invisible mentors, and can offer a useful sounding board to those company boards wise enough to identify them and make use of them.

The best family companies survive through the years because they are backed by a group of investors, with a serious commitment to the success of the business. There are other companies which maintain regular and effective contact with *all* their shareholders, not just with the larger fund managers and consequently can expect continuing mutual commitment to the success of the business when *they* need support to raise additional capital or repel an unwanted bid from a rival company. The problem is that these behind-the-scenes, supportive investors are too often unable to exert their beneficial influence to encourage businesses to strive for better corporate governance and thus enable them, when required, the more readily to attract further capital for those businesses to grow.

UKSA believes there is a need to ensure that all public companies put themselves into a position where there is a regular dialogue with private investors as well as with the major institutions. Our preferred mechanism for this is the establishment of shareholders' committees, elected by and answerable to all a company's private shareholders. We give detail for this proposal in Part Two of this booklet.

4. Diversity is Strength

It is the universal cry of despots that 'Unity is Strength'. Conversely democrats (and believers in private enterprise) see strength in diversity of opinion and diversity in media which enable that diversity to be expressed. Individual private shareholders are by definition independent by nature and, although they may meet occasionally and discuss their opinions with others, they ruggedly come to a variety of conclusions regarding how the businesses in which they invest should be run. Some of these conclusions may appear simplistic, but others represent careful and coherent consideration of factors that can easily be overlooked or neglected by collegially-minded company boards.

Any reader sceptical about this proposition should consider the recent history of boards of any of the major clearing banks, who clearly did not appreciate the risks they were running in their lending and investment banking operations. They merely noted with appreciation (and bonuses all round) that these operations apparently yielded endless profits beyond the dreams of Croesus and did not worry themselves that these apparent rewards were matched by commensurate risks. These were people with varied and extensive business experience but, because they were constantly in the company of others of the same ilk, they ended up being content with a form of 'group think' which they took to be the highest common factor, but was in fact the lowest common denominator. They neglected the possibility of an extraordinary event outside their experience of the kind that Nassim Nicholas Taleb3 terms a 'black swan' event.

Peter L. Bernstein[4], in his discussion of 'The Remarkable Story of Risk' argues that in fact unusual events should not be seen as surprising in the world of finance, because unpredictability is built into the system. He goes on to ask:

> *"If these events were unpredictable, how can we expect the elaborate quantitative devices of risk management to predict them? How can we program into the computer concepts that we cannot program into ourselves, that are even beyond our imagination?"*

One of the most vivid illustrations of this proposition is the history of the USA firm Long-Term Capital Management. Run by a mixture of supposedly hard-headed traders and Nobel Prize winners in economics, they thought that they understood risk and could measure it with an accuracy that would allow them to multiply returns through taking on eye-watering levels of gearing. But uncertainty and the human factor caught up with them in the end, leaving only a remarkable and riveting case study that was timely enough to provide prior warning to bank boards around the world.[5]

The lessons were in fact being taught much earlier than that. John Maynard Keynes recognised that, although some economic risks can be measured and allowed for, fundamental areas of uncertainty remain. He took the view that, *"Uncertainty becomes an issue for economics only when our livelihood or prosperity depends on our taking a view of the future,"* but then, of course, it most assuredly does.[6]

There is a real need for more genuinely independent thinking, which must include a capacity to 'think the unthinkable.' This is difficult for those who are only happy in a collegial atmosphere, where they test their every idea only against the common view of their colleagues before taking it further. Warren Buffett has stated that one reason for his remarkable and consistent success as an investor is that he chose to establish himself in

Omaha, Nebraska, rather than Wall Street and thus insulate himself from the temptations of 'group think' that affect most financial communities. He had no choice but to absorb facts and think business strategies through without interruption. As he put it *"You can think here. You can think better about the market; you don't hear so many stories, and you can just sit and look at the stock on the desk in front of you. You can think about a lot of things."*[7]

Ideally both the investors in and the managers of the business should share an owner orientation, meaning that they see themselves as partners in its development. Indeed, Warren Buffett sets out in Berkshire Hathaway's Owner's Manual a set of 'Owner-related Business Principles', which state that he and Charlie Munger (Berkshire's Vice Chairman) think of their shareholders as owner-partners, and of themselves as managing partners.[8] But individual shareholders can only think of themselves as partners if they are treated as partners. Unfortunately it remains both relatively difficult and relatively expensive for individuals to buy shares in their own names and thereby see themselves as 'owner-partners', as distinct from the alternatives of derivative or remote engagement with the businesses in which their funds are invested.

5. Forces that Divide Investors from their Investments

There are principally three separate but linked causes for this worrying trend for shareholders to become more remote from the companies in which they invest:

- the pressure to purchase shares through nominee accounts where share holders have no direct influence;
- the use of collective indirect investment vehicles such as unit trusts, OIECs and investment trusts, in ignorance of their true cost and the lack of potential influence that this gives over those investments; and
- the growing promotion of derivative mechanisms such as spread betting.

Nominee Accounts are a cheap means of purchasing an interest in an attractive company, but they separate investors from companies they are invested in, entitling them to few if any company documents, with no right or even opportunity to attend and vote at company meetings except by the leave of some financial intermediary. Some companies (particularly investment trusts) do make special arrangements to overcome these disadvantages, but these are usually companies that perform satisfactorily anyway.

Nominee accounts are attractive for the intermediaries, because they lead to lower costs and sometimes allow them to make a continuing return rather than a one-off commission, but they damage the prospect of improved corporate governance because they make investors remote from the companies in which they invest. In consequence they usually find it difficult to gather data on their performance, let alone have a beneficial influence on developing policies and strategies.

