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Reducing the Costs of Proxy Voting

GEOF P. STAPLEDON AND JONATHAN J. BATES

1. INTRODUCTION

In recent years, there have been several regulatory changes in the UK directed at removing the need for share certificates and decreasing the settlement period for share transactions. Further reforms have been proposed (HM Treasury 1999). These changes have been justified on efficiency grounds.

At the same time, there has been growing concern about the low level of voting by institutional investors in listed UK companies. Although the latest figure is 50 per cent, during the 1990s it was common for only 30–40 per cent of a company's equity to be voted at a shareholder meeting (PIRC 1998; 1999). Unlike in the USA, where private-sector pension plans (the largest category of institutional investor) are effectively obliged to vote due to regulations made under the ERISA legislation,¹ the most relevant legal obligation on UK institutional investors is merely to consider whether to vote (Stapledon 2000). But voting by institutional investors is increasingly seen as an important element of corporate governance (OECD 1999: section I; Financial Services Authority 2000: Combined Code, Part E.1). And empirical studies have demonstrated that the voting right has economic value, although that value can change depending on the circumstances (Lease *et al.* 1983; Grossman and Hart 1988; Barclay and Holderness 1989; Zingales 1994; 1995; Nicodano 1998).

In the light of this, in 1998 and again in 1999 the British government warned that if the level of voting by institutions did not increase, regulations to mandate voting may be imposed (Martinson 1998; 1999*a*). This led to the formation of the Committee of Inquiry into UK Vote Execution (Newbold Committee), which spent nine months investigating why the voting record of institutional investors (pension funds, in particular) has, overall, been so poor. The Newbold Committee (1999: para. 1.7) found that, among other things, 'the voting cycle represents a tortuous process'.

This chapter explains why voting is currently a tortuous process for many institutional investors (domestic and foreign) holding shares in UK companies, and then details a reform

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proposal aimed at reducing the costs involved in the voting process, and potentially providing further benefits. The chapter's focus is institutional share ownership because institutions account for about 70 per cent of listed UK equities.² While the chapter focuses on the UK corporate sector and UK regulations, its themes apply more broadly—for two reasons: first, the existing regulatory scheme that gives rise to the voting difficulties in the UK (outlined in the next paragraph) is closely mirrored in many other countries. Most common law countries whose corporate law grew out of the English companies legislation of the mid-nineteenth century have retained the central concept under which the registered holder of shares (called the 'member' in the current UK statute) has the right to receive meeting documents and to vote.³ Second, the institutional investor sectors in countries like Canada, Australia, and New Zealand closely resemble that in the UK, in relation to the use of investment management firms and custodians. So, although this chapter refers throughout to UK regulations and UK ownership structures, it is likely that the chapter's central themes and the reform suggestion developed in relation to the UK statute are of some relevance in other jurisdictions.

The reform proposal advocated in this chapter would be effected via a change from a mandatory rule to an enabling rule. Examining the nature of the current 'mandatory' rule is essential in understanding the significance of the proposed change. In short, a key impediment to institutional investor voting stems from a combination of these three factors:

1. Section 22 of the Companies Act 1985 (UK), under which a company's 'members' are defined as those persons entered in the company's register of members, commonly called the share register in the case of companies limited by shares. Where institutional investors invest in equities, they commonly engage custodians. It is the custodian whose name is entered in the company's register of members.
2. Those sections of the Companies Act⁴ and companies' articles that require general meeting documents to be sent to members which also confer the right to vote on these members (i.e. the persons entered in the share register e.g., custodians); and
3. The fact that, in practice, the power to determine how to vote shares held in a custodian's name normally rests not with the custodian (the member) but elsewhere, often with a fund manager.⁵

The combination of these three factors means that meeting documents and votes must pass through custodians who serve as nothing more than conduits in these processes. This in itself is costly. But there is an additional shortcoming with the existing rule: it is a factor in unsuccessful attempts to vote. The Newbold Committee (1999: 3) received evidence of 'mismatches' where institutional investors' voting instructions given to custodians were not registered in the final result. As flagged in a moment, whether this impact on the level of institutional investor voting is a costly feature of the current rule depends on whether institutional investor voting is an efficiency-enhancing activity from society's viewpoint. In any event, the proposal detailed later in the chapter would enable a member, acting on the instructions of the beneficial owner, where the member is not the beneficial owner, to designate a person to whom general meeting documents⁶ must be sent, and from whom a completed proxy form must be accepted. It is expected that the designated person would

often be the fund manager engaged by the beneficial owner of the shares. In essence, the proposed reform would enable custodians to be by-passed in the voting process.

The proposed provision described below involves a clear distinction between the 'operational' and 'property' incidents of shareholding. The provision would not compromise the property aspects of share ownership, namely security of title and security of transfer. It would affect only one operational aspect of shareholding: exercise of the voting right. But once activated, the provision would alter fundamentally the traditional notion of share ownership by separating its operational and property aspects.⁷

Two key benefits appear certain to flow from the proposed reform: first, the reform should give some way to reducing the complexity inherent in the existing system and thereby reducing the costs currently involved in exercising voting rights. This reveals the main premise of this chapter: that there is evidence to suggest that there are costs which arise in the transfer of meeting documentation to, and the transmission of voting instructions from, the person who has the interest in the potential benefit of holding voting rights (e.g. a pension fund trustee representing the fund beneficiaries; or a fund manager who, under contractual obligations and performance incentives, stands to gain from the outcome of voting right exercise).

Second, there should be a spin-off benefit for listed companies. This indirect benefit to companies should flow from the identification of voting-right holders that would occur under the proposed provision. Companies currently pay external firms to analyse the share register to determine the identity of the largest voting-right holders (Stapledon 1996: 322). There would be less demand for this service in its current form—and cost savings for companies (an indirect benefit for all shareholders)—if there were to be a reasonably significant take-up of the designation power by members. It is not possible, in the absence of empirical data, to do more than speculate about the magnitude of these two benefits.

A third benefit may also flow from the reform proposal. On the assumption that institutional investor activism increases efficiency in certain cases, any measure that makes it easier for institutional investors to exercise their voting rights, and leads to a higher level of successful attempts to vote by institutional investors, would enhance the gains from institutional investor activism. The assumption just stated is important. This article does not contribute to the central issue in the debate about the efficiency potential of institutional investor activism. The only contribution made to that debate is that, assuming institutional investor activism increases efficiency in certain cases, the potential gains will be partially dependent on a low-cost system for the operational incidents of a share.

It is acknowledged that certain costs would accompany the introduction of a provision like the one proposed. However, it is argued below that the benefits of the proposal are likely to outweigh the costs. Also, importantly, the proposal respects the importance to financial market participants of secure title and secure transfers, and of anonymity for those investors who seek it.

The remainder of the chapter is structured as follows. Section 2 identifies the three main 'interest-holders' in a parcel of shares: the member or registered shareholder; the beneficial owner; and the holder of the control rights. In some cases, one person will hold all three interests, but in the case of institutional share ownership this is rare. This is followed by two sections which provide data on the proportion of the UK equity market owned beneficially

by institutions, and controlled by institutions, respectively. This helps illustrate the practical importance of the reform proposal made later in the chapter. Section 5 unpacks institutional share ownership. That is, it identifies, by legal analysis, the three interest-holders for each of the main categories of institutional investor: insurance companies; pension funds; unit trusts; investment trusts; and open-ended investment companies. Section 5 explains in more detail how the structure of institutional share ownership is problematic for voting. Section 9 considers whether market rather than regulatory mechanisms may provide a solution to the voting problem. It is considered unlikely that the main market mechanism currently available—the power of attorney—will be utilized widely. The reform proposal is then explained and justified through what is essentially a preliminary cost–benefit analysis. Section 10 raises the possibility of the proposed bypassing procedure being extended to other incidents of shareholding, for instance, payment of dividends.

2. THE INTEREST-HOLDERS IN SHARES

Assessing the shareholding population of listed UK companies involves identifying three main interest-holders in any parcel of shares:

1. *The member.* That is, the person/entity entered on the company's register of members. The member is also known as the registered shareholder or the legal owner of the shares. For example, where a custodian holds shares on behalf of a client, the custodian is the member. It is common to refer to shares held by custodians as being held by 'nominees'. This reflects a structure under which a custodian holds shares on a bare trust for its client.
2. *The beneficial owner of the shares.* For example, where the member is a trustee, it holds the shares on trust for the beneficiaries of the trust, who are (collectively) the beneficial owners of the shares. Even where the member is a custodian appointed by the trustee, the shares are still, ultimately, held on trust for the beneficiaries of the trust.⁸
3. *The holder of the control rights.* In this chapter, the term 'control rights' means the right to receive information from a listed public company, and the right to exercise votes attached to shares.⁹ For example, where the trustee of a pension scheme engages a fund management firm to manage the scheme's equity investments, the fund management contract typically provides the fund manager with the power to give voting instructions to the custodian (the registered shareholder/member), subject to any overriding instruction from the trustee (Stapledon 1996: 89).¹⁰ Here, the fund manager holds the voting control right attaching to the shares.¹¹

Sometimes all three interests are held by the one person/entity, but, as shown later in the chapter, in the case of institutional share ownership it is more common for at least two different parties to be involved.

3. BENEFICIAL OWNERSHIP OF LISTED UK EQUITIES

Table 24.1 provides the most current aggregate statistics on the beneficial ownership of listed UK equities.

Table 24.1. Beneficial ownership of UK equities, 1998

Sector of beneficial owner	Beneficial ownership of total listed UK equities (% of market)
Insurance companies	23.5
Pension funds	22.1
Unit trusts, investment trusts and other institutions	10.6
Overseas	24.0
Individuals	16.5
Charities	1.9
Industrial and commercial companies	1.2
Banks	0.1
Public sector	0.1
Total	100

Source: Office for National Statistics (1999). Figures as at 31 December 1997.

The classes of beneficial owner listed in Table 24.1 that fall within the definition of institutional investor are life insurance companies, pension funds, unit trusts, investment trusts, and other financial institutions. The shareholdings of banks identified in Table 24.1 should not be classified as institutional shareholdings. Most large UK banks have fund management arms which manage equities on behalf of pension funds and other beneficial owners, but the shares owned beneficially by banks are mostly either corporate holdings or the result of debt-for-equity swaps. They are not portfolio investments.

As at 1998, domestic institutional investors owned 56 per cent of the UK share market. However, overseas-based institutional investors are a growing force in the UK share market. They probably accounted for at least half the overseas holding of 24 per cent.¹² Taking one-half as an estimate, the figure for total (domestic and overseas) institutional ownership of listed UK equities would be almost 70 per cent.

The proportion of shares held by local institutions increased markedly in the UK between the early 1960s and the early 1990s. The total holding of locally based institutions was: 29 per cent in 1963; 34 per cent in 1969; 47 per cent in 1975; 58 per cent in 1981; and 60 per cent in 1992 (Office for National Statistics 1999).

As Table 24.1 shows, the total for domestic institutions had slipped back a bit (to 56 per cent) by 1998. This seems to be attributable to pension schemes re-allocating some of their holdings into bonds (Office for National Statistics 1999: para. 3.12). This, in turn, is presumably at least partly a result of the minimum funding requirement imposed by the Pensions Act 1995 (UK).

