ShareSoc and UKSA

Position Paper re Digitisation Taskforce

8 March 2024

Introduction

ShareSoc and UKSA submitted a response to the consultation paper.

That paper responded to specific questions posted by the Digitisation Taskforce.

It has become expedient to distil the combined views of ShareSoc and UKSA on the key issues.

Our Position

We are primarily concerned with ensuring that the rights of individual shareholders, whether as formal members of companies or as Ultimate Beneficial Owners (UBOs), are protected and enhanced.

The Companies Act 2006 vests multiple obligations in companies and confers multiple rights in members. Members' rights include, but are not limited to: rights to receive information including annual reports and notices of corporate actions (multiple sections including Sections 291, 293 and 423), to call general meetings (Section 303), to receive notice of general meetings (Section 310), to propose members' resolutions (Section 338), to vote at general meetings, to circulate statements to members (Section 314) and to inspect and receive copies of the register of members (Section 116).

The automatic rights of UBOs under the Act are significantly more restricted. Section 153 provides certain rights in relation to rights to circulate statements (Section 314) and to circulate resolutions for AGM (Section 338), but rights to receive information, to call general meetings and to receive notice of general meetings are notably absent.

Nominees have the ability (but not an obligation) under Section 145 to nominate individual UBOs to enjoy rights under Sections 291, 293, 303, 310 and 423.

Nominees have the ability (but not an obligation) under Sections 146 to 150 to nominate individual UBOs to receive information directly under Section 423.

Thus, the rights enjoyed by UBOs are significantly restricted relative to the rights of direct members. UBOs cannot rely on nominees to enhance those rights.

HM Treasury's policy paper on the Digital Taskforce's Terms of Reference notes that progress in digitising shares has not seen consistent or commensurate progress in improving the way that the rights attached to such shares flow to end investors.

A stated objective of the Digitisation Taskforce is to work with stakeholders to identify means of improving the current intermediated system of share ownership so that:

- investors as beneficial owners are better able to exercise rights associated with shares which intermediaries hold on their behalf;
- issuers can identify and communicate more easily with investors as the underlying beneficial owners, including on secondary capital raising offers; and

- efficiencies can be identified to reduce costs and time delays in the existing system.

A further, related objective is to eliminate the use of paper certificates for traded companies.

The stated principles in the Treasury's policy paper on the Taskforce's Terms of Reference go further, specifically (using the numbering in the policy paper):

> Principle 2: Rights of intermediated investors
>
> Ultimate investors who hold shares with intermediaries should be able to effectively and efficiently exercise the rights associated with direct share ownership including voting, receiving information and other corporate actions. The ability to exercise such rights as a default should be universal, irrespective of the intermediary that an investor uses.
>
> Principle 3: Rights of existing certificated shareholders
>
> The removal of paper certificates should not result in the degradation of the rights of current holders of paper certificates to, for example, vote, receive information and participate in corporate actions.

Our position is that these matters are inextricably linked and that any outcome from the Digitisation Taskforce must achieve both objectives.

We have not adopted a specific position as to how this should be achieved, but instead have focused on reviewing the Taskforce's options (sometimes referred to as 'models' in this paper) to assess viability and / or shortcomings.

<u>Taskforce Model 1 – Subsidiary Register in Digitised Form</u>

We are comfortable that Model 1 is viable as a means of preserving the rights of existing certificated shareholders.

The approach has the benefit for direct shareholders of eliminating intermediary insolvency risk and of ensuring a mechanism by which individual shareholders can enjoy direct member rights under CA 2006.

It is also beneficial to both issuers and shareholders in placing the individual investor's name (and presumably electronic contact details) directly on the register.

Any implementation of Model 1 would need to provide a satisfactory mechanism for frictionless trading via a broker of the investor's choice.

We are of the view that a variant of this approach could be explored using company sponsored nominees (which could be either single company nominees or multi company nominees) operated by the registrars. Such nominees would nominate their UBOs to enjoy rights under Section 145 of the Act. This variant would eliminate the need for a second register of shareholdings.

Model 1 does not, however, address the rights of intermediated holders and therefore does not provide a standalone digitisation solution. If implemented, it must be accompanied by other initiatives to address the rights of UBOs.

Taskforce Model 2 – Direct Crest Membership

Direct membership of Crest has proven problematic for individual investors due to cost and the requirement for a sponsoring broker. The brokerage community has actively discouraged investors from taking this approach.

If the requirement for a sponsoring broker were dropped, if direct Crest costs were kept at a minimum and if frictionless trading via a broker of choice were facilitated, then Model 2 could be viable as a means of preserving the rights of existing certificated shareholders while eliminating intermediary insolvency risk.

Model 2 does not address the rights of existing intermediate holders and therefore does not provide a standalone digitisation solution. If implemented, it must be accompanied by other initiatives to address the rights of UBOs.

Taskforce Model 3 – Enforced Intermediation

The Digitisation Taskforce's interim report favours enforced intermediation via nominees. When examining this option, the report is silent on the issue of the rights of intermediated investors, which is troubling.

Model 3 raises issues of cost, of initial operational friction and of loss of rights.