Collective Investment Vehicles can be a useful way for the small investor to achieve diversification, thus reducing investment risk. Some investment trusts, too, are exemplary in inviting and paying attention to the views of their shareholders on fund allocation. These give informative and frank presentations at AGMs, and issue regular commentaries on their investment thinking and activities through websites. However, other 'collectives' communicate with their investors with a caution bordering on contempt (apart from regular invitation to sink more money in their funds either directly or through the annual ISA allowance).

Spread Betting and Other Derivatives are attractive to those who see public companies as no more than symbols on a screen, rather than an opportunity to participate in real businesses with real employees and real customers. They lead investors into a mindset which is quite remote from any potentially beneficial effect arising from long-term investment performance, yet engender what are very often false hopes of making a fortune at the risk of losing one.

So the situation is, in the words of Anthony Powell, *"capable of considerable improvement before being regarded as in the least satisfactory."* How can such improvement be brought about? Piecemeal measures could ameliorate certain aspects of the situation, but we believe there should be a co-ordinated series of measures directed to establish an investment environment that would enable individual shareholders to exert a positive influence on the companies in which they invest.

6. An Enabling Environment

Small may be beautiful, but private shareholders with a limited shareholding in a large company often lose out in debates on the direction of companies simply because they lack the powerful block votes of the institutions. They also rely for information on annual reports, which are often written so as to give a favourable gloss to any situation – good or bad. Professional investment analysts, on the other hand, enjoy special access to management and are in a position to question management and make a more objective assessment of a company's strengths and weaknesses.

One practical way in which UKSA seeks to redress the balance is by arranging analyst-style meetings for its members, at which the participants can question a company's strategy in a more detailed and coherent way than is possible at a typical AGM. But the success of these meetings depends on the willingness of companies to participate and recognise that they have a responsibility to take account of the views of all their shareholders, rather than simply cultivate a cosy relationship with a few large investors who control the bulk of the votes.

One proposal, which is being pursued by UKSA and is discussed in greater detail in Part Two, is that companies should be required to establish shareholders' committees to represent individual shareholders, at least where these are requested. These committees would be expected to report back to other individual shareholders on issues where they have concerns.

We do not suggest that individual private investors invariably have wisdom to impart. Indeed we believe that the lack of a substantial body of *informed* investors remains a significant problem. UKSA tries to play a part in providing education opportunities, but as a small voluntary organisation our resources are inevitably limited. Commercial providers often have an axe to grind and their charges can put off all but the keenest potential participant.

It has been truly said that if you think education and training are expensive, try ignorance! Political parties may fear that there are few votes in assisting individual private investors but, if they are serious about strengthening the national economy over the longer term, they would be wise to gradually augment the numbers of voters who have a clear understanding of how corporate governance works - or fails to work.

We applaud the noticeable shift in the political climate in the last couple of years with the Financial Services Authority (FSA) leading a National Strategy in Financial Capability. But the educational approach, as exemplified by the FSA's website, presents the investment process as a choice between pre-packaged products with no attempt to clarify the underlying principles.

It is true that some newspapers and magazines print articles and analysis that assist in the education process, but it remains a problem that most mainstream media providers, including public broadcasters, make very little effort to guide and inform potential savers and investors at anything other than a woefully shallow level. This is as much a reflection of the general problem of little knowledge and poor understanding among savers generally as it is a contributing factor to it.

7. What is to be Done?

This booklet attempts to bring together, in three parts, the reasons why private investing in equities matters, the reasons why such a prudent form of saving has been declining and what must be done to remedy the decline.

Part Two develops the matters outlined in Part One. It goes into detail and tries to lay bare the malign factors which have created or led to the present situation. We say what UKSA believes should be done and we conclude, in Part Three, with our own manifesto for change.

The manifesto and this booklet will not be our last words on these matters, but they lay the foundation of a case which must be increasingly asserted, not just for our members (whose number if growing), nor just for private shareholders and savers generally, but for the future prosperity of UK business and therefore of our nation.

This booklet is not asking for hand-outs. It is not asking for special privileges. It is asking for fairer treatment, but it is also asking for the opportunity to make a contribution to better corporate governance of UK businesses.

Statistics show that simply investing in the whole stock market, or an index-related sample, will not itself provide great certainty of growing wealth for the investor. Sensible investment involves choice, educated choice, with the opportunity to exercise some influence over the businesses invested in, in order to help their managements become more successful. This is, if given the opportunity, a powerful driver for better performance across the spectrum, which is what brings together the two parts of this booklet's title, *Responsible Investing – for the Individual and for Society*.

1. David Howell, *The Edge of Now*, Macmillan, 2000, p. 151.
2. Niall Ferguson, *The Ascent of Money*, Penguin Books, 2008, p.177.
3. Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable*, Penguin Books, 2008.
4. Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk*, Wiley, 1996, p.335.
5. Roger Lowenstein, *When Genius Failed: The Rise and Fall of long-Term Capital Management*, Fourth Estate, 2002.
6. Robert Skidelsky, *Keynes: the Return of the Master*, Allen Lane, 2009, p 84.
7. Adam Smith. *Supermoney*, Wiley, 2006, p. 180.
8. Lawrence A. Cunningham, *The essays of Warren Buffett: Lessons for Investors and Managers*, Wiley, 2002, p.29.

Part Two:
REMOVING OBSTACLES & CONSTRAINTS

1. Deprivation of Ownership Rights

Who owns UK plc?

The most recent figures available show the structure of share ownership in the UK as follows.
Source: Office for National Statistics

Ownership of UK Equities (%)		
	1963	*2006*
Individuals	*54*	*13*
UK Institutions	*28*	*33*
Overseas (predominately institutional)	*7*	*40*
Others	*11*	*14*
	100	***100***

The striking feature of this table is the decline in direct share ownership by individuals. Among the reasons for this are the increasing sophistication and variety of investment vehicles provided by the financial services industry and the growth (over this period) of defined-benefit corporate pension schemes. The latter animal is, of course, now in terminal decline.

