ShareSoc
UK Individual Shareholders Society
Suite 34, 5 Liberty Square, Kings Hill,
West Malling, ME19 4AU
Phone: 0333-200-1595 Email: info@sharesoc.org
Web: www.sharesoc.org

UK Shareholders' Association
UKSA, 1 Bromley Lane, Chislehurst, BR7 6LH
Phone: 01689 856691
Email: officeatuksa@gmail.com
Web: www.uksa.org.uk

Intermediated Securities and Individual Shareholders

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In announcing its Review of Intermediated Securities, the Law Commission has highlighted that, while there are benefits from share "dematerialisation" and "intermediation", there is also:

- concern about the effect that the current system of intermediation has on corporate governance and transparency
- uncertainty over what legal redress is available to investors if issues with their securities arise.

This paper summarises ShareSoc and UKSA's view of these issues as they affect individual shareholders.

1. Impact on Corporate Governance and Transparency

It is widely accepted that both corporate governance and transparency of share ownership are currently unsatisfactory and must be improved. We strongly endorse the concern that the current system of intermediation is a significant contributor to this. This system disenfranchises individual investors in both law and practice.

There is a strong public policy case for improving corporate governance by enabling and encouraging individual investors and their support organisations to participate in delivering effective stewardship. Individual investor stewardship is necessary if all listed companies are to be held to account. It is clear that effective investor stewardship of the full range of listed companies cannot be delivered by institutional investors alone.

1.1 AIM and Small Cap Companies

While individual investors and their support organisations can play a role in improving corporate governance at larger companies, the case for their involvement is particularly clear for AIM and small cap companies.

According to the Office for National Statistics (ONS) at end 2016, UK individual investors held 9.5% of FTSE 100 shares, 19.4% of other quoted shares and 29.7% of AIM shares.

AIM and small cap companies form not only a significant group of companies in their own right but are likely to include the potential major companies of tomorrow. As such, it is important that they are encouraged to develop good corporate governance practices.

Most institutional investors have to be selective in how they focus their stewardship effort. Smaller companies tend to receive less attention as they are less significant to institutional portfolios. Effective investor stewardship of these companies therefore requires individual investors working alone or with their support organisations to be able to exercise ownership rights both in theory and in practice, i.e. both individually and collectively and at proportionate cost - both financially and in time commitment.

1.2 Support for Individual Investors
The case for enabling and encouraging stewardship by and on behalf of individual investors should not be based on their current participation levels or on research on their interest in voting or attending AGMs.

Data on current voting and attendance levels is not representative of the true demand, because of the problems in the current system. While there is a motivated core of well-informed individual investors who are willing to incur additional cost and make significant effort to exercise their ownership rights, it is not surprising that many are deterred by the problems they face. Inaction is reinforced by a perception by some that their vote will make little difference. Only in exceptional cases are the votes of individual investors actively sought, with GKN/Melrose being a notable example[1].

A smooth process for exercising voting and AGM attendance rights could transform this. An increased number of informed individual investors should see value in using their participation rights. This should particularly benefit the corporate governance of AIM and small cap companies as such investors are probably more likely to hold these shares compared with the average individual investor. Equally significantly, the provision of guidance, support and representation for both informed and less engaged individual investors would become worthwhile. International evidence suggests that this should deliver improved participation.

The current barriers to participation in the UK have resulted in very little stewardship support being available to individual investors to assist them to participate directly in corporate governance or to delegate their proxy. ShareSoc and UKSA are interested in playing such a role in the future, building on initiatives such as our voting guidelines on executive pay, and we anticipate that others might also wish to do this. The Australian Shareholders Association, our sister organisation, demonstrates in its “Your Proxy Counts” programme what can be achieved in a supportive legal and regulatory environment. It reports that the proxies that it holds at an AGM are often equivalent to a position in the top 20 shareholders list.
https://www.australianshareholders.com.au/Public/Advocacy_monitoring/Your_proxy_counts.aspx

In our view, it is very unlikely that greater participation by or on behalf of individual investors will develop without fundamental changes to the current system. Also, nominee account providers or investment platforms are unlikely to expand their role in investor stewardship. They have shown no interest in this historically; they see their function as purely administrative and, as such, any addition to their administrative role is a cost that they will have to absorb or pass on. This problem is exacerbated by the fact that their fee structure is often related to trading volumes rather than long-term corporate success.