The total 'overseas' holding of UK equities increased from 7 per cent in 1963 to 13 per cent in 1992. It then accelerated to 24 per cent by 1998. As a significant proportion of the total overseas holding would be the shareholdings of overseas-based institutional investors, the slight decline in the proportionate holding of local institutions between 1992 and 1998 has almost certainly been offset by an increase in the holding of overseas institutions.

Another clear trend in the UK is the decline in the proportionate holding of individuals: from 54 per cent in 1963 to 16.5 per cent in 1998. This is explained partly by the growing proportionate holding of the institutions, and partly by individuals swapping their money from directly held shares to indirect investment in equities via investments in unit trusts, investment trusts and pension funds.¹³

The two primary causes of the increased proportion of listed UK equities held by local institutions now, compared to the early 1960s, appear to be: (1) the growth in long-term saving since the Second World War, and the resultant massive increase in funds available to the institutions for investment (Davies 1993: 70–3); and (2) the disposition of insurance companies and pension funds towards equities, since the 1960s. There are several factors behind each of (1) and (2). In relation to (1), demographic trends, inadequate state pensions and income growth have all contributed (Davis 1991). In relation to (2), the concern of institutions to protect their capital bases during periods of inflation, and the relative performance of equities compared to gilts and cash since the end of the First World War, appear to be the central factors. Over any rolling 20-year period from 1918 to 1990, UK equities produced better returns than gilts and Treasury Bills (WM Company 1990: 4–6).¹⁴

4. CONTROL OF LISTED UK EQUITIES

An important thing to note about Table 24.1 is that equities owned beneficially by institutional investors (insurance companies, pension funds, unit trusts, investment trusts, and other financial institutions) are managed by fund management firms. Some fund management firms are 'in-house' at the institutions, such as Prudential Portfolio Managers Ltd., which is a wholly owned subsidiary of Prudential Corporation plc (the large UK life insurance and financial services group).¹⁵ Other fund management firms might be termed 'external' investment managers. In the case of firms such as Mercury Asset Management plc and Schroder Investment Management Ltd., for example, the vast majority of assets under management are those of external clients such as pension fund trustees.

Fund management firms manage not only the funds of the institutional investors just mentioned, but also the funds of individuals, charities, and other bodies. The proportion of the UK equity market managed by locally based fund management firms would, therefore, have been higher than the proportion of total equities owned by domestic institutions as detailed in Table 24.1. This distinction is significant because (as mentioned above) it is common for fund managers to have the power to exercise the voting rights attached to their clients' equity investments. Possession of the power to exercise the voting right attached to a share, places one in the position of, effectively, 'controller' of that share. Thus, the proportion of the equity market managed by fund managers is a close approximation of the proportion of the equity market controlled by them. However, the way in which the control rights attached to shares are allocated is not static. Although it is still common for the voting right to be delegated to the fund manager under the fund management agreement, there is evidence that some large UK pension scheme trustees have recently varied the typical arrangement by shifting the voting right from the fund manager to another firm, also in the business of fund management, but marketing itself as an 'active investor' from a corporate governance perspective. The recipient of the voting right charges a fee for

exercising that right on behalf of the pension scheme. This fee provides some evidence of the economic value of the voting right in the UK (cf. Zingales 1995).¹⁶

Nevertheless, at present the proportion of the UK equity market managed by fund managers is still a close approximation of the proportion of the equity market controlled by them. On that basis, Table 24.2 shows the fund management firms that controlled significant stakes in the listed UK equity market at the beginning of 1998. The investment management arms of financial conglomerates and insurance companies dominate. There were nine in each category in the top twenty UK-based fund managers, at the date of Table 24.2.

A striking point that emerges when comparing Tables 24.1 and 24.2 is that pension schemes are significant beneficial owners of equities, but relatively insignificant controllers of equities. The explanation lies in the widespread use by pension schemes of external fund managers. Indeed, only one in-house pension fund manager ranked in the top twenty equity managers at the date of Table 24.2. This was Hermes Investment Management Ltd.,

Table 24.2. *Twenty largest managers of listed UK equities, 1998*

Fund manager	Market share ^a	Running total
Prudential (Ins.)	3.87	3.87
Mercury (FC)	3.52	7.39
Schroder (FC)	3.42	10.81
Barclays (FC)	2.21	13.02
Legal & General (Ins.)	2.11	15.13
Phillips & Drew (FC)	2.08	17.21
Morgan Grenfell (FC)	2.03	19.24
Standard Life (Ins.)	2.03	21.27
Gartmore (FC)	1.92	23.19
Royal (Ins.)	1.91	25.10
CGU (Ins.)	1.77	26.87
Hill Samuel (FC)	1.47	28.34
Norwich Union (Ins.)	1.36	29.70
Threadneedle (Ins.)	1.27	30.97
Hermes (Pens.)	1.17	32.14
HSBC (FC)	1.03	33.17
Scottish Widows (Ins.)	1.01	34.18
Fleming (FC)	0.98	35.16
M&G (Indep.)	0.96	36.12
AMP (UK) (Ins.)	0.94	37.06

^a'Market share' equals value of local equities under management ÷ total domestic market capitalization.

Sources: Our own calculations based on information in Hymans Robertson (1998) and London Stock Exchange (1998); information supplied by Michelle Edkins (Corporate Governance Executive, Hermes Investment Management Ltd.); and company annual reports. Figures as at 31 December 1997.

Abbreviations: See Appendix.

which is owned by the trustee of the BT Pension Scheme, and manages the bulk of the assets of that scheme and the Post Office's pension schemes.¹⁷ As at 31 December 1998, 80 per cent of directly invested UK pension schemes¹⁸ used solely external fund managers, while only 12 per cent managed their assets wholly in-house, and 8 per cent used both external and in-house fund managers.¹⁹ Minns (1980: 41) conducted a study using 1975 data, and found that: pension funds owned beneficially 16.8 per cent of listed UK equities, but controlled only 5.6 per cent; whereas banks, stockbroking firms and merchant banks owned beneficially only 1.1 per cent of listed UK equities, but controlled (through their investment management arms) 23.9 per cent.

It appears beyond doubt that a similar contrast exists today, given: (i) the large beneficial holding of pension funds but virtual absence of in-house pension fund managers among the largest equities managers; and (ii) the tiny beneficial holding of banks but prevalence of financial conglomerates among the largest equities managers. This contrast is very significant for present purposes. Where the trustee of a pension scheme engages an external fund manager, the trustee usually also engages an external custodian in whose name the scheme's equity investments are registered. The use of external custodians is, in general, accompanied by logistical difficulties in the exercise of voting rights. Where a pension scheme's trustee employs in-house fund managers, the scheme's assets are often registered in the name of the trustee²⁰ or another internal entity. Here, voting is a less complicated issue. But, as highlighted above, pension scheme trustees use external fund managers more commonly than in-house fund managers, which explains the extent of the voting difficulties reported by the Newbold Committee, which in turn provided the impetus for this chapter's reform proposal.

5. THE STRUCTURE OF INSTITUTIONAL SHARE OWNERSHIP AND CONTROL

5.1. *Insurance Companies*

Major insurance companies operating in the UK fall into three groups: (1) Mutually owned companies. Mutuals are 'owned' by their policyholders (or certain types of policyholders). That is, the policyholders are the members of a mutual insurance company;²¹ (2) companies limited by shares and listed on the London Stock Exchange. As with other companies limited by shares, it is the registered shareholders who are the members of a share-capital insurance company; and (3) companies limited by shares and which are subsidiaries of other companies, including overseas-based insurance groups and UK and overseas banks.

Most of the equity investments of insurance companies are in their life funds as opposed to their general funds, such as household, vehicle, and/or health.

Registered ownership. Although practices vary among the insurers, it is common for equity investments to be registered in the insurance company's own name. Less commonly, a custodian may be engaged to be the registered owner of the shares (in which case the custodian is the member of the investee company concerned; but it holds the shares on a bare trust for the insurance company, which is the beneficial owner).

Beneficial ownership. The insurance company is the beneficial owner of the equity investments and other assets which make up its insurance funds, and back the policies issued by it.

Policyholders have no collective rights of ownership (legal or beneficial) in respect of the assets backing their insurance policies. Instead, they are creditors of the insurance company. This is the case regardless of whether the insurer is a mutual or a share-capital company.

In addition, the members (i.e. the shareholders in the case of a share-capital insurance company; and the policyholders, in their capacity as members, in the case of a mutual) have no ownership interest, legal or beneficial, in the equity investments or other assets of an insurance company. The insurance company is treated by the law as a legal entity separate from its members.²² The insurance company is the owner of the assets backing the policies that it issues; the company's members have a membership interest and membership rights, but no ownership interest in the company's assets.²³

Control rights. Virtually every well-known UK company authorized to write life insurance has a fund management subsidiary (or division) which manages the investment of most, if not all, of the group's insurance funds. Where an insurer's equity investments are managed in-house in this way, the voting control rights attaching to the shares would normally rest with the insurer's fund management staff. Some small insurers, which do not have the resources to conduct investment management, use external fund managers.²⁴ In these cases, the control rights would normally be delegated to the external fund management firm.

5.2. Pension Funds

Nearly all funded occupational pension schemes are constituted as trusts, separate from their sponsoring entities.²⁵ They may have individual trustees, but most large schemes have a corporate trustee, which is usually a wholly owned subsidiary of the sponsoring employer. The directors of a corporate trustee are usually senior executives of the sponsor, plus member representatives.²⁶

There are three ways in which the cashflows of funded pension schemes may be invested: in insurance policies; in pooled funds; or directly invested.

5.2.1. Insured Schemes

Small pension schemes often just take out insurance policies. The policy is usually a with-profits endowment policy or a deposit-administration contract (which operates similarly to a bank account) (Goode Committee 1993: paras 2.4.23–2.4.26). The policy of an insured pension scheme is treated like most other insurance policies: the premiums are pooled together with those of other policies into a large fund which is invested in the name of the insurance company. The insurance company is the beneficial owner of any equity investments, and (as detailed above) normally also the registered owner and the holder of the control rights. The pension scheme trustee is simply the owner of one or more insurance policies.

5.2.2. Pooled Funds

A pooled pension fund is one in which the moneys of a number of different pension schemes are aggregated and invested, as one fund, by an external fund manager. Most pooled funds are either unit-linked insurance funds (known as life company 'managed funds') or authorized unit trusts.²⁷ In relation to managed funds, a unit-linked insurance fund is not a separate legal entity: the life company merely keeps separate accounts recording the assets representing the fund, the present value of those assets, and transfers of cash into and out of

the fund (Linklaters and Paines 1989: para. A2.0310). The fund forms part of the insurer's life fund, and is notionally divided into units. Trustees of pension schemes effectively buy 'units' in the fund, which are then liquidated as necessary to meet the schemes' obligations as they fall due (Goode Committee 1993: para. 2.4.27). In law, however, the beneficial owner of the assets comprising a managed fund is the insurance company. The insurance company is (as detailed above) normally also the registered owner and the holder of the control rights. The investing pension scheme trustees own just their insurance policies.