The consequence is that corporate Britain is controlled by the 'institutions' - a portmanteau word covering corporations and partnerships that typically are investing other people's money and not their own - pension funds, pooled investments (unit trusts, OEICs, investment trusts, ETFs), nominee shareholders, hedge funds and insurance funds. (There is a case for putting those in the last group in a different category because they are the legal beneficiaries of the with-profit funds they manage: this is a discussion we will leave to another time.)

Conspicuously different are the sovereign wealth funds, now 10% of the UK market and growing (in 2006, a smaller percentage included under 'others').

Ownerless Corporations

A presumption of good corporate governance is that shareholders care about the companies they own. They may not agree with each other, they may have different ideas on what matters (money, ethics, people, the planet, ideology), but they *care*. Governance should follow this path: shareholders elect directors, directors run companies as the shareholders want and companies struggle to survive and thrive. It may not be pretty, but - like democracy - it can be judged to be the least bad way of doing it.

It might seem better for major companies to be controlled by sophisticated professional investors - the financial institutions: good for individual shareholders, who can delegate their ownership control rights to people who know more than they do; good for companies, who are controlled by people who understand business and wealth creation, instead of by people they view as ignorant amateurs.

This argument (though it may create a small worm of doubt in the minds of those who recognise it as the case for autocracy in place of democracy) is seemingly quite convincing. But a funny thing is happening: institutions don't seem to care very much. They sometimes vote only because they are pressured to do so, through the guide to good governance practice, set out in the Combined Code for Corporate Governance administered by the Financial Reporting Council. Worse, they don't put in the work necessary to decide *how* they should vote, but blindly follow a 'lead steer' or the advice of one or two advisory bodies such as PIRC (Pensions Investments Research Consultancy).

Lord Myners, City Minister, has publicised a phrase for this condition: 'ownerless corporations'. If it's true, the governance chain that runs from beneficial owners through to the directors who work for them is broken. If those with the vote don't care, they won't be considerate voters. It will be governance by lottery.

Lord Myners' solution, endorsed by the Walker Review of bank corporate governance, has been little more than to berate the institutions for their indolence and demand or plead for greater action, commitment and governance responsibility from them. Section 5 will show why this is bound to be ineffective.

Voting Rights

Private shareholders do care. But they are mostly disenfranchised. The current system, which drives most private shareholders into nominee accounts where their governance rights are neutered, is incompatible with any concept of shareholders as owners and is another reason why the governance chain is broken. UKSA was led to believe that this problem would be solved by provisions in the Companies Act 2006, but such limited assistance as the Act gives has not proved to be very effective.

The benefits of cheap and on-line dealing are only available to those holding their shares through nominees; and the small number of nominee firms whose contracts provide for shareholders to be able to direct how the nominee shall exercise their votes typically do not offer this facility within their lowest-cost dealing services. The result is that those who hold their shares through nominees usually lose all the rights that should accompany ownership.

The government has connived in this situation by allowing its tax-advantaged savings vehicles (ISAs and SIPPs) to be available *only* if held in nominee names.

There is also a fundamental flaw in the whole model of shareholder governance: even where shareholders are beneficially interested in the shares they own, this may not represent their total interest. This is because derivatives allow them to sell their interest (so that they are neutral) or sell, double, treble (or more - the sky's the limit) their interest, so that they are 'short' (ie have sold shares they don't own), or 'very short' (ie are heavily deficient of them). If you are a hedge fund manager with access to a lot of capital, it is not difficult to devise a dozen different strategies to exploit this.

There is no certain way of correcting this flaw, but it does place great weight on the need for governance to be grounded in an underlying morality. This is an additional and powerful argument for empowering the private investor and encouraging their number to grow. One method of doing this lies in the establishment of private shareholder committees (for which see below).

This is a moral, as well as a governance, issue. It is wrong that individuals carrying the risks of ownership do not have all the rights of ownership; and it is wrong that administrators of nominee accounts should be able to vote a substantial block of shares in which they have no beneficial interest - and where the interests of the financial institutions of which they are a part could be in conflict (see Section 5).

Legal rights

The Companies Act 2006 specifies that the status of nominee shareholder 'does not confer rights enforceable against the company by anyone other than the [shareholder on the register]' (S145.4). The adverse effect of this is most shockingly seen when a company is taken over by a scheme of arrangement under Part 26 of the Act. Whereas under the Takeover Code an acquirer has to achieve a 90% holding before he can force the remaining shares into his hands, under a scheme of arrangement there is no minimum, as all that matters is a 75% vote in favour of those actually voting. As those holding their shares in a nominee account may not even be aware of the proposed change, let alone have a vote, their shares may be compulsorily acquired at a price at which they may not wish to sell, even if those participating in the vote hold less than 5% of the equity as happened in one such major acquisition in 2008.

UKSA has also had reason to be concerned at the security of shares held in nominee accounts. As *Investors Chronicle* reported in October 2008, "*When Pacific Continental Securities… went into administration in June 2007, customers with shares in the nominee account found themselves at the mercy of the administrators' bureaucratic process…and could not obtain full title to the shares or sell them for several months."*

The Modern Stock Exchange: an Ownership Casino

The functioning of a modern stock exchange primarily as a trading platform is now overwhelming the established mechanisms of shareholder democracy. UK Treasury minister Lord Myners has mentioned his concern at companies becoming *"the playthings of speculators".*

As shares become more important as tradable instruments than as entitlements to ownership rights, so the imperatives of traders supplant the requirements of governance. In particular there is a negligent attitude on the Exchange and by regulators towards those who actually own shares and therefore have the right and responsibility to vote them.