1.3 Transparency and Shareholder Actions
Under the current system of nominee accounts in the UK, the legal shareholder is the nominee, even though the nominee is only an agent for the beneficial shareholder. Consequently, the current implementation of nominee accounts fails to provide transparency as to who the true investors (the beneficial owners of companies) really are. Individual investors using nominee accounts, including those required to do so to use SIPPs and ISAs, are unable to initiate or participate in shareholder actions directly. And, as the names of beneficial shareholders do not appear on the shareholder register, companies are unable to communicate directly with their true investors.

[1] The statistics on voting by retail shareholders on the GKN takeover vote (e.g. for, against, % of shares voted) have not to our knowledge been published.

2. Legal Detriment

The legal detriment from the current situation goes beyond uncertainty as to legal redress when things go wrong. In spite of Part 9 of the Companies Act 2006, there are also issues for individual investors in accessing the full property rights associated with a share, including the right to exercise ownership by voting and participating in AGMs and collective shareholder actions. In addition, there are issues of legal protection that arguably go beyond "redress".

2.1 Property Rights

The shareholder rights defined in the Companies Act 2006 are increasingly recognised to have material value. They enable shareholders to protect and enhance the value of their ownership of the company. However, those holding shares through nominee accounts are deprived of these rights in law (i.e. they are not company members) and alternative provisions often fall short in practical use:

- Increasingly, individual investors do not have access to personal CREST accounts, either at all or at affordable cost, through investment platforms, e.g. in May 2019, Charles Stanley Direct announced an annual fee of £420 + VAT for such accounts for existing clients having previously withdrawn this service some years ago for new clients. Following a change of platform provider, Tilney has recently withdrawn this service for new and existing clients.
- Access to the tax advantages of SIPP and ISA wrappers currently requires individual investors to accept the reduced property rights that come from using nominee accounts rather than being a company member.
- In *Eckerle and others v. Wickeder Westfalenstahl and another [2013] EWHC 68,* the judge ruled that a "shareholder" via a nominee account did not have the rights of a company member. (The case also has implications for the issue of legal protection and redress.)
- During court hearings to approve corporate constitutional changes, such as Unilever's recent proposed corporate restructuring, the judge will consider not only the number of shares voted in favour or against, but also the number of shareholders in favour or against. *Eckerle* would suggest that the considerable number of individuals using the same nominee would be counted as a single shareholder although this has yet to be tested in court.

When shares are held in nominee accounts, there is no requirement on investment platforms or brokers to provide access to these rights either at all or in a usable way. Currently some brokers do provide access for committed investors but many do not. In addition, we are not aware of any instance where investment platforms enable individual investors to put in place a general provision whereby third parties can vote their shares or attend AGMs on their behalf.

2.2 Legal Protection and Redress

- In *Eckerle and others v. Wickeder Westfalenstahl and another [2013] EWHC 68,* the judge found that a nominee company could not bring an application to exercise a minority shareholder's rights if, as is usual, it had already voted on behalf of some other investors on the relevant matter.
- During the special administration of Beaufort Securities, the High Court approved a distribution plan (on 26 July 2018) which distinguished between Physically Held Certificates and other securities.

3. Other Factors

3.1 Dematerialisation

The Law Commission needs to consider not only the current situation where shares held outside SIPPs and ISAs may be held in paper form but also the situations that may arise when the CSD Regulation is fully implemented.

3.2 International experience

There are lessons to be drawn from international experience where the rights of individual investors are better protected and their engagement and participation in investor stewardship is higher.

3.3 Potential Solutions

One legal approach to address the current problems could be:

- Introduce a legal concept of “discretionary beneficial shareholder” (ie. a beneficial shareholder able to make stock purchase/sale decisions and exercise ownership rights)
- Ensure that discretionary beneficial shareholders have the same rights as company members without additional cost or effort
- Require the maintenance of a register of discretionary beneficial shareholders that is accessible in the same manner as the register of members.

Another approach could be to

- define the company member to be the discretionary beneficial shareholder (defined as above)
- Require the register to hold information on both the nominee and the discretionary beneficial shareholder.

Arguably this was the intent of the SRD II, but it was then undermined by the inclusion of a provision to allow each EU country to use its own definition of a company member. Adopting a system similar to other EU countries would be beneficial, including for cross border voting and vote audit trails.