ShareSoc and UKSA are of the view that any decision to progress Model 3 must have as a fundamental prerequisite a commitment to improve the rights of intermediated investors in line with the Taskforce's terms of reference:

> *Ultimate investors who hold shares with intermediaries should be able to effectively and efficiently exercise the rights associated with direct share ownership including voting, receiving information and other corporate actions. The ability to exercise such rights as a default should be universal, irrespective of the intermediary that an investor uses.*

There are many ways in which this might be achieved, including:

a) Amending the Companies Act to make Section 145 obligatory for nominees in relation to individual UBOs. This has cost implications for nominees which would be passed on to UBOs but could, alternatively, be passed back to issuers, who would normally pay for the company law costs on behalf of their shareholders (direct or UBOs). This would result in dual names (member and UBO) being held on the register. Communication costs would fall to the registrars and therefore to the issuers, as intended by the Companies Act.

b) Requiring nominees to provide registrars with the accounts and associated contact details underlying their holdings on a regular basis. This again results in dual names on register, and has the benefit of minimising any reconciliation work required in the case of nominee insolvency. Registrars would communicate directly with UBOs

c) Requiring nominees to pass on all communications issued by the company under CA 2006 (including report and accounts, corporate actions, meeting notices) and to facilitate the exercise of shareholder rights (including attendance at general meetings) without specific associated fees. Costs would fall to the nominees and be recharged to UBOs as part of the generic service fee.

The interim report mentions the possibility "in the first instance" of a nominee arrangement facilitated by individual issuers or a centralised nominee. This is consistent with the variant of Model 1 discussed above.

Enforced intermediation has the disadvantage of forcing individual investors to accept the risk of broker / nominee insolvency and administration. There have been numerous cases where such administration deprived investors of timely access to their assets and presents serious risk of asset erosion through administration fees, absent FSCS intervention.

In our view, the FSCS compensation limits should be removed in relation to the insolvency and administration of regulated custodians and nominees, and that this should be a prerequisite of any enforced intermediation.

Model 3 as described in the interim report fails to address either the rights of intermediated investors or those of existing certificated shareholders. The model has the potential to be viable, but only if significant work is done to address the rights of UBOs under nominee structures. An enhanced model 3 can be progressed either as a standalone solution or in conjunction with models 1 and 2. It would also need to address the issue of how the costs of administration would be covered in the case of a nominee or broker insolvency. It is not appropriate that the UBOs should have to cover these.

Taskforce Model 4 – Distributed Ledger Technology

Distributed Ledger Technology (DLT) has the potential to address dematerialisation at the same time as solving issues of communication and of the exercise of rights by individual shareholders.

However, as the report notes, the technology is not yet sufficiently developed or proven to effectively replace many of the functions of CSDs, registrars and nominees.

It would be logical for the taskforce to bifurcate its work between the short / medium term digitisation solution for immediate issues on the one hand, and the development of a long-term reimagined alternative depositary model.

From a short- and medium-term perspective this model is not considered relevant.

Other Concerns

In relation to shareholder rights, the Taskforce suggests that intermediaries should have the option *not* to facilitate those rights. In other words, individual investors wishing to avail themselves of the rights attaching to a share would need to find and deal with a broker / nominee who specifically offers that service. If an intermediary has the ability to disallow a right, then it ceases to be a right and becomes a service.

The suggestion has two problematic effects. Firstly, it places an obstacle in the way of intended information flows from the company to its investors; and secondly it ensures that most individual investors will be unable to participate in or vote at contentious meetings. This perpetuates the ownerless corporation and the disenfranchisement of individual investors, removing the utility of the general meeting as a check and balance on the activities of the directors, a major plank of corporate governance.

The Companies Act requires the production and dissemination of material to shareholders. It cannot be right that intermediaries can at their sole discretion choose to disrupt transmission of that material to individual investors.

The presumption should be that intermediaries *must* transmit to their underlying investors any and all information disseminated by companies to their shareholders, and *must* facilitate the exercise of any shareholder rights. Only the UBO should have the right to override that information flow, and even then the default selection should be to receive it.

The Taskforce also suggests that market forces should determine the fees charged by intermediaries for nominee services. We do not believe that UBOs should be charged for services that would normally be paid for by the issuers in relation to their direct shareholders.

Separately, the interim report suggests that the shareholder register disclosure provisions should exclude UBOs (at the same time as suggesting that individual investors should all be UBOs). This will significantly reduce the value of the shareholder register by hiding all individual investors behind nominee names.

Given the existing protections around lawful purpose and the need on occasion for communication to and between shareholders, this restriction is again an unwarranted attack on a long-standing governance mechanism.

<u>Conclusion</u>

ShareSoc and UKSA's position is that none of the proposed models as described in the interim report satisfactorily address the dual requirements of enhancing the rights of intermediated investors/UBOs and protecting the rights of existing shareholders.

In our view, the nominee system needs to be improved so that UBOs enjoy the universal ability to exercise the rights associated with share ownership *irrespective of the intermediary that an investor uses* as required by the terms of reference.

If that is achieved, then a fully intermediated model might be viable. If not, the Taskforce will have failed to address its terms of reference and a once in a lifetime opportunity to improve corporate governance and stewardship in the UK will have been lost.

Both Model 1 and Model 2 solutions (including the company sponsored nominee variant of Model 1) can certainly sit alongside improvements to the nominee system, but arguably there should be no need for these alternatives if the nominee system is made fit for purpose.

If we are to be denied the universal ability to exercise rights regardless of which intermediary we use, then there remains a need for an alternative, direct means of owning shares through Model 1 to preserve the rights of existing certificated holders. This, however, would be an admission of the Taskforce's failure to achieve the intended outcome.