5.2.3. *Directly Invested Pension Schemes*

Most large pension schemes are directly invested. Here, the scheme trustee invests directly in assets such as equities, bonds, and/or real property.

Registered ownership. In the case of a directly invested pension scheme, the registered owner of equity investments may be the trustee of the scheme, or a custodian engaged by the trustee. The latter is very common.

Some custodians use a 'pooled nominee system' under which the shareholdings of all clients are registered in just one nominee name (with reliance on internal records to differentiate the different underlying holdings). The single nominee holding is sometimes called an 'omnibus account'. Other custodians use a 'designated nominee system' under which each client's holding is registered in a unique name (for example, ABC Nominees Ltd., A/C 001, ABC Nominees Ltd., A/C 002, etc.) (Securities and Investments Board 1993: ch. 6).

Beneficial ownership. The beneficiaries of a directly invested pension scheme are, collectively, the ultimate beneficial owners of the scheme's equity investments. This is the case regardless of whether the registered owner is the scheme trustee or a custodian.

Where the scheme trustee is the registered owner, it—like the trustee of any trust—holds the shares on trust for the scheme beneficiaries. It does not matter whether the pension scheme has individual trustees or a corporate trustee.²⁸ Even a corporate trustee, under trust law principles, has no beneficial interest in the scheme assets. The assets are held by the corporate trustee on trust for the scheme beneficiaries.²⁹

Where a custodian is the registered owner, that custodian holds the shares on a bare trust for its client, in this case the trustee of the pension scheme. But the trustee itself holds scheme assets on trust for the scheme beneficiaries.³⁰ The scheme beneficiaries are, therefore, collectively the ultimate beneficial owners of a directly invested pension scheme's equity investments, regardless of who is on the share register.

Control rights. Where the scheme trustee is the registered owner of a directly invested pension scheme's equity investments, the law of trusts dictates that the exercise of voting rights is a matter for the trustee.³¹ It would be open to the trustee to 'retain' those voting rights or to delegate them, for example, to an external fund manager hired to manage the scheme's assets.³²

Where a custodian is the registered shareholder, it is the member and therefore receives general meeting notices and proxy voting material. It, as a matter of company law, has the right to exercise voting rights or to appoint a proxy to do so on its behalf.³³ However, the custodian holds the shares as a bare trustee, and as such it is required under equitable principles—and usually also by an express contractual provision—to exercise the voting rights as directed by the pension scheme's trustee, or somebody specified by the trustee. Thus, a modern fund management agreement (the contract between the scheme trustee and

the external fund manager) will often provide that the fund manager may, at its discretion, give voting instructions to the custodian, subject always to any specific instructions from the trustee (Stapledon 1996: 89).

5.3. Unit Trusts

Unit trusts are open-ended investment funds operated under a trust structure. They may be authorized or unauthorized; only authorized unit trusts may be marketed to the public.³⁴ Authorized unit trust schemes must have a trustee independent of a manager.³⁵ The trustee is responsible for the custody or control of the scheme's assets.³⁶

Registered ownership. The registered owner of a unit trust scheme's equity investments may be the trustee of the scheme, or a custodian engaged by the trustee.

Beneficial ownership. Beneficial ownership of a unit trust's assets rests with the collective body of unit-holders.³⁷ Where a custodian is the registered owner, the unit-holders' collective beneficial interest arises in the same indirect way that the beneficiaries of a directly invested pension scheme enjoy beneficial ownership of assets registered in a custodian's name.³⁸

Control rights. Ordinarily, the manager of an authorized unit trust scheme possesses the control rights attached to the scheme's equity investments. Under the Regulations, the voting rights attached to the property of an authorized unit trust scheme must be exercised or not exercised as directed by the manager.³⁹

5.4. Investment Trusts

Investment trusts are closed-end investment funds. Despite their name, they are not trusts; they are public companies. As companies, they are legal entities separate from the persons who invest in them (i.e. their shareholders).⁴⁰

Most investment trust companies engage a fund management firm to manage their assets. In fact, many existing investment trusts were promoted, and effectively established, by fund management firms. The choice of, and contractual engagement of, the fund management firm to manage the assets of a newly established investment trust might therefore seem a foregone conclusion. However, the Listing Rules of the Financial Services Authority (2000: paras 21.9(d), 21.10, 21.20) include a requirement that the board of directors of a listed investment trust 'must be able to demonstrate that it will act independently of any investment managers of the investment [trust] and a majority must not be employees of or professional advisers to the investment managers or any other company in the same group as the investment managers'.

Registered ownership. The registered owner of an investment trust's equity investments may be the investment trust company itself, or a custodian engaged by it. Where a custodian is the registered owner, it holds the shares on a bare trust for the investment trust company.

Beneficial ownership. The beneficial ownership of an investment trust's equity investments rests with the investment trust company. The investment trust's own shareholders have no ownership interest, legal or equitable, in the assets of the investment trust.⁴¹

Control rights. The control rights attached to an investment trust's equity investments are commonly delegated by the board of directors of the investment trust to the fund manager of the trust's assets.

5.5. *Open-Ended Investment Companies*

An open-ended investment company (OEIC) is a pooled investment vehicle that, as its name suggests, is open-ended like a unit trust. However, OEICs differ from unit trusts because OEICs are companies. Investors receive shares rather than units.⁴²

OEICs must have: (1) one or more directors. One director must be a body corporate authorized under the Financial Services Act 1986 to carry out investment business; this director, called the Authorized Corporate Director (ACD), is responsible for the day-to-day management of the scheme; and (2) a 'depository' to whom the scheme property is 'entrusted' for 'safekeeping' under the Regulations. The depository must be independent of the OEIC and its directors.

Registered ownership. The registered owner of an OEIC's equity investments may be the depository of the OEIC, or a custodian engaged by the depository.⁴³ In either case, the shares are held on a bare trust for the OEIC (Morse 1976: para. 5A.006).

Beneficial ownership. The beneficial ownership of an OEIC's equity investments rests with the OEIC. The OEIC's own shareholders have no ownership interest—legal or beneficial—in the assets of the OEIC.⁴⁴

Control rights. The control rights attached to an OEIC's equity investments are the responsibility of the ACD. The depository (or other registered holder) must exercise the voting rights attached to equity investments as directed by the ACD.⁴⁵

6. THE CASE FOR REFORM

As highlighted earlier, there are three interest-holders in any parcel of shares in a listed company: the member (or 'registered shareholder' or 'legal owner'); the beneficial owner; and the holder of the control rights. Sometimes all three interests will be held by the one person. But, where institutional investors are concerned, the analysis above shows that there will commonly be two or three different parties involved.

Figure 24.1 shows a typical arrangement for a 'directly invested' pension scheme.⁴⁶ It is, despite its appearance, actually a simplified illustration of the typical arrangement. In reality, the picture is often more complicated due to two factors. First, custodians sometimes amalgamate several clients' shareholdings. That is, they register the shareholdings of several different clients in a single nominee name (e.g. ABC Nominees Ltd.) rather than registering each client's holding in a unique (or 'designated') nominee name (e.g. ABC Nominees Ltd. A/C 001, ABC Nominees Ltd. A/C 002, ABC Nominees Ltd. A/C 003, etc.). As mentioned earlier, the use of a single nominee is known as a 'pooled nominee system' of registration or an 'omnibus account'.⁴⁷ Here, the custodian relies on internal records to differentiate the different underlying holdings.

Second, large pension schemes will often engage more than one fund manager, and there may as a result be more than one custodian holding shares on the scheme's behalf in a particular listed company.

The example of a directly invested pension scheme has been given because, in terms of UK equity holdings, directly invested pension schemes account for a very significant proportion of total holdings of institutional investors: approximately 30 per cent, which translates to about 21 per cent of the entire listed UK equities market as at 1998.⁴⁸ However,

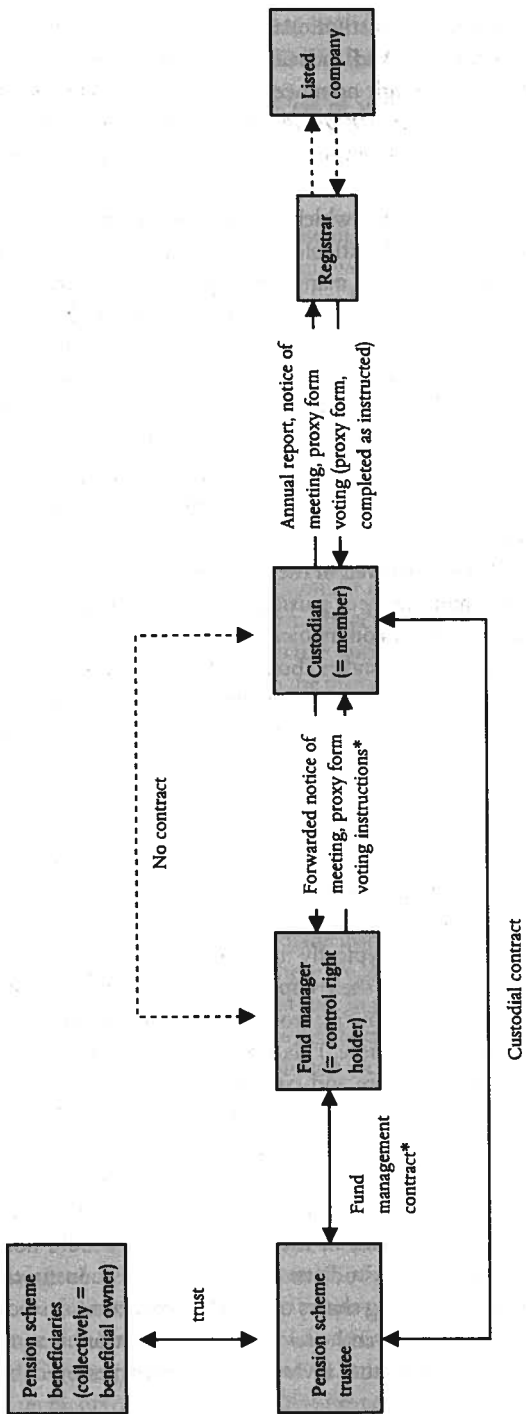


Figure 24.1. Typical directly invested pension scheme

* Commonly the fund management contract gives the fund manager power to give voting instructions to the custodian. The fund management contract usually says that these voting instructions are subject to any instructions that the trustee(s) of the scheme may give from time to time. See Stapleton (1996).

it was demonstrated earlier that other institutional investment arrangements also commonly entail two or more interest-holders. And, indeed, where directly invested private investors hold their equity investments through nominee accounts, there will also be at least two interest-holders (DTI 1996; Davies 1999: 345–6). Similar issues to those considered below in relation to directly invested pension schemes will, therefore, sometimes apply to these other types of investors.