This is most clearly illustrated by stock-lending practices. This activity has grown exponentially along with the trading it supports. It is by no means clear what happens to the votes that go with the shares that are lent, although one certainty is that the stock lender loses his vote even though his economic interest is unchanged (he has only 'lent' – i.e. rented out, not sold, the stock).

The extent to which the FSA is unconcerned with issues of shareholder democracy is illustrated by the following footnote in its recent 70-page consultation paper on short selling (the only mention of stock lending in the whole document): "*Clients may borrow stock to be able to influence voting and other corporate action events (as legal title passes to the borrower); and firms use stock lending to facilitate their sometimes complex trading and investment strategies*." In other words, a statement that should ring major governance alarm bells is presented without comment.

The conclusion must be that major reforms in law, regulation and practice are needed, to change for the better the environment in which private shareholders invest their savings. Such reforms are for their protection, but the need for appropriate education also exists, to enable savers to navigate their way with better judgement.

2. Savers' Dependence on Agents

Personal Responsibility Lacking

There is, or used to be, in this country a tradition of thrift, but this has not brought a tradition of intelligent investment. In the USA, every medium-sized town has its walk-in brokerage – looking and acting like a friendly local bank branch. In Australia, 40% of individuals own shares directly compared to 13% in the UK.

Whether as cause or effect, there is no culture of investing in equities for retirement. The state pension (now enhanced by a network of targeted benefits) has provided a safety net at the bottom end. Defined benefit pension schemes have protected the employees of companies of all sizes from the need to think about their retirement. Defined contribution schemes sponsored or 'advised' by companies have filled another gap. The additional investment of choice for many has been in domestic property, which has contributed to an imbalanced economy, accompanied by illiquidity and lack of diversification for savers.

Now, the virtual demise of defined benefit pension schemes has been just one of many factors throwing onto individuals a responsibility that they are ill-equipped to handle. Public financial literacy, which is one essential cornerstone of efficient retail saving, does not exist. An ability to manage money is not considered a necessary life skill. It is not included in school curricula. Courses at colleges of further education with encouraging titles usually turn out to be providing only a grounding in the minimum standards necessary to *sell* investment products to others equally ill-educated.

Financial Advice Prejudicial

An industry of so-called independent financial advisers has been able to distribute commission-bearing products to those aware of the need to save but with no clear idea how to do so. Being 'advisers' and sanctioned as such by regulation, such an arrangement allows them to make savers feel that a sales process is in fact a piece of independent advice by an expert and thus negate any feelings of doubt or inadequacy that the saver might otherwise have about his or her 'decisions'.

Many financial advisers are merely product salesmen, including some of those allowed to be described as 'independent'. They do not charge for advice but live on commission, so genuine advisers have to contend with zero-cost competition. The result has been entirely predictable – an 'advice industry' with little value other than for the rich. The efforts of the FSA to regulate them, as it is required to do, have at different times led to different sorts of advice with different names, including 'basic advice', 'restricted advice', 'primary advice', 'generic advice' and 'professional financial planning and advice'. All of these have either had little impact or have not survived the consultative process. The ineffectiveness of the FSA is expanded upon in Section 3.

The way to create an economically efficient advice market is to be ruthless about what can be described as advice. UKSA's belief is quite simple: all 'advice' must be described as 'sales guidance' unless it is given by a firm whose financial performance, and the remuneration of its staff, is unaffected by the decisions of the client. In this definition, the word 'independent' is redundant.

An Educational Deficiency

There is no tradition of financial education in this country. Survey after survey highlights the lack of understanding of the simplest investment principles. Actually, retail fund managers (i.e. those selling to individuals), providers of investment products and so-called independent financial advisers, do not want educated customers. It is antithetical to their business models, which rely on *ad valorem* charges on constructed products which an appropriately educated person would know were either unnecessary or uneconomic (for the buyer). So the energy behind projects to educate the would-be saver tends to be commercially inspired. It is significant that such projects are kept firmly in the control of the FSA, ostensibly in its guise as protector of the 'consumer' but actually in its true identity as protector of the industry.

This is evidenced most starkly in the wording of the Financial Services Bill going through Parliament as this booklet is being written, which formally places control of a new consumer education function under the FSA by means of an addendum to the Financial Services & Markets Act 2000. The objectives of the function are elaborated in the following clause:

"The consumer financial education function includes, in particular -

(a) promoting awareness of the benefits of financial planning;

(b) promoting awareness of the financial advantages and disadvantages in relation to the supply of particular kinds of goods or services;

(c) promoting awareness of the benefits and risks associated with different kinds of financial dealing (which includes informing the Authority and other bodies of those benefits and risks);

(d) the publication of educational materials or the carrying out of other educational activities; and

(e) the provision of information and advice to members of the public."

By not including here any reference to the basic principles underlining good personal financial management, the Bill inevitably institutionalises a perception of savers as primarily consumers of industry products (i.e. particular kinds of goods or services as in (b) above). UKSA made representations to the Bill's Scrutiny Committee in the Commons recommending that (a) and (b) above be replaced by the following:

> (a) promoting an understanding of the basic principles of personal financial management, including management of debt, control of spending, living within an income and protection against disaster;
>
> (b) promoting an understanding of the basic principles of planning for the future, including the process of saving to meet financial objectives.

It is instructive to look at the FSA’s consumer education website - Moneymadeclear. It is evidently put together on a limited budget, does not compare - as a user experience - with commercial sites and has no sense of being authoritative. It is focussed (rightly) on basic financial education but does not include any learning paths. The subject of ‘Savings and Investment’ is fundamentally flawed, being treated as an exercise in product choice with no attempt at teaching the basic principles of investment to enable an informed decision to be made. There is no mention of what is known as ‘cost drag’ and no explanation of the damaging effect of the compounding of costs over a long period, both of which work to the disadvantage of pooled investments sold as savings ‘products’.

