Review of the impediments to voting UK shares

Report by Paul Myners
to the Shareholder
Voting Working Group

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EXECUTIVE SUMMARY

Background

This review has been undertaken following persistent concerns that the system for voting the shares of UK issuers is not as effective and efficient as it should be. Votes are "lost". In the past, this was the subject of detailed study by the Newbold Inquiry in 1998/99[1] and the Shareholder Voting Working Group in 2001[2]. Most recently, a report by Unilever plc highlighted the problems encountered by some shareholders in recording proxy votes at its 2003 Annual General Meeting.

The problems are largely the product of a process that is still quite manually intensive, where the chain of accountability is complex, where there is a lack of transparency and where there is a large number of different participants, each of whom may give a different priority to voting. The participants in the process are:

- The beneficial owners (pension fund trustees, mutual funds, life assurance funds, and so on) ultimately own the shares, but frequently delegate voting decisions to their investment managers.
- Pension fund trustees look to investment consultants to advise them in relation to investment matters. However, in the main, this advice centres on economic and financial, rather than governance and voting, issues.
- The registered owner of the shares is often a nominee company, owned and operated by a custodian. The custodian will have a contract directly with the beneficial owner or with his investment manager. Its key priority is – quite properly – the safe custody of the assets of the beneficial owner.
- Investment managers may issue voting instructions, but can only do so indirectly since they are not the registered owners of the shares.
- Proxy voting agencies may contract with the custodian, the investment manager and/or the beneficial owner to advise on voting, and/or to issue voting instructions on each client's behalf.
- The registrar will manage the share register on behalf of the issuer.
- Finally, the issuer has responsibility under the Companies Acts for the proper conduct of its business, including general meetings and voting.

Thus, there may typically be four parties between the beneficial owner and the issuer, all with distinct and important roles. For voting instructions to be recorded, they therefore need to pass along a complex chain.

My overall assessment, following the review, is that there is not one structural weakness that needs to be addressed. Rather, it is like old pipework which could have been more effectively maintained over the years, and is now leaking at various points. It does not need to be ripped out and replaced, but instead the points of weakness need to be overhauled and upgraded.

It is sometimes suggested that the level of voting in company general meetings is too low and that this is a reflection of shareholder apathy. I agree that higher voting levels are a very desirable outcome. I would, however, counsel caution as to what can be achieved in practice, given the number of overseas investors in UK companies who are outside the jurisdiction of UK regulation or best practice guidance and the complications imposed by legitimate market

[1] In 1998/99, the National Association of Pension Funds sponsored an independent inquiry into proxy voting, the Newbold Inquiry.
[2] The Shareholder Voting Working group was established in September 1999 to take recommendations of the Newbold Inquiry forward.

practices, such as stock lending. Nevertheless, I believe that my recommendations will help to achieve a significant increase in shareholder participation, particularly on contentious or other important resolutions.

Key Issues

Four key issues have been raised with me.

Beneficial owners

The complexity of the voting process is undoubtedly a problem. However, the routing of corporate actions frequently involves the same process as does voting, but appears to be more effective and efficient. This would suggest that the act of voting shares is not given the importance it deserves and the standards operated are deficient in some way.

For standards to improve, I consider it important for the beneficial owners, as the end beneficiaries of shares, to drive those standards and ensure that any deficiencies are addressed. It is the beneficial owners who are responsible for ensuring that there is a clear chain of responsibility for voting their shares and that this is set out in the various agreements between the participants. They should also have a clear voting policy and be aware of the implications of other activities and arrangements on their ability to exercise voting rights. For example, stocklending affects the voting rights attached to the shares, as the lender does not retain the right to vote. When a resolution is contentious I recommend that the stock lent is automatically recalled, unless there are good economic reasons for not doing so.

Electronic voting

The existing system is predominately paper based, making it cumbersome and prone to processing errors. To address this, one of the key recommendations of both the Newbold Inquiry and the Shareholder Voting Working Group's report in 2001 was the need to establish a means by which voting intentions could be recorded electronically. In January 2003, CRESTCo[3] introduced such a system which had a disappointing take up in its first year. There are several explanations for this. It is not part of my task to point the finger of blame at particular participants.

It is nevertheless my conclusion that electronic voting remains the key to a more efficient voting system, and all parties – issuers, institutional investors and the intermediaries – need to make conscious efforts to introduce electronic voting capabilities in 2004. I therefore urge that issuers in at least the FTSE 350, investment managers, custodians and proxy voting agencies should all have introduced the necessary system changes so that electronic voting capabilities are universally available. I also recommend that beneficial owners should over the next three months make direct and specific enquiries of their agents and others to establish the extent to which they have, or will have, introduced electronic voting capabilities to be used this year.

Given the importance I attach to electronic voting, I propose to revisit this subject in a year's time to assess the extent to which the relevant participants in the voting process, particularly the proxy voting agencies and custodians, have introduced electronic voting capabilities.