The sections of the Companies Act which confer information and voting rights on the registered holder were perfectly justifiable when they were introduced in nineteenth-century predecessor legislation and for many years afterwards. Shareholding structures would, in a majority of cases, have been very simple in the sense that there would have been only one interest-holder in a particular parcel of shares. However, there have been major changes in the structure of share ownership and control in the UK and elsewhere in recent decades. These changes have come about largely due to the massive increase in institutional share ownership.⁴⁹ These changes in the marketplace mean that the rule that was efficient in earlier years is now a source of costs in the voting process. This is because, even where the registered holder is now merely an intermediary, under the current rule that party must be involved in the voting process.

As well as the additional costs involved in the voting process, the Newbold Committee (1999: 2) reported that the 'multiplicity of participants in the voting cycle and the lack of modern technological means to allow communication of votes by those participants has led to a system where opportunities for mistakes abound'. The Committee (*ibid.*, see also para. 1.8) received evidence of 'mismatches' where institutional investors' instructions to vote were not registered in the final result. That is, an attempt was made to vote, but due to a breakdown somewhere along the line the proxy form was never actually received by the listed company's registrar. The evidence suggests that breakdowns will often involve the custodian (*ibid.* para. 2.13).

The Newbold Committee (*ibid.*: 3) formed the view that the introduction of electronic means of transmission and recording of votes would not, by itself, lead to a higher level of voting. As Fig. 24.1 demonstrates, even if electronic voting were introduced overnight, there would still be a situation where, typically, a custodian is interposed between the fund manager (holder of control rights) and the company's registrar. And in terms of the added costs involved in the voting process flowing from the current rule, the evidence suggests that electronic voting will not remove these. This is because the process must still take place. If the interface between fund managers and custodians required to generate and lodge a proxy appointment and voting instruction is not internally resourced, then a third party service is used. To the extent that costs are reduced by the economies of mass processing and electronic communication, costs savings would be expected to result. But this does not alter the structure of the process: in contrast to the option proposed in this chapter.

Any analysis of the role of custodians in the voting process should not overlook the benefits of the services provided by custodians to their customers. Institutional investors are likely to value cost savings in trading shares offered by competing custodians, administrative convenience in settling trades and providing reconciliation, a sense of security, and in some cases secrecy both from other investors and companies over their investment choices.

7. COULD THE PROBLEM BE OVERCOME WITHOUT REGULATORY REFORM?

Decreasing the costs involved in the process of voting and decreasing the incidence of unsuccessful attempts to vote need not involve regulatory change. There are likely to be some developments through market processes. The most likely development is the use of powers of attorney.

The Newbold Committee (*ibid.*: 9) forecast an increased use of powers of attorney once electronic voting becomes more common. This would involve the custodian (the 'member') providing a power of attorney in favour of the fund manager (the holder of the control rights) after being instructed to do so by the pension scheme trustee. The company (or its registrar) would be given a copy of the power of attorney. This would enable the company's registrar validly to recognize a proxy form transmitted directly by the fund manager to the registrar.⁵⁰

However, there are several disadvantages that suggest that the costs in the current system will not be significantly reduced through market forces alone. First, the custodian may not be able to direct the company's registrar to send the notice of meeting and proxy form straight to the fund manager. The power of attorney may work only in one direction, that is, when the completed proxy form is returned to the company's registrar. Second, even if the power of attorney did work in both directions, it is a paper-dependent process with verification requirements. Third, from an international perspective, use of a UK-specific power of attorney is unlikely to be the most attractive option for foreign control right holders.

The issue of the appropriate response to the problems presented by the 'member' concept has current policy significance.⁵¹ Government has shown increased willingness to find regulatory means to boost the level of voting in UK public companies.⁵² The choices available to it include primary legislation (such as reform of the Companies Act as advocated in this chapter), reform of securities regulation, and promotion of self-regulatory practices. The option of using securities regulation might be considered an attractive alternative to primary legislation. If USA precedent were followed, intermediaries would be obliged under securities market regulations to distribute information to beneficial owners of shares, and voting procedures would have been made available to those persons. Costs would be levied directly on issuing companies.⁵³ There are, it seems, reasons peculiar to the USA for the evolution of this form of 'voting regulation'. In particular, federal securities law overlays state corporate law. And, since general corporate law is within the constitutional jurisdiction of the states, a primary legislation solution would be beyond the constitutional limits of the federal government's power.⁵⁴ The UK does not face this difficulty.

8. A REGULATORY SOLUTION

8.1. *Outline of Proposed Reform*

Regulatory change could facilitate the exercise of the control right and decrease the incidence of unsuccessful attempts to vote. The proposal outlined below would involve changes to the UK Companies Act and could be bolstered by associated changes to the financial services regulatory regime. The proposal involves a clear distinction between the 'operational' and 'property' incidents of shareholding. The proposal would not compromise the property

aspects of share ownership, for example, security of title and security of transfer. It would affect only one operational aspect of shareholding: the exercise of the voting right.

The proposal would effectively enable a bypassing of the custodian, or other intermediary, in both directions. A provision of the Companies Act would enable a company to opt into a regime. The provision would say that, once a company has opted into the regime, a member has the right to notify the company of a 'designated person' in respect of a 'designated shareholding' on the company's share register: (1) to whom 'meeting documents' must be sent; (2) who is entitled—to the exclusion of the member—to exercise the voting rights attached to the designated shares; and (3) from whom the company must accept proxy instructions.

'Meeting documents' could be defined as the annual report, notice of meeting, proxy form, and any other documents which the company is required to send,⁵⁵ or chooses to send, to members in respect of a general meeting.

The provision should state that, once a company has been notified of a designated person, the only person to whom the company is required to send meeting documents is the designated person.⁵⁶ The company should not be required to send the documents to the member as well. If the provision required the documents to be sent to the designated person and the member: transaction costs would increase; and there would be no obvious benefit given that the member (the custodian in the pension scheme example) has waived their power over voting by making the notification.

It would be a matter of contract between the member and the designated person as to whether the meeting documents received by the designated person must be copied to the member. Similarly, it would be a matter of contract between the beneficial owner and the designated person as to whether the meeting documents received by the designated person must be copied to the beneficial owner. This contracting process would allocate cost and risk. In the pension scheme example, the pension scheme trustee would be the contracting party on behalf of the beneficial owners—the collective body of beneficiaries.

In the pension scheme example, the pension scheme trustee would direct the custodian (the member) to notify some or all listed companies in which shares are held that the designated person in respect of those shares is the fund manager. The actual processes would very likely be automated. It should be possible for custodians to provide the listed company's registrar with the details of the designated person by way of an electronic file transfer on the meeting record date.

A provision of this nature would probably lead to an extra element in competition between custodians. In all likelihood, not all custodians would offer the designation service as part of their package of services. A client, for example, a pension scheme trustee, who wanted its equity investments to be designated, could shop around for a new custodian if the incumbent did not offer the service. It would be a matter of contract between the client (beneficial owner) and the custodian as to whether the client could direct the custodian to make a designation.

In terms of comparable existing provisions, the closest is probably the USA 'recognition procedure'. For example, the Indiana Business Corporation Law permits a company to adopt a recognition procedure under which a beneficial owner of shares that are registered in the name of a nominee may be recognized by the company as the shareholder. The extent

of that recognition is at the discretion of the company.⁵⁷ This procedure is drawn from section 7.23 of the Model Business Corporation Act 1997 Supplement.⁵⁸ There are two major limitations on this USA model. First, it has not been adopted by Delaware (home to a very large proportion of major USA companies), New York or California (among other states). Second, as the extent of recognition is a matter for each company that chooses to adopt the recognition procedure, the regime established by a particular company may be limited to distribution of shareholder meeting documents and proxy forms by the company. That is, the actual voting procedure may still involve the registered holder with the proxy votes having to pass through the registered holder on their way to the company. This type of single-direction regime is, in any event, effectively applicable to all major USA companies—even those whose state of incorporation has not legislated to apply the Model Business Corporation Act procedure—due to federal securities law.

Rules promulgated by the Securities and Exchange Commission (SEC) pursuant to the Securities Exchange Act of 1934 impose certain obligations on companies and financial intermediaries (registered brokers and dealers; and banks) with the objective of beneficial owners of shares receiving company reports and proxy solicitation material. Under Rule 14a-13(a), if a listed company knows that shares are held 'of record' in nominee name, and the company intends to solicit proxies, the company must: (1) inquire of record holders (registered holders) as to the number of copies necessary to supply material to beneficial owners; (2) supply that material to the record holders who respond to the inquiries; and (3) pay the record holder's reasonable expenses for completing the mailing of the material to beneficial owners.⁵⁹

This is a single-direction regime. Unlike the provision that this chapter proposes, the SEC rules do not address the costs problems related to the involvement of custodians in the voting process.

8.2. *Should the Provision be an Enabling Provision, a Default Rule or a Mandatory Rule?*

It was noted earlier that the rules of the Companies Act 1985 which, in our view, contribute to the problem do not fit neatly into the traditional categorization of 'mandatory', 'enabling', and 'default' rules. Rather, they are 'boundary-setting' rules which in combination have the effect of determining who is included within, and conversely who is excluded from, the company law framework. The solution proposed can be defined within the traditional framework, and this is set out below.

The provision could be:

- (1) an enabling provision, applying only to those companies that opt in (via a clause in their articles);
- (2) a default rule, applying to all companies except those whose shareholders have elected to waive the rule;
- (3) or a mandatory rule, applying to all companies regardless of what their articles say.⁶⁰

The provision should not be a mandatory rule, because for some companies and their shareholders, the regime would be very unlikely to confer net benefits. For example, a listed company in which a majority of the shares are controlled by one investor—possibly the

company's founder—and which has only a handful of institutional shareholders. Here, the costs to the company of facilitating designations may very well outweigh any benefits. The majority shareholder will control the general meeting—at least in normal circumstances (cf. Davies 1997: 707–17, discussing the equitable constraint on the power of majority shareholders to bind the minority). But as time goes by and ownership disperses, and the number of institutional shareholders increases, the cost–benefit equation may change and thereby encourage shareholders and the board to adopt the regime. This may be seen as a useful step in promoting institutional investor interest in the company, particularly among USA institutional investors.

The choice is therefore between a default rule and an enabling provision. If it were to be a default rule, there would be transaction costs for those companies that choose to opt out. They would have to insert a clause into their articles of incorporation to waive the rule. On the other hand, if it were to be an enabling provision, there would be transaction costs (associated with inserting a clause into the articles) for those companies that choose to opt in.

In general, whether any regulatory provision should be a default rule or an enabling provision depends on whether the provision corresponds with the preferences of most companies, and their shareholders (Cheffins 1997: 262). If so, it should be a default rule, in order to minimize transaction costs. If not, then it should be an enabling provision—again, in order to minimize transaction costs.⁶¹

It seems likely that a provision of this nature would correspond with the preferences of a majority of listed companies, but of only a small minority of unlisted companies. The above example of a listed company for which the provision may entail more costs than benefits was a company controlled by its founder, and with few institutional shareholders. However, a very large proportion of companies listed on the London Stock Exchange are widely held, with no controlling non-institutional shareholder (Franks and Mayer 1996; Stapledon 1996: 188). For listed companies, therefore, a default rule appears preferable to an enabling provision. On the other hand, compared to the average listed company, many unlisted public companies, and virtually all private companies, would have: (a) far fewer shareholders; (b) very few or no 'arm's length' institutional shareholders;⁶² and (c) few or no beneficial shareholders using an external custodian to hold legal title to the shares, or a fund manager to 'manage' their investment in the company. For these reasons, the cost–benefit equation for unlisted companies would normally see the costs of the provision outweighing the benefits. For unlisted companies, therefore, an enabling provision appears preferable to a default rule.