UKSA has urged that control of the government’s financial education programme be given to a body properly focused on education rather than on creating a market for products.

3. A Disinterested Regulator

Compromised Regulation

The official response to market failure is regulation. But regulation carries the seeds of its own failure, because regulators, as individuals, depend for their careers on the industry they are regulating. That is inevitable because of what might be regarded as a number of iron laws.

- To be effective, regulators of financial services need a deep knowledge of the industry they are regulating, and there is no substitute for gaining that knowledge by having worked in it and therefore being part of it.

- Bankers who have worked as regulators have an insight that is valuable to their employers, but they retain a banker’s mentality.

- Regulators cannot match the pay of financial services, which limits their quality.

- Regulation, by constraining the pursuit of self-interest, will always be seen as hostile to the industry it regulates and therefore something that should be resisted.

The operation of these iron laws means that regulation is driven to be consensual and merely peripheral - which is not to imply that regulators are anything other than conscientious, honest and well intentioned. The point is that they are condemned by systemic weakness to be ineffectual.

Structural Weakness in Regulation

Regulation to promote efficient markets and regulation to protect the customers of those markets clearly reside uncomfortably within a single institution. Allied to the lack of any effective counterweight to the industry dominance of the regulatory process, private savers’ interests have been, and are being, neglected.

It is not clear that the policy of any political party will remedy this. The political approach to regulation will continue to change. What we currently have is a single regulator – the Financial Services Authority (FSA).

The Financial Services Authority

The FSA is the financial regulator established under the Financial Services and Markets Act in 2000, replacing a whole host of separate regulatory bodies. The regulation of the whole financial services industry is entirely in its hands. It reports to the Treasury.

The FSA has four stated objectives: to maintain market confidence; promote public understanding of the financial system; protect consumers; and to fight financial crime. In its business plan the FSA condenses these to two (plus an operational efficiency objective): promoting efficient orderly and fair markets; helping retail consumers (as it calls savers and investors) achieve a fair deal.

The FSA has the same difficulty dealing with the public as any branch of the civil service. It issues a stream of consultation and discussion papers, many of high quality. But the process of response is inevitably dominated by professional submissions. Professional in this case frequently means industry members fighting their corner. While UKSA does attempt to make representations on behalf of individual savers and investors as a class, there is no separate, easy, well-publicised channel either for general representations from the public or for comments on specific financial products. Allied to the structural flaws noted above, this means that the FSA's protection of the private saver (always disparagingly described as a 'retail consumer') comes a long way second to its protection of the industry.

This is most strikingly illustrated by the nine years it has taken to acknowledge in consultation that describing commissioned salesmen as 'independent' and as 'advisers' might possibly be misleading to the uneducated saver.

The Financial Services Consumer Panel (FSCP)

Even so, a body does exist to *'represent the interests of consumers'* (to quote from its objectives), namely the Financial Services Consumer Panel (FSCP). You may not have heard of it. This is not the FSCP's fault. It has only a handful of staff and neither the time nor the budget for self-promotion. Nor can it afford actually to engage with the public. The Panel's website used to state: *"The Panel is interested to hear comments and views from consumers on the way that financial services are regulated, although it is not possible to respond to comments individually."* Only very recently has the word 'always' been inserted before the word 'possible'.

However, the dozen Panel members represent a wide spread of interests and it remains one of the few consumer bodies with the expertise and inclination to push the interests of the individual saver with the FSA, notwithstanding that the FSA appoints its members. The Panel should be given the means to do more.

4. Conflicts of Interest: Owners versus Managers

Directors and the Agency Problem

The 'agency problem' is economists' shorthand for the difficulty of getting others to work for you in your interests and not in their own.

As the 2009 Walker Review has commented: "*A core challenge is that of the agency problem, the seriousness of which is a direct function of the distance between owner and manager... In the listed company sector…the agency problem is amplified by the very large number of shareholders, …, and the wide array of regulatory and related constraints relevant to contact between owner and manager. These constraints have increased over the last two decades, in part as an unintended consequence of additional financial regulatory measures designed to protect overall market integrity.*"

The Review is referring, of course, to institutional shareholders and *'constraints….. to preserve market integrity'* refers to the need to prevent insider trading. In passing, this is just one example of the way that the imperatives of the Stock Exchange as a trading platform have come to distort the governance needs of concerned shareholders.

The Agency Problem surfaces most obviously when the interests of directors and shareholders are directly opposed – and that occurs with directors' remuneration.

Directors’ Remuneration

Remuneration is the word that covers the wide range of avenues through which directors can take money from the owners of the businesses they run: pay, deferred pay, bonuses, share options, share grants, pension rights and benefits. For a listed company these items (and the other terms of a director's contract such as his severance terms) are set by a remuneration committee of independent directors of the company. 'Independent' means 'non-executive' and ‘without other potential for bias’.

Shareholders may vote on the remuneration committee report but the results of such votes are non-binding. Indeed, as things stand, they have to be, since the contents of the report are already a done deal: the pay has been set, the option and share grants have been made. More importantly, the employment contracts have been signed. UKSA’s view is that the engagement and termination clauses in such contracts can potentially be so expensive that it is unreasonable for them to become binding without shareholder scrutiny. Directors’ employment contracts should be non-binding until they have been subject to a (currently non-binding) vote at the AGM.

In effect, directors' remuneration is set by other directors. Further, remuneration consultants are retained by the people whose pay they consult on, their reports are not public and they are not answerable to the shareholders. This is clearly corrupt. Remuneration consultants should be treated like auditors: that is, elected by the shareholders and reporting to them.