A solution may lie in the multi-tiered regulatory approach that has become common in the corporate and financial sectors in the UK. The provision in the Companies Act would be an enabling provision available to all companies, and it would effectively become a default rule for listed companies via the Financial Services Authority Listing Rules. It should be remembered, however, that this would not be tantamount to a mandatory rule because a company would merely be making the regime available to those investors in co-operation with legal owners who contract to take up the designated person status.

The question of the appropriate boundaries of company law is an interesting topic for the current UK Company Law Review. The proposal in this chapter has particular relevance to that topic because it suggests redefining the existing boundaries. It implies a policy choice

that company law should not be excluded as a regulatory tool for defining and enforcing certain of the legal incidents of the relationships between investors and the enterprises in which they invest; in other words, the legal process of voting.⁶³

8.3. *The Shares Subject to a Designation must be Specified*

A designation would relate to a particular registered shareholding. Assume a fund manager is a designated person in respect of shares in XYZ plc registered in the name of custodian ABC on behalf of a pension scheme (the beneficial owner). The same fund manager makes a further investment in XYZ plc shares, using custodian ABC again, but on behalf of a different client (beneficial owner). The original designation would not apply in relation to the newly-acquired shares. This would clearly be the case where the custodian uses a designated nominee system because the newly-acquired shares would be registered in a name different to the name in which the original shares were registered.

But what if the custodian uses a pooled nominee system?⁶⁴ The provision would have to allow for a custodian whose registered holding is held on behalf of, say, thirty different clients (beneficial owners). The custodian (member) in this example might be required to notify the listed company of a designated person in relation to only one client's underlying holding which might be 3,000,000 shares out of the 65,000,000 total shares in that company registered in the name of that custodian.

It should be pointed out that if, as recommended below, only meeting-specific designations were allowed, further purchases and sales of shares would not be problematic. A designation would take effect only on the record date⁶⁵ for a particular general meeting, and the relevant number of shares could be precisely identified as those held at the record date.

8.4. *Should only Meeting-Specific Designations be Allowed?*

An issue for consideration is whether the provision should allow only meeting-specific designations or also standing designations. A 'standing designation' is one that is valid for all future general meetings of the company concerned until revoked. It may be desirable for the provision to give a member the option of making a standing designation. Where, as in the pension scheme example, the member is not the beneficial owner, it will be the beneficial owner who will be driving the decision as to whether or not the member makes a designation. And the beneficial owner may wish to take the low transaction cost option of having the member make a standing designation, rather than having the member make a new meeting-specific designation each time a general meeting is convened. This may be the case, for example, where a pension scheme 'indexes' most or all of its UK equity holdings.⁶⁶ A key reason why some institutional investors choose to index their equity holdings is because the fund management fees to manage a portfolio passively are considerably lower than those charged for managing a portfolio using active management techniques.⁶⁷

On the other hand, allowing standing designations would introduce extra risk because a listed company's registrar would need to reconcile on an ongoing basis the registered shareholdings that have been made subject to designations. When a complete shareholding is sold, the member ceases to be a member. In the pension scheme example, when the

pension scheme's entire holding in a listed company is sold, then: (1) if the custodian uses a designated nominee system,⁶⁸ the unique name used by the custodian to register that holding is removed from the listed company's share register; or (2) if the custodian uses a pooled nominee system,⁶⁹ the custodian's name will remain on the listed company's share register but its registered shareholding will be smaller.

In either case the nomination of the designated person is no longer of any relevance. But if only meeting-specific designations were to be allowed, and not also standing designations, a sale of shares would not be problematic. Legal relations between a listed company and a designated person, in relation to the operational incidents of shareholding, would arise only at the record date for the particular meeting. The number of shares subject to a particular designation could be precisely identified as those held at the record date. Legal relations between listed company and designated person would end once the general meeting had been held.⁷⁰

On balance, it seems preferable to allow only meeting-specific designations. Certainly, meeting-specific designations should at least be an optional, if not the exclusive, form of designation. A meeting-specific designation would be advantageous for a control-right holder seeking anonymity. In the pension scheme example, the fund manager may see strategic benefit in not having its identity revealed in respect of a particular registered shareholding for a particular period of time. Provided its client, here, the pension scheme trustee, was comfortable with this, no designation would be made for that shareholding even if the trustee's general policy was that designations should be made. It would be a matter of contract. A meeting-specific designation could always be made in respect of a later general meeting if circumstances changed.

If confidential voting is a concern to investors, directors and company secretaries of public companies could be expected to put in place procedures to ensure that voting instructions are attributed to designations only for the purposes of recording and tabulating the vote. This expectation seems in line with the representative nature of the non-executive directors' role; they could be expected to provide the necessary assurance to investor-shareholders on this point.⁷¹

8.5. Should the Proposal be Limited to Institutional Investors?

A case could be made for the provision to be limited, at least initially, to institutional investors. The Newbold Committee's inquiry has revealed problems with the existing system as far as institutional investors are concerned. In contrast, when the Department of Trade and Industry (DTI) consulted on private (individual) shareholders' corporate governance rights in 1996/7, it found little evidence that private shareholders either found the existing system inadequate or supported reforms (DTI 1996).

The shortening of settlement periods and the introduction of the CREST electronic settlement system has led to an increasing proportion of private investors holding their equity investments through custodians (DTI 1996: para. 2.3; Davies 1999). Here, just as with institutional investors, the custodian is the registered shareholder (member) and is therefore the recipient of general meeting documents and the party who sends the completed proxy form to the company. However, private investors currently have the option of 'CREST sponsored membership' as an alternative to using a custodian or holding their

shares in paper form. Private investors who take up CREST sponsored membership gain the benefits of holding and transferring shares in electronic form through CREST, but at the same time keep their name on the company's register of members, thus receiving general meeting documents directly from the company, and voting directly (DTI 1996: para. 2.5). As mentioned above, the DTI's consultation revealed a lack of significant support for legislative change to give private investors further mechanisms for gaining direct corporate governance rights.

On the other hand, it may be politically difficult to 'sell' a reform of this nature if private shareholders were to be excluded. It may be expedient to make the provision available in respect of any shareholding, regardless of whether the beneficial holder is an institutional or private investor, or otherwise. In terms of additional costs, these may prove to be minimal if the take-up of the provision by private investors reflects the low level of private investor interest in the issue when the DTI consulted on it in 1996–7.

8.6. *Stock Lending*

Where stock lending takes place,⁷² this new system could achieve the recommendation of the Newbold Committee (1999: para. 2.23) that stock lending agreements should include a condition that the borrower undertakes to vote the shares in accordance with the directions of the lender. The condition could specify the designated person as the party in accordance with whose instructions the borrower must exercise voting rights.

8.7. *Property in the Information Supplied*

Consideration should be given to the question of the 'property' in the information (the details about the designated person) held by the custodian and passed to the listed company, or the listed company's external registrar. Although not the subject matter of this chapter, the exercise of construing the legal issues surrounding the holding and disclosure of information should not provide either a conceptual or practical problem. Part VI of the Companies Act currently (1) requires anyone with an 'interest' in 3 per cent or more of a public company's share capital to disclose details of the interest to the company; the legislation then requires the company to make this information available in a publicly accessible register,⁷³ and (2) empowers public companies to 'trace' interests—that is, to require anyone with an interest in the company's shares (no matter how small or large the interest) to provide information about their identity as well as the nature of the interest; the legislation then requires that this information be made available by the company in a publicly accessible register.⁷⁴

The definition of 'interest' is extremely broad and covers voting-right holders.⁷⁵ The process under which this information is actually procured for listed companies is well established. In fact, for companies that currently operate a shareholder identification programme using the tracing power, the introduction and widespread take-up of the designation provision recommended in this article would probably not reveal much new information to the company.

While companies legislation has an established system for identification of those with voting power to the company in this way, the wider issue of protection of that data once lawfully obtained under the legislation is an issue for a separate analysis.

8.8. *Supportive Financial Services Regulations*

The regime could be bolstered by regulations under the Financial Services Act 1986 (UK) to require custodians and other intermediaries holding shares as nominees for beneficial owners to bring to each client's attention that they or their fund manager (or other appointed agent) could be a 'designated person'. The supervision of this conduct of business by authorized firms should also ensure specific and not general disclosure; ensure that clients' details, given to a custodian to be relayed to listed companies under the designation provision, are used by the custodian only for this purpose; and ensure intermediaries' terms of trade do not unfairly establish obstacles to the designation.⁷⁶

9. BENEFITS AND COSTS OF THE REFORM PROPOSAL

9.1. *Categorizing Benefits and Costs*

The issue for regulatory reform is whether existing law, which allocates control rights only to those persons who are 'members' on the register, is optimal. To determine whether or not the existing legal regime is optimal requires analysis of the benefits and costs of it, and of alternative regimes. The description, below, of the benefits and costs of the reform proposal also contains analysis of the benefits and costs of the current legal regime.

It is difficult to categorize and quantify the costs and benefits of a system which plainly allocates the rights of control to those who in reality do not hold them. It is acknowledged, therefore, that this is an area where input is needed from users of the existing system to identify and quantify the benefits and costs of the current system, and to comment on anticipated benefits and costs of the reform proposal. The main (and simple) contention made here is that, if the law permits the voting right to be exercised as a matter of legal process without interposing the custodian whose name is entered on the register of members, then costs will reduce.

9.2. *Sources of Benefits*

9.2.1. *Cost Savings from Reduction in Complexity*

This chapter argues that there is a prima facie case for regulatory reform based on the complexity inherent in the existing legal regime (as analysed earlier in the chapter), and the dissatisfaction about this among institutional investors, as reported by the Newbold Committee (1999: paras 1.7–1.8):

For all institutions the voting cycle represents a tortuous process which must be conducted against a background of set deadlines imposed by the Companies Act 1985, by companies themselves and, in relation to the Annual General Meeting (AGM), by The Combined Code. The greater the number of links, the greater the complexity. . .

The costs flowing from the current complex system stem largely from the custodian (member) having to be involved in the voting process. To recap: the manner in which the control rights are defined in company law, focusing on the 'member' or registered holder, does not reflect how they are distributed in practice. The distribution of material to the actual holder of the voting control right, and the process by which votes are cast, is complex. Complex processes cost, and the cost is ultimately borne by investors (whether

pension fund beneficiaries, insurance companies, or private investors (direct or indirect)). That is, the costs are shared over the investors in any given company: they are passed through the financial system. They are part of the cost of ownership; not the cost of capital to the entrepreneurs who establish and run public companies, but a cost to those who contribute their capital to the enterprise.

9.2.2. *Possible Efficiency Gains from Greater Level of Institutional Investor Voting*

The following passage from the report of the Newbold Committee (*ibid.* para. 1.8) highlights a second potential source of benefit from our reform proposal:

[V]oting outcomes on issues which concern the strategic or financial direction of a company are clearly crucial. Indeed, in matters of corporate governance, key opportunities to convey institutional [investor] sentiment to companies may be lost or not fully exploited [due to the complexity of the voting system].

The benefit here is that, assuming institutional investor activism increases efficiency in certain cases, any measure that makes it easier for institutional investors to exercise their voting rights, and leads to a higher level of successful attempts to vote by institutional investors, would enhance the gains from institutional investor activism. The assumption is important, because this chapter does not contribute to the central issue in the debate about the efficiency potential of institutional investor activism. The only contribution made to that debate is that, assuming institutional investor activism increases efficiency in certain cases, the potential gains will be partially dependent on a low-cost system for the operational incidents of a share.

Does institutional investor voting and other forms of involvement in corporate governance enhance efficiency? Empirical studies have produced mixed results.⁷⁷ Recent work by Romano (Chapter 23, this volume) suggests that the mixed results may be a factor of which specific corporate governance feature was being targeted in the institutional investor voting or other action. Romano demonstrates that institutional activism aimed at board structure and composition, for example, does not generally produce a statistically significant effect on company performance. This, according to Romano, is explicable by the fact that board structure and composition itself does not have a statistically significant impact on corporate performance. This fact is discernible from a review of the broad range of empirical studies in this area.⁷⁸ On the other hand, institutional investor activism aimed at dismantling certain kinds of takeover defences, by voting against them, is often associated with positive share-price performance. Romano attributes this to the fact that these types of takeover defences have themselves been shown, empirically, to be shareholder-wealth destroying.

The upshot of the USA empirical studies, in particular, appears to be that the growth in institutional shareholdings over recent decades has had an impact on corporate performance, but not in an across-the-board sense. Exercise of voting rights by USA institutional investors does appear to be value enhancing in some areas, such as removal of certain types of takeover defences. So, to the extent that voting by institutional investors is an efficiency-enhancing activity, barriers to the exercise of voting rights by these types of investors are a cost for the company as a whole—ultimately spread over the entire shareholder body—and therefore for society. A low-cost system for exercising voting rights where there are

multiple interest-holders in a parcel of shares should enhance any long run gains that flow from institutional investor activism.

9.2.3. *Cost Savings from Identification of Control-Right Holders*

Companies currently pay external firms to analyse the share register to determine the identity of the largest control-right holders (Stapledon 1996: 322). Firms providing this type of service include information service providers and also stockbroking firms. The service provider gleans from the share register every registered holding above a threshold level (which in some cases is as low as 10,000 shares, but is usually either 20,000, 25,000, or 30,000 shares).⁷⁹ Databases showing the fund managers (control-right holders) and beneficial owners sitting behind nominee holdings are matched against the collected registered holdings to construct a list of the largest control-right holders.⁸⁰ Companies use this information for, among other things, determining which fund managers to invite to management presentations, and road-shows. The information is therefore an integral element of corporate governance in the listed sector.⁸¹

There would be less demand for this service in its current form and cost savings for companies (ultimately a benefit spread across the entire body of shareholders) if there were to be a reasonably significant take-up of the designation power by members. The designation would reveal the identity of, in most cases, the fund manager controlling the shares in question.

9.2.4. *Preservation of Security of Title and Security of Transfer*

One obvious benefit of the current system is that section 22(2) of the Companies Act 1985 (UK) provides a solid foundation for two aspects of an equity securities market trading system: security of title and security of transfer. Section 22(2) provides that every person who agrees to become a member, and whose name is entered in the register of members, is a member of the company. By security of title, a person or their agent is assured that they own the share because they can point to an entry in a register.⁸² By security of transfer, a person or their agent can, in a clear, transparent, and simple manner, transfer shares and receive consideration in exchange, or equally receive shares and transfer consideration in exchange. Settlement of transactions is therefore effected by reference to the register.⁸³ Participants in the UK equity market value security of title and security of transfer. Liquidity and efficiency is enhanced by these aspects of the existing UK system.⁸⁴

For two reasons, equity market participants should have confidence that a reform like the one proposed in this chapter need not sacrifice the 'property' aspects of trading and holding shares—that is, security of title and transfer: first, the proposal goes only to certain 'operational' aspects of shares (voting and receiving general meeting information). It would not interfere with the 'property' aspects, although it would be necessary to reconcile the entry in the register with the designation(s) for that holding. Second, developments in the trading and settlement procedures for equity securities, and in the clearing and custodial functions, arguably imply that the role of a company's register of members in providing security of title and transfer is in any event disappearing, at least for the majority of investors who hold shares in uncertificated form. The remainder of this section explains this point.

60. HM Treasury (1999) has recently consulted on amendments to the Uncertificated Securities Regulations 1995 (UK). These regulations enable electronic trading and settlement in shares: they specify the property rights arising in uncertificated securities and their transfer. The consultation paper seeks responses on certain suggested amendments that are proposed in the name of 'efficiency and security of national and international settlement systems' (HM Treasury 1999: Introduction). Specifically, the proposal is to eliminate the gap between settlement and registration, with the effect of reducing 'the risk and perception of risk in the settlement system' (ibid. para. 8). The 'gap' is the time between settlement of a trade in the CREST system, and the confirmation from the company's registrar of change to the register. Paradoxically, this approach indicates that, rather than being a foundation of security of transfer, current section 22(2) is perceived as a source of risk to future UK competitiveness because it involves the company's registrar having a role in title and transfer of uncertificated securities.

61. The UK government proposes that section 22 should be amended to provide that, in relation to uncertificated securities, membership of a company arises when stock accounts within an operator system are updated (ibid. para. 9). 'Stock accounts' are the records of holdings of securities of CREST members, typically financial intermediaries, and custodians. Under the existing regulations, a 'participating issuer' (company) is required to enter on the register of members the number of shares each member holds in uncertificated form, and certificated form, respectively.⁸⁵ Such an entry provides security of title.⁸⁶ A participating issuer is required to register a transfer of title to uncertificated units in accordance with an operator instruction, thus providing security of transfer.⁸⁷ In addition to the change to section 22(2), the proposal would require company issuers to arrange for CREST to keep the register for uncertificated securities, and for CREST to accept this obligation.

62. Another relevant development is the change in structure of nominee accounts maintained by custodians. There has been a marked increase in the use of pooled nominee systems under which the investments of many clients are registered in just one nominee name.⁸⁸ Custodians rely on their internal records to differentiate underlying entitlements. One reason for this trend is consolidation in the custodial services sector. USA global custodians, in particular, have acquired UK custodians and in the integration process have persuaded clients to switch from designated accounts into pooled accounts. This could imply that investors accept the security of title and transfer associated with a move to pooled holding.⁸⁹ It also reinforces the idea that security of title and transfer is provided for investors not by company issuers, but through the electronic record-keeping systems of the custodian and other financial intermediaries participating in systems such as CREST.

In summary, then, the role a company's register of members plays in providing security of title and transfer appears to be diminishing because of developments in the financial services sector.

9.3. Costs

9.3.1. Transitional Costs

Introduction of the reform proposal would entail transitional costs for company registrars and custodians where the power to designate was taken up. These would centre on the

development or adoption of systems. However, some custodians' systems already contain data on control-right holders linked to registered shareholdings in particular companies.⁹⁰ In these cases, the transitional systems costs would be minimal.

9.3.2. *Ongoing Costs*

It could be argued that the proposal would see companies spending more on general meeting documents, in that: currently, where a custodian operates a pooled nominee system, a listed company is obliged to send only one annual report and notice of meeting, etc., because there is only one 'member'; whereas, if the proposal were to be implemented and then taken up enthusiastically, meeting documents would have to be sent to many different fund managers, acting as the designated persons in respect of a single pooled custodial holding.

This argument overlooks the fact that, under current practice, listed companies commonly send multiple copies of the annual report and notice of meeting to any custodian running a pooled account, and the custodian then distributes these to control-right holders.

Companies' registrars would face some ongoing costs. For example, costs incurred when processing designations. Even where, as is very commonly the case, the registrar is an external firm engaged by the listed company, and not an in-house operation, the registrar's costs would ultimately find their way back to client listed companies, and thus all shareholders. Custodians, too, would face ongoing costs associated with processing designations. However, where a designation is made, the custodian is no longer involved in the processing of votes so there is an offsetting cost saving.

Also, this chapter has advocated that the provision should operate as an enabling provision for unlisted companies and, by operation of the Financial Services Authority Listing Rules, as a default rule for listed companies—not a mandatory rule.⁹¹ Any unlisted company for which the designation power would probably be more costly than beneficial would not opt into the regime. And any listed company for which the designation power would probably be more costly than beneficial could ask its shareholders to amend its articles and waive the provision.

Finally, bearing in mind that any system will involve costs, the proposal has the advantage of making the costs more transparent. Under the optional system proposed in this chapter, companies and investors who choose designation will have made a conscious decision on the basis of mutual benefit. This is consistent with the principle set out in the Combined Code that companies should be ready, where practicable, to enter into a dialogue with institutional shareholders based on a mutual understanding of objectives (Financial Services Authority 2000: Combined Code, Principle C1).⁹²

9.4. *Conclusion*

This section of the chapter has categorized the sources of benefits and costs likely to be associated with a reform of the nature proposed earlier. At this stage, the authors are not in a position to discuss the magnitude of the various benefits and costs due to the lack of empirical data. Nevertheless, the authors believe that, on balance, the benefits of the proposed reform are likely to outweigh the costs, in the listed company sector overall. This view is subject to industry participants identifying any further benefits or costs not identified thus far. It is also based on the assumption that the provision would not be a

mandatory rule, but rather an enabling provision, with secondary regulation making it a default rule able to be waived under the Articles of Association for all listed companies. Further, the rule would allow listed companies to make meeting-specific designations.

10. POSSIBLE EXTENSIONS OF THE PROPOSAL

The proposal discussed in this chapter is confined to delivery of general meeting documents, and voting. The importance of these matters to corporate governance suggests that they are the most pressing incidents of shareholding to be considered in a reform of this nature.

If the proposal were to be implemented successfully, then at a later stage it may be appropriate to consider whether other incidents of shareholding should be added to the items able to be designated. For example: payment of dividends (inherently a property incident of shareholding); and other powers given to members by the Companies Act, for example, to requisition general meetings⁹³ and to requisition the serving of a tracing notice under Part VI.⁹⁴

11. CONCLUSION

If reform along the lines advocated in this chapter were to take place, it would not be the first time company law had recognized the interests of persons other than members on the register. Part VI of the Companies Act 1985 (UK) deals with 'Disclosure of Interests in Shares'. As discussed earlier in this chapter, the Part VI provisions are designed to enable companies to discover the identity of those who exercise control over the shares in the company. The provisions both require holders of interests above a threshold level, generally three per cent, to disclose them, and enable companies to 'trace' the identity of holders of interests in their shares. Section 209 is interesting in this regard. The section exempts certain financial services providers who could acquire otherwise notifiable interests in the course of their business. As the exemption covers only 'technical' interests, the exemption saves these firms the cost that would flow from having to disclose, but without undermining the goal of Part VI. In sum, company law has in this respect been responsive to change by imposing duties on investors, and granting powers to companies, while at the same time taking account of developments in financial market products. This chapter has considered whether it is desirable, in respect of control rights, to provide a mechanism which instead grants rights to investors and imposes duties on companies in certain circumstances.