Company directors are naturally assumed to be as conscientious, honest and public-spirited as any other group bound together by a common occupation. But the consequences of these arrangements are both obvious and predictable: remuneration creep. The increase in directors' remuneration has outstripped the increase in average earnings by many percentage points annually for at least 25 years. So long as these remuneration-setting arrangements continue, so will the directors' pay explosion.

It is not the high profile cases that matter so much: it is the many cases of quite average directors who are given well above average remuneration. An executive director of even a second-tier company would consider himself poorly rewarded if he did not get more than the Prime Minister as basic pay, with bonuses and options on top. It cannot be healthy that there is seemingly more competition for higher pay than there is for higher performance. The concern of investors should be that pay is fair throughout a company and that its leaders lead by example.

5. Conflicts of Interest: Institutions - Owners or Businesses?

Paragraphs 5.17-20 of the Walker Review interim report set out very clearly some of the obstacles to active governance by institutional investors. These include: agency problems, particularly where the financial imperatives of the institution may be in conflict with the what is best for the company; the cost of governance; ‘free-riding’ by less scrupulous institutions on the governance efforts of others; the irrelevance of individual corporate performance to funds benchmarked against an index; fear of adverse publicity; fear that confrontation will restrict subsequent access to the company; and concern that voting against management could cause a fall in the share price and be seen as a breach of fiduciary duty.

Now that these problems are on the official public record they cannot be ignored. It has been formally acknowledged that institutional shareholders as a class cannot be relied upon to contribute to better governance.

Good governance costs money

For institutional investors to contribute to good governance pro-actively, they must employ clever and determined (therefore expensive) people to spend time getting to grips with each company's strategy, engage with each company's management and, if necessary, apply pressure to create change. To be worth doing, there must be a payoff to those institutions which do it. For most institutions there is not.

For example, nominee companies – institutions that hold shares on behalf of individuals investing in ISAs, SIPPS, and other non-certificated brokerage accounts - are just bystanders. So are the managers of index funds, exchange traded funds and other program-driven funds. They won't spend money on governance. Indeed it would be irresponsible of them to do so: they would have expense ratios worse than their competitors and their clients would have inferior returns. This matters because of the way that the performance of funds is measured.

Fund performance measurement

Tony Golding, a retired investment banker, puts it well in his book 'The City: Inside the Great Expectations Machine': *"Institutional investors inhabit a relative world."* [1] So, trackers and index funds aim to *match* a benchmark, most other funds aim to *beat* a benchmark and all funds aim to beat others in the same market sector.

If an index constituent such as Vodafone is held in your fund (as it will be), an improved Vodafone performance will benefit your fund. But it will equally benefit the index, because a rising tide lifts all boats. There is no point in spending money on getting the tide to rise when your performance is measured solely by how far you float *above* the water.

Free riding

Alternatively, let us suppose that you are a manager of the virtuous Pickwick Fund, who has determined to be an activist investor. You spend, say, 1% of your funds under management on governance, which you charge to the fund. The companies do well, helped by your benign influence, so your governance money has been well spent.

However, down the road is your competitor who manages the Scrooge Fund. He spends no money on governance, yet he invests in many of the same companies that you do. So the Scrooge Fund will also have done well. *What is more, his costs will be 1% lower than yours.* So not only will his historical performance be 1% better, but his published TER (total expense ratio) will be a whole one percentage point better. Scrooge has had a *free ride* on your governance work. Since both historical performance and TER are key data for selling funds to new investors, Scrooge has built a competitive advantage out of Pickwick's well-intentioned governance efforts.

Actually it is worse than this. There are better ways – not only for you but for your clients also - of profiting from your governance efforts, which is to buy or sell the shares depending on what you have found. Why put the facts into the market through inevitably slow and public attempts to create beneficial change where previously you had an information advantage?

These are the dismal realities, to which the official response is to seek more 'engagement'.

Engagement is not Governance

The Walker Review and many other authorities refer to institutional shareholder 'engagement'. This is reasonable shorthand for *'engagement for the purposes of active governance'*. But much shareholder 'engagement' is not for that purpose. Perfectly reasonably (in a market-driven society) it is to serve the interests of the institution. Those interests are only rarely aligned with corporate performance. What institutions want above all else is information on the one hand and, on the other, a relationship that will lead to some special benefit (for example an investment banking mandate where this is within the institution's scope).

These conclusions on the inevitable ineffectiveness of institutional engagement are intuitively obvious. Unsurprisingly, they are supported by an academic study of the University of Exeter Business School, which found that, *"…fund managers who advertise a capability in responsible investment seemed to value the time they spent talking to company directors mostly for the investment information they gleaned. This was seen as more than twice as important on average as communicating to gain influence or effect change."*

Profit drivers of the financial services industry

Shareholders who do not vote and do not care would not matter very much if that left control of enterprises in the hands of those who did. But diversified financial institutions have other activities that conflict with the objectives of those trying to run businesses well.

- Private equity funds make most money from buying companies that they can improve – i.e. ones that are poorly managed and inefficient users of capital.
- The investment banking businesses of debt and equity funding, 'corporate actions' (i.e. acquisitions and disposals) and general corporate advice do not make much money from well-run companies that grow organically by building on their internal strengths. But they make a lot of money from companies that grow too quickly in areas they do not fully understand.
- Investment funds, and the buy-side analysts that feed them, need an informational or analytical edge. They are less likely to get this from a well-managed company in a well-understood business that communicates clearly with shareholders.
- Stockbrokers only make money when clients trade.
- Any trading business needs volatility to generate trading opportunities. Equity trading needs equity volatility. Equity volatility follows from taking on risk. This is easily achieved by 'exciting' forays into uncharted waters and by high leverage. It is not achieved by well-judged business development and prudent leverage within a coherent and comprehensible long-term plan.
- Institutional managers in all parts of the business, including those administering nominee companies or passive index funds, are aware of the group profits that may enhance their personal bonuses and share options.

All this adds up. In fact it adds up to an astonishing £2.2 trillion of assets in the UK quoted sector potentially misdirected to benefit a selected constituency of shareholders.

No process or regulation exists to resolve these conflicts, so something more fundamental is needed.

6. Introducing a New Governance Mechanism

Annual General Meetings

AGMs cannot be seen as a means of ensuring good governance. Ignored by the dominant institutional shareholders, held during working hours so that they can only be attended by those without jobs, sometime hijacked by special interest groups, 'voting' on resolutions already decide by other means, accessible – in a globalising world – only to those capable of travelling to the location, they are events designed for another age. But as things stand at the moment, they are all we have.

AGMs do achieve a degree of accountability. An AGM is the only democratic method available for holding the directors to account. Until that changes, UKSA believes that the AGM must be preserved and, for the sake of accountability, be strengthened. In that wish we are supported by the Combined Code of Corporate Governance.

Shareholder Committees

William Cash MP presented a Private Member's 'Protection of Shareholders Bill' to Parliament on 17 March 2009. The Bill promotes the idea of shareholder committees to represent the interests of individual shareholders alone. UKSA strongly supported this initiative and wants to see boards of directors introducing such committees on a voluntary basis, without waiting for legislation.

Among the key features are:

- members of the committee to be elected by individual shareholders only;
- committee members to be unpaid, apart from out of pocket expenses;
- the committee to have no power to impose actions on the company, but;
- the committee to have channels of communication with the company and a mechanism for communicating with the world outside;
- the committee to meet at least quarterly and
- one director to be specifically designated to attend its meetings.

In short, the Committee is intended to be a representative body with *influence* -the influence that comes with access to publicity, whether restricted (such as emails to private shareholders), or general (such as a press release). These rights for those who are owners of the business are no more than are already given to its employees through the Information and Consultation of Employees Regulations 2004 (SI 3426).

Being a *representative* body, it circumvents the problem of coordinating the actions of individual shareholders acting alone. The cost of communications is made trivial by the use of the internet. A voice is given to a significant group of investors who will take a long term view and focus on the sustainable corporate performance that is the prize and objective of good governance.

The concept of private shareholders' committees was included in the final report of the Walker Review (paragraph 5.17) following UKSA representations to Sir David Walker, quoted below.

"In respect of individual shareholders, Annex 6 of the July consultation paper observed that, largely for logistical reasons, individual shareholders, who together hold more than 10 per cent of UK equities, can rarely be brought into engagement initiatives. In a submission to the Review, the UK Shareholders Association (UKSA) said that many private shareholders could make a positive contribution to governance and propose empowering this behaviour through shareholder committees elected by individual shareholders. Under this proposal, such committees would seek to have regular meetings with companies in which they were specifically interested, to be attended by at least one director of the company at which he or she would be prepared to discuss and be questioned on key aspects of the company's policy. This proposal could clearly have attraction in bringing together a group of well-informed and committed individual shareholders to provide challenge and a fresh perspective to directors and management. But the conclusion of this Review is that balancing of the potential costs and benefits of such engagement, attractive as it may be in principle, should be a matter for individual boards to determine as part of their investor relations strategy, and accordingly no recommendation is made in this respect."

The absence of a recommendation was entirely reasonable in view of the need for exposure of a new idea (or an old idea resurrected) to debate. However, the suggestion in the Report that such committees should be voluntary on companies is misguided: good governance cannot be voluntary and engagement is not the same thing as advice. Even so, we are very encouraged that the idea has been given some official endorsement and is now firmly in the public domain.

7. A Platform for Reclaiming Private Shareholder Rights

Although the concept of private shareholders committees is not a new one and has even been adopted abroad (most notably, perhaps, in France), it has become for UKSA a cardinal objective in a campaign for the restoration and reinforcement of private-shareholder rights in general. As this booklet sets out to demonstrate, this is not a desire for special privileges to be given to a select group of the rich elite, but for the strengthening of private saving on the one hand, throughout society, while at the same time strengthening the hands of those who would use their investments to improve the governance and hence the future prosperity of UK businesses in general and the nation at large.

Nothing in this booklet / document is intended to be the last word on the subject, but as a foundation stone for what needs to be developed, UKSA's aims have been incorporated into a manifesto and this forms Part Three of this booklet. Written in the style of the highly respected Combined Code of Corporate Governance, UKSA's manifesto seeks to change attitudes towards the private investor at all levels, within companies, within the regulators and within Parliament.

[1]Tony Golding, *The City: Inside the Great Expectations Machine,* Pearson Education Ltd, 2003, Second Edition, p.140.

Part Three:
THE UKSA MANIFESTO

THIS IS THE MANIFESTO OF THE UK SHAREHOLDERS' ASSOCIATION, formed of private investors in shares. It is a statement of what needs to be done to restore the rights of ownership where these have been lost or weakened, to enhance them in the interests of better governance, better company performance and better accountability for the decisions taken by company directors.

It is also a manifesto for those who might wish to invest directly in shares but don't, either through ignorance, or fear, or misleading information from third parties.

In the interest of all these objectives, which we hold to be for the good of British business, for the British economy and for the greater prosperity of all British citizens, what we seek – set out on the pages which follow – may be summarised as set out below.