Appendix. Abbreviations used in Table 24.2

FC	fund management arm of a financial conglomerate
Indep.	independent fund manager
Ins.	fund management arm of insurance company
Pens.	in-house manager of pension fund assets
AMP (UK)	AMP Asset Management plc (now Henderson Investors)
Barclays	Barclays Global Investors Ltd.
CGU	CGU Asset Management
Fleming	Fleming Investment Management Ltd.

Gartmore	Gartmore Investment Management plc
Hermes	Hermes Investment Management Ltd.
Hill Samuel	Hill Samuel Asset Management Ltd.
HSBC	HSBC Asset Management
Legal & General	Legal & General Investment Management Ltd.
M&G	M&G Investment Management Ltd. (now owned by Prudential)
Mercury	Mercury Asset Management plc
Morgan Grenfell	Morgan Grenfell Investment Management Ltd.
Norwich Union	Norwich Union Investment Management Ltd.
Phillips & Drew	Phillips & Drew Fund Management Ltd.
Prudential	Prudential Portfolio Managers Ltd.
Royal	Royal & SunAlliance plc
Schroder	Schroder Investment Management Ltd.
Scottish Widows	Scottish Widows Investment Management
Standard Life	Standard Life Investments Ltd.
Threadneedle	Threadneedle Investments

Notes

1. Employee Retirement Income Security Act.
2. See [p. 571]. From the mid-1960s to 1998, the proportion of listed UK equities held directly by individuals reduced sharply from 54 per cent to 16.5 per cent (Office for National Statistics 1999). Over the same period, indirect investment in equities by individuals—through collective investment vehicles (e.g. unit and investment trusts)—has increased considerably, in part offsetting the reduction in the proportion of the stock market held directly by individuals (Committee on Private Share Ownership 1996: 2). The term 'listed UK equities' means issued ordinary shares of UK-registered companies listed on the London Stock Exchange.
3. For example, Canada (Canada Business Corporations Act 1985, § 51(1): '(1) A corporation . . . may . . . treat the registered owner of a security as the person exclusively entitled to vote, to receive notices, to receive any interest, dividend or other payments in respect of the security, and otherwise to exercise all the rights and powers of an owner of the security'; § 51(4): 'A corporation is not required to inquire into the existence of, or see to the performance or observance of, any duty owed to a third person by a registered holder of any of its securities or by anyone whom it treats, as permitted or required by this section, as the owner or registered holder thereof'); Australia (Corporations Law, §§ 231, 249], 250E); New Zealand (Companies Act 1993, §§ 89(2), 96); Singapore (Companies Act 1967, §§ 148, 158); Malaysia (Companies Act 1965, §§ 148, 158). In the case of Canada, note that the various Securities Commissions have adopted a USA-style 'recognition' procedure: Canadian Securities Administrators (1987, 1998). The USA recognition procedure is outlined [on p. 582–3].
4. See Companies Act 1985 (UK), §§ 370, 372.
5. The nature of the current rule which allocates the rights of control to a member (contained principally in §§ 22 and 360 but bolstered by other provisions) is a categorization rule. It is mandatory in the sense that it defines the persons who are subject to the rights and duties of the statutory framework. The effect of this so-called mandatory rule is to exclude those outside the category from having direct access to those rights. In [section 8.2], which sets out the proposed solution, the rules necessary to carry out the proposed reform are defined in the traditional 'mandatory', 'default', and 'enabling' manner.

6. Including, in the case of an AGM, the annual report and accounts, the notice of meeting and the proxy form.
7. The ideas in this chapter continue a line of analysis to which Manne (1964) contributed several decades ago. Professor Manne characterized the share as a package composed of two parts: 'an underlying investment interest and a vote' (*ibid.*: 1430). He argued that the system of corporate law should permit the transfer of the vote without the transfer of the investment interest, in effect the delegation of voting power by investors to financial market participants. At the time Professor Manne wrote this article, he argued that rules on disclosure of information in proxy contests lowered the cost of securing information for shareholders and thereby opened the voting option for them (*ibid.*: 1443). Equally, he argued that collective action by brokers and investment advisers on behalf of shareholders was made more feasible by the lower-cost means of securing information (*ibid.*: 1443). This chapter follows the spirit of Manne's conceptual clarity in separating the components of a share. But 36 years later, and in a different jurisdiction, this chapter addresses whether it is not time to reassess whether the ownership structures that have grown up in the shadow of a company law framework have frustrated the objective of a freely transferable vote component of a share which Professor Manne argued is central to the health of the system of corporate law.
8. See [p. 576].
9. The former 'information right' includes information required by statute as well as, for example, the Financial Services Authority Listing Rules. The 'voting right' includes any matter on which shareholder approval is required or sought voluntarily—for example, election of directors, takeovers, or changes in capital structure. As discussed towards the end of the chapter, another issue for consideration is whether additional rights could be added to the reform model, for instance, rights to receive declared dividends and to requisition general meetings.
10. The fund manager will normally also have an unrestricted power to sell the shares. See Pensions Act 1995 (UK), § 34, in relation to the power of pension scheme trustees to delegate their powers. Whether in practice the fund manager has an unrestricted 'ability' to sell the shares will be influenced by economic considerations. It may not be possible to sell certain shares at a particular time due to a lack of willing buyers at an acceptable price. Note also that the allocation of the voting control right is by no means a static area. As discussed below, there is some evidence that some large UK institutional investors have varied the typical arrangements just described.
11. The terms on which different fund managers hold those rights will differ according to specific contractual arrangements with beneficial owners.
12. USA institutions held 8 per cent of listed UK equities at early 1999 (Riley 1999).
13. See note 2 above.
14. A lesser factor behind (b) was the statutory recognition given to equities as acceptable trust investments by the Trustee Investments Act 1961 (UK); equity investments were previously possible only if there was an express power in the trust deed.
15. These internal fund management subsidiaries normally also offer their services to external clients (such as pension fund trustees). For example, as at 31 December 1997, Prudential Portfolio Managers Ltd. managed £9,634 million on behalf of external pension funds—about 10 per cent of its total funds under management from the UK (£93,197 million). The amount of external pension fund assets managed by Legal & General Investment Management Ltd. at the same time was even greater: £25,789 million (45 per cent of its total funds under management from the UK (£57,264 million)) (Hymans Robertson 1998).
16. Voting services operated by firms outside the fund management industry are also appearing. See, for example (<http://www.manifest.co.uk>).
17. Hermes now also manages some external funds, but it is classified as an in-house fund manager here because a very large proportion of its funds under management are internal funds.

18. The difference between 'directly invested', 'pooled' (or 'managed'), and 'insured' pension schemes is explained at [p. 575-577].
19. Own calculations based on figures in National Association of Pension Funds (1999: 57).
20. As mentioned at note [28] below, most large pension schemes have a corporate trustee rather than individual trustees.
21. Many mutuals are companies limited by guarantee.
22. *Salomon v. A Salomon & Co. Ltd.* (1897) AC 22.
23. *Salomon v. A Salomon & Co. Ltd.* (1897) AC 22; *Macaura v. Northern Assurance Co. Ltd.* (1925) AC 619.
24. For example, in 1993 Crown Financial Services Ltd., the UK life insurance, pensions and unit trust subsidiary of Crown Life of Canada, ceased to manage its funds in-house. Its funds under management, some £700 million, did not amount to the 'critical mass' necessary for high-quality fund management. Therefore, fund management was contracted out to an external fund management firm: 'Lazard to Manage Crown Funds' (*Financial Times*, 19 January 1993: 21).
25. Local authority schemes are not formally constituted as trusts. They are constituted under the Superannuation Act 1972 (UK), and regulated under various sets of regulations made under that Act. The local authority ('administering authority') is nevertheless in a position analogous to that of a trustee (Quarrell 1990: ch. 4).
26. See Pensions Act 1995 (UK), §§ 16-21, in relation to member representatives.
27. For unit trusts, see [section 5.3.].
28. The more common of the two options is a corporate trustee. Here, a company is appointed as the trustee of the scheme. The directors of that company are sometimes loosely referred to as the scheme's trustees. In law, though, the company is the trustee.
29. The beneficial interest of the scheme's beneficiaries is reflected in the wording of Companies Act 1985 (UK), § 209(1)(a).
30. In similar circumstances, an Australian court was prepared to 'look through' the two trusts and find that the registered owner of the assets owed fiduciary duties to the ultimate beneficiaries: *Australian Sec. Comm. v. AS Nominees Ltd.*, 18 ACSR 459, 472 (1995).
31. There is a debate about whether institutional investors should be required to exercise their voting rights in the interests of good corporate governance. Importantly, however, existing UK law imposes no obligation to vote. As far as pension fund trustees are concerned, the principal duty is to give real and genuine consideration to whether, and if so how, votes should be cast (Stapledon 2000).
32. See Pensions Act 1995 (UK), § 34.
33. Companies Act 1985 (UK), § 370(1), (2); Table A, Art. 38.
34. Financial Services Act 1986 (UK), § 76.
35. Financial Services Act 1986 (UK), § 78(2).
36. Financial Services (Regulated Schemes) Regulations 1991 (UK), reg. 7.10.2.
37. *Charles v. Federal Commissioner of Taxation* (1954) 90 CLR 598, at 609; Linklaters and Paines (1989: para. A2.0420).
38. See [section 5.2.3.].
39. Financial Services (Regulated Schemes) Regulations 1991 (UK), reg. 7.11.1. There is an exception where the scheme property is shares or units in collective investment schemes managed or otherwise operated by the manager or its associates.
40. *Salomon v. A Salomon & Co. Ltd.* (1897) AC 22.
41. *Salomon v. A Salomon & Co. Ltd.* (1897) AC 22; *Macaura v. Northern Assurance Co. Ltd.* (1925) AC 619.
42. OEICs are regulated under the Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulations 1996 (UK), and the Financial Services (Open-Ended Investment Companies) Regulations 1997 (UK).