> Directors of all public companies - especially, but not only, listed companies – must always endeavour to treat private members of their companies no less favourably than institutional shareholders, fund managers and those seeking to exercise influence through derivative devices.
>
> Regulatory authorities such as the Financial Services Authority but including the London Stock Exchange and similar bodies, must take private shareholders' needs into account when framing regulations, listing requirements and the like, unsubordinated to the interests of other 'market participants' in order to ensure that the interests of the former are not disadvantaged by the interests of the latter.
>
> Parliament must enfranchise those who hold their shares in nominee accounts and review all legislative and other statutory barriers to the exercise of private shareholders' rights of ownership with a view to remedying any deficiencies there may be compared with other owners of shares in public companies and closing any gaps there may be in ownership rights overall.

In the pages which follow, we set out the principles which we believe should apply to the treatment of private shareholders, by companies and their directors, by the regulators and by Parliament.

We also set out a list of objectives. Achievement of these may not be sufficient to ensure all that needs to be done to satisfy the principles, but these are objectives that need to be met now.

Section 1 Relating to Companies and Directors

Main Principle

Private shareholders should have the right, in practice, to equality with other shareholders, as owners of the business. This means collectively in proportion to their number, as regards influence, distribution of a company's earnings and wealth and participation in new fund raising.

Supporting Principles

Company boards should ensure that all private shareholders are given access to information that is equal to that given to other shareholders.

Company reports must not only meet statutory and regulatory requirements, but must also ensure that all information which may be relevant to the company's future solvency and profitability which is known or should be known by the board is presented clearly for all shareholders to see.

The importance of the AGM to private shareholders must be recognised by company boards and chairmen in particular, being the only forum in which they can be heard and call directors to account. Its importance should be enhanced rather than diluted, to ensure that private shareholders collectively are given full opportunity to exercise their rights.

Company boards should seek opportunities to meet one or more representative groups of private shareholders other than at the AGM, to provide them collectively with an opportunity to influence matters of concern to them equivalent to that which is given to institutional and other major shareholders meeting in private.

Objectives

1. At any general meeting, each agenda item should be dealt with separately, with questions invited and comments allowed, a hand vote taken and the result declared, before there is any question of moving to a poll or to the next item. Voting by show of hands must be retained and votes cast at a meeting should be distinguished from those cast by proxy.

2. All general meetings must be run in such a way that members present are able to question any director on any relevant matter, which should be supplemented by each company establishing a practicable method of answering and publishing the answers to all pre-submitted questions.

3. Where a group of private investors formally requests the establishment of a representative private shareholders' committee, the board should facilitate this, through access to the share register for the purposes of election, the provision of appropriate meeting facilities, use of secretarial facilities and the availability of one or more directors to meet the committee, to enter into a continuing dialogue with it based on the mutual understanding of objectives and to ensure that all members of the board are aware of that dialogue

4. New directors' contracts of employment and any significant changes to directors' contracts of employment should be written in such a way that they will not have full legal effect until after members' approval has been given to the directors' remuneration report.

5. A company's owners must have the right to control the pay of directors and senior employees. Remuneration consultants must therefore be made accountable to the shareholders, their reports made available to shareholders and their reappointment sanctioned at each AGM.

Section 2 Relating to regulators

Main Principle

Regulation must recognise that investors are not consumers but, to the extent that they are in number or nature a minority, need regulatory protection from exploitation and other mistreatment. Regulation to protect the individual is as important as regulation to promote efficient, orderly and fair markets and the former must not be subsidiary to the latter.

Supporting Principles

Service providers such as stockbrokers, registrars and commercial providers of nominee accounts must be regulated as such, with the interests of private investors in mind, not as members of a financial service industry with an entitlement to profit protection.

In order to protect the individual, the regulatory function must not only prevent abuse of the individual, but must also ensure a climate of openness and transparency to enable the individual to make the best judgement in all circumstances.

Pre-emption rights for existing shareholders, when new shares are issued at a price below that of existing shares, must be preserved.

Objectives

6. Private shareholders must be treated as company owners, not as 'consumers', with provision for any organised group of them to have the same or equivalent facilities of access to pursue a complaint of inadequate regulatory control, or inadequate official supervision, as is available to institutions, professional bodies and other 'market participants', with the right to publication of any adjudication and the reasons behind it.

7. It should be a regulatory function to protect private shareholders from abuse of the pre-emption principle, setting the standards to be achieved, supervising adherence to them and seeking means of ensuring that the processes to be followed for rights issues are not unduly onerous.

8. Directors, employees and connected parties should be prohibited from participating in any issue of new shares that does not carry pre-emption rights, unless as part of a shareholder-approved remuneration arrangement.

9 All broker platforms must be required to identify clearly shares that are quoted in markets which function with lesser rules and rights than the highest level, with a link that provides information about the main differences in shareholder rights.

Section 3 Relating to Parliament

Main Principle

Parliament must legislate to ensure that commercial corporations are subject to ultimate control by those who have a beneficial interest in their long-term future.

Supporting Principles

All beneficial owners of equities must enjoy equal ownership rights and not be subordinate to those whose interest is merely agency or derivative.

The rights of those holding company shares on behalf of others (nominee account providers in particular) should be obliged to take account of their beneficial owners' individual interests at all times.

Other holders of shares who are not the beneficial owners, including custodians and share borrowers, should be disenfranchised.

Objectives

10. No company or commercial nominee account provider should be allowed to make any distinction between the rights of those holding shares in certificated form, private CREST accounts or nominee accounts, whether or not they have internet access, thus removing voting rights from those who provide nominee accounts.

11. Parliament must legislate to bring the security of ownership of non-certificated beneficial interests up to the same level as certificated ownership.

12. Companies Act provisions intended to protect shareholders in public companies must be made more readily enforceable by those who have cause to take such action and the remedies available must be appropriate for the offences committed.

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