43. The depository is permitted to entrust some or all of the scheme's property to a third party (e.g. a custodian): Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulations 1996 (UK), reg. 5(2)(b).
44. Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulations 1996 (UK), reg. 39(2).
45. Financial Services (Open-Ended Investment Companies) Regulations 1997 (UK), reg. 6.02, para. 3b.
46. See [section 5.2.3.], for discussion of directly invested pension schemes.
47. See [section 5.2.3.].
48. Own calculations based on figures in National Association of Pension Funds (1999) and Office for National Statistics (1999).
49. There have been other factors. For example, measures taken to speed up the settlement process have led to an increasing number of private investors holding shares through nominees.
50. There have been somewhat similar developments in the USA. The clearing agency Depository Trust Corporation of New York uses a nominee called Cede and Co. Ltd. Cede and Co. executes an 'omnibus proxy' to all persons on its book on the record date with the power of substitution. This enables the 'street names' (i.e. banks and brokers) to be proxy with a power of substitution. However, it is not clear that the power of substitution is a power to appoint multiple substitutes. Also, due largely to investors' concerns over disclosure of identities, and contact details, a private-sector provider (not the listed company) sends the voting material and receives back voting instructions.
51. Indeed the Company Law Review Steering Group (2000: paras 4.6–4.18) has raised the issue discussed in this chapter for consultation in its March 2000 consultation document.
52. Under a 1999 reform, pension scheme trustees must now declare in their statement of investment principles 'their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments': Occupational Pension Schemes (Investment) Regulations 1996 (SI 1996/3127), reg. 11A (inserted by the Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy, etc) Amendment Regulations 1999 (SI 1999/1849)). The statement of investment principles is a requirement of the Pensions Act 1995 (UK). The scheme trustee, or any investment manager hired by the trustee, must exercise powers of investment 'with a view to giving effect to [these] principles . . . so far as reasonably practicable': § 36(5).
53. See [p. 583] below.
54. As discussed in [section 8.1.] below, some USA states have adopted a primary legislation solution: the 'recognition procedure'.
55. Whether by the Companies Act (UK), the company's articles, the Financial Services Authority Listing Rules or any other regulation.
56. Therefore, it would only be once a designation is made that a legal relationship between the company and a non-member control-right holder would arise. Equally, the provision would relieve the company from duties and liabilities to the member in respect of control rights attached to shares that have been designated.
57. Indiana Business Corporation Law, § 23-1-30-4(a).
58. The Official Comment explains § 7.23 in this way: "Traditionally, a corporation recognizes only the registered owner as the owner of shares. Indeed, § 1.40 defines "shareholder" basically as the registered owner of shares. But it has become a common practice for persons purchasing shares to have them registered in the "street name" of a broker-dealer or other financial institution, principally to facilitate transfer by eliminating the need for the beneficial owner's signature and delivery. In addition, in order to avoid the burdens of processing securities transfers, which caused a crisis in the securities industry in the late 1960s, a system of securities depositories (defined as "clearing corporations" in § 8-102(3) of the Uniform Commercial Code) has been developed.

In this system, financial institutions deposit securities with the depository, which becomes the registered owner of the shares. Transfers between depositories are then accomplished by book entry of the depository. As a result, there may be two entities interposed between the corporation and the beneficial owner with the depository being the registered owner for the account of the brokerage firm that in turn holds the shares for the account of the beneficial owner.

The purpose of § 7.23 is to facilitate direct communication between the corporation and the beneficial owner by authorizing the corporation to create a procedure for bypassing both the registered owner and intermediate brokerage firms. The adoption of this procedure is discretionary with each corporation and affirmative action by the corporation is necessary to accomplish it. The procedure is also discretionary with the shareholder, who must elect to follow the applicable procedure prescribed by the corporation. The shareholder retains all of his rights except those granted to the beneficial owner' (Statutory comparison Model Business Corporation Act, Annotated 1997: S7-130).

59. Where the list of record holders indicates a clearing agency, the company is required to make the same enquiries of the agency and the participants whose names are disclosed to the company as a matter of course by that agency. Rules 14(b)-1 and 14(b)-2 set out the obligations of registered brokers and dealers and banks in relation to prompt forwarding of company documents to beneficial owners. Similar provisions apply where proxies are not solicited but the same material is distributed: Rule 14(c)-7. In certain circumstances, the company may itself distribute materials (such as the annual report) to beneficial holders, in which case the company must in its enquiry of holders of record indicate that it will do so. This relieves the holders of record of their duties in respect of mailing those persons: Rules 14(a)-13(c), 14(b)-1(c)(2)(ii), and 14(b)-2(c)(2)(ii).
60. For an analysis of enabling, default and mandatory rules in company law, generally, see Cheffins (1997: 216-63).
61. This is probably an oversimplification of the relevant considerations. Klausner (1995) argues that network externalities may be associated with default rules in corporate law, in much the same way as network externalities arguably exist in 'network' industries like the personal computer industry. That is, just as the value to a particular person of an IBM-compatible PC depends on how many other people own PCs and thereby create markets for compatible software, hardware, and repair services, default rules in company law may eventually become entrenched after a body of legal interpretation and understanding builds up around them. This may be a good thing or a bad thing: 'The right default term can enhance social wealth by facilitating coordination and thereby creating network values that individual firms may be unable to create themselves. . . . On the other hand, the wrong default rule can promote the formation of suboptimal contracts': Klausner (1995: 829). See also Ayres and Gertner (1989).
62. An arm's length institutional shareholder is one holding a relatively small proportion of the total issued shares in a company as part of a diversified portfolio of equity investments. In contrast, the venture-capital arm of an institutional investor may hold a significant proportion of the issued shares in an unlisted public company.
63. Note that under the existing Financial Services Act regulatory framework the role of the intermediary (e.g. custodial service provider) is set out: Before a firm provides safe custody services to a customer, it must notify the customer in writing of the obligations which the firm will have to the customer in relation to: exercising voting rights (Rule 4.109(1)(e) of the Client Money and Custody Rules within the Securities and Futures Authority Rules).
64. See [section 5.2.3.].
65. The term 'record date' refers to a definitive point in time at which eligibility to vote or appoint a proxy for a particular general meeting is determined. Under the current system in the UK, this 'record date' is effectively 48 hours before the meeting because of the combination of § 372(5) of

- the Companies Act (UK)—which has the effect of prohibiting a company from refusing to receive a proxy appointment more than 48 hours before the meeting—and reg. 34(1) of the Uncertificated Securities Regulations 1995 (UK)—which allows a company to determine who has the right to vote in relation to uncertificated securities at a time not more than 48 hours before a meeting. In a paper based system where proxy forms along with the notice of meeting are sent out to those persons on the register weeks before the date of the meeting, there is a requirement to reconcile the persons and holdings of those to whom notices were sent at that earlier time, with the record of the persons and number of votes received up to the 48 hour cut-off. This presents logistical challenges for those involved in collating the vote. There may be some merit in the UK Company Law Review considering the benefits and costs of other approaches, such as that in the USA where there is a 'voting record date' set well in advance of the meeting. The data effective at that point in time determines who is entitled to receive documentation and to exercise a vote.
66. 'Indexing' or 'passive' fund management involves the purchase of a portfolio of shares that matches the shares included in a particular stock market index, such as the FT All Share Index (which consists of the largest 700 or so companies listed on the London Stock Exchange).
 67. Fees for indexed management of a wholesale (institutional) segregated fund are as low as five basis points (0.05 of 1 per cent of the value of funds under management) per annum, compared to about fifty basis points (0.5 of 1 per cent of the value of funds under management) for an actively managed UK equities wholesale segregated fund. It is estimated that about 20 per cent of listed UK equities are currently under indexed management (Martinson 1999*b*). It may be that a pension scheme's trustee would want a standing designation made in relation to the scheme's 'core' holding in a particular company, but a meeting-specific designation (or no designation at all) in respect of a 'satellite' holding in the same company. The trustee would be guided by the fund manager responsible for the satellite holding. The fund manager might, for instance, see strategic benefit in not becoming a designated person in relation to the satellite holding.
 68. See [section 5.2.3].
 69. See [section 5.2.3].
 70. On the other hand, if the provision were to allow standing designations, there would be an ongoing legal relationship between a listed company and a designated person, in relation to the operational incidents of shareholding.
 71. The Listing Rules suggest that voting instructions should be known to companies. See Financial Services Authority (2000: Combined Code, provision E.1.3): 'Institutional shareholders should take steps to ensure that their voting intentions are being translated into practice.' In practice, there is a range of approaches to vote communication from institutional investors to company representatives (often investor relations or company secretarial functions). Some investors personally inform companies of their voting intentions in advance. Others maintain a strictly confidential, and last minute approach.
 72. Stock lending is a common practice in the UK equity market. It involves a shareholder (normally an institutional investor) 'lending' some of its shares in a particular listed company to another entity (often a stockbroker) to enable the other entity to cover a short position temporarily. A fee is paid to the institutional investor for this service.
 73. Companies Act 1985, §§ 198–211, 219. In some circumstances, the disclosure threshold for investment managers and other financial institutions is 10 per cent rather than 3 per cent: § 199.
 74. Companies Act 1985, §§ 212–219.
 75. Companies Act 1985, § 208.
 76. Other general legislation on contractual terms may apply.
 77. There is a review of most of the USA studies in Black (1998). For UK studies, see Faccio and Lasfer (2000); Franks *et al.* (2001). See also Stapledon (1999).

78. For a review of studies of the impact of board composition on corporate performance, see Stapledon and Lawrence (1997).
79. It is common for registered holdings of 10,000 and above (for small and medium-sized listed UK companies) and of 30,000 and above (for large listed UK companies) to account for over 90 per cent of the issued ordinary share capital.
80. In some instances, the listed company—or the service provider as agent of the company—supplements or confirms this information by regularly serving notices under Companies Act 1985 (UK), § 212, on the largest registered shareholders. As discussed above, § 212 gives a public company power to require a person whom the company knows or reasonably believes to have, or to have had, an interest in its shares, to provide details about that interest.
81. For a description of this interaction between company managements and fund managers, see Stapledon (1996: 100–6, 117–21).
82. This is a simplification. An entry in the register is evidence of ownership. Of course, ownership will be absolute when the interest in the shares is absolute and the title indefeasible.
83. Transactions in most listed UK equities are cleared and settled in uncertificated form through the CREST system.
84. The benefits of security of title and transfer extend to the company or issuer of securities as well. Section 360 of the Companies Act 1985 (UK) provides that 'No notice of any trust, express, implied, or constructive, shall be entered on the register, or be receivable by the registrar, in the case of companies registered in England and Wales'.
85. Uncertificated Securities Regulations 1995 (UK), reg. 19(1).
86. Uncertificated Securities Regulations 1995 (UK), reg. 20(1) provides that an entry on a register mentioned in reg. 19(1) shall be evidence of such a title to the units as would be evidenced if the entry on the register related to units of that security held in certificated form.
87. Uncertificated Securities Regulations 1995 (UK), reg. 23(1).
88. See [section 5.2.3.].
89. According to anecdotal evidence gathered from meetings with fund management firms, clients are comfortable with their investments being held in pooled accounts because they do not consider there to be any material risk. The main benefit is the saving in transaction costs when large trades are made on behalf of a number of clients. These savings arise because, instead of being reconciled to designated accounts in CREST, a single entry is made in the CREST system, and the custodian's system provides a record of designation to a particular client. A cost of adopting a pooled system arises from the added work involved in processing corporate actions (e.g. voting) and dividend entitlements, because clients' entitlements must be reconciled back to the pool. This 'cost' prompted one manager to persuade clients to switch back to designated accounts.
90. Anecdotal evidence provided to the authors.
91. See [section 8.2.].
92. Listing Rule 12.43A requires a company to describe in its annual report how it has applied this and the other principles in the Combined Code.
93. Companies Act 1985 (UK), § 368.
94. Companies Act 1985 (UK), § 214.

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