[3] There are other operators of electronic voting, including the standard electronic message format that was developed in 2001 by the registrars and Manifest, but for convenience throughout this report we refer to CREST or CRESTCo to cover CREST and similar service providers.

Registering shares in a nominee company in a designated account

It was also put to me that there was a greater need for transparency in the voting process. In this respect, many custodians pool their clients' shareholdings such that the shares of several beneficial owners are registered in the name of one nominee company in an omnibus account. A number of those I consulted suggested that, once held in an omnibus account, there is not a clear audit trail as to who is the true owner. Some custodians maintain a designated account for each client, and it was suggested that voting works much more smoothly in such cases because, depending on the designation used, there can be clarity about who owns the shares facilitating a much more transparent voting process.

I considered very carefully whether I should recommend the universal adoption of designated accounts. For institutional investors, there are benefits in registering title in the name of a nominee company with a specific designation, although it may be more costly. While I find myself disposed to designation from a governance and voting perspective, I accept that other issues have to be taken into account when clients determine the form of custody most appropriate to their requirements. Decisions on custody arrangements must, however, include a full evaluation of the consequences for governance and voting.

The private investor's position is somewhat different. There are greater numbers of private investors whose investments are generally small scale, and designation is unlikely to be practical on cost grounds. I do not, therefore, recommend designated accounts as absolutely necessary for private clients, but note that any such client who wishes shares to be registered in a designated account is at liberty to use a custodian who offers that service.

My conclusion is that investors who wish to establish a direct relationship between the issuer and the person making the voting decision, with the resulting benefits of transparency and accountability, should consider arranging for their shares to be registered in the name of a nominee with a specific designation. This does not preclude the use of nominee companies offering only omnibus accounts if the beneficial owner concludes, in the round, that this is more appropriate to their particular needs.

An advanced record date

At present, a company may specify a time no more than 48 hours before a meeting for the receipt of proxies and for determining entitlements to vote. I asked myself the question whether this timetable is too compressed and leaves insufficient time to conclude checks which would improve the efficiency of the system by, for example, permitting earlier identification of discrepancies in the number of shares in respect of which proxy appointments have been received and of share transfers since the notice was circulated.

I consider these arguments have merit, and most of those I consulted would have no objection to a record date for voting entitlements and receipt of proxies at least, say, five days ahead of the meeting. This would, however, require legislative change and I believe that the required improvements could be achieved by the other, non-statutory, recommendations in this report, particularly electronic voting. While there may be a case for an advanced record date as an interim measure, I am satisfied that such a change is not necessary.

I do, however, recommend that:

- the current 48 hour limit should be amended to two business days to take account of bank holidays and weekends; and
- the time limit should be standardised by issuers as the close of business on the day that is two working days before the day the meeting is held. Issuers should not be able to set a shorter time frame.

I have written to the Secretary of State for Trade and Industry and to the Financial Secretary to the Treasury setting out this recommendation.

Recommendations

Throughout the course of this project, it has been apparent to me that there is a great willingness to improve the voting process. I believe there is now an opportunity to build on this to bring about a noticeable improvement in voting practice. In order to achieve this, the different parties need to take the following steps.

Beneficial owners will need to:

- ensure that the agreements between the various participants who are accountable to them:
  - include specific service standards for voting;
  - establish a chain of responsibility for voting and an information flow which enables all parties to meet their responsibilities;
  - require those responsible to report back on the discharge of their obligations;
- determine a voting policy and ensure it is implemented;
- make enquiries in the next three months as to whether their agents and others will have introduced electronic voting facilities this year;
- ensure that, when voting through CREST, their agents complete the necessary details of source;
- consider requiring their shares to be registered in a nominee company with a designation in their name or some other unique identification;
- be fully aware of the implications for voting if their shares are lent and when a resolution is contentious automatically recall the related stock, unless there are good economic reasons for not doing so, and not vote shares held as collateral; and
- question the manager's report and hold him to account for the manner in which the votes have been cast.

Issuers will need to:

- ensure that voting reflects the shareholders' views and that the vote is administered in a fair manner;
- introduce electronic voting capabilities during 2004 if they have not already done so;
- call a poll on all resolutions at company meetings;
- disclose the results of polls and, where an issuer decides not to call a poll, they should disclose the level of proxies lodged on each resolution;
- when declaring the results, publish the total number of votes or proxies received, the votes or proxies "for" and "against", and the number of votes or proxies consciously withheld; and
- allow proxies to speak and vote on a show of hands and amend their articles if this is not currently permitted.

Registrars will need to:

- enable participants to check that instructions have been received and votes registered where electronic voting is used;
- confirm the receipt of electronic voting instructions;
- report the late receipt of instructions, or if the instruction will not be voted the reasons why; and
- query instructions which appear on their face to be incorrect or invalid.

Investment managers will need to:

- introduce electronic voting capabilities for 2004;
- when voting through CREST, complete the necessary details of source;
- where a resolution is contentious, automatically recall lent stock and not vote shares held as collateral;
- include the voting process in FRAG 21/94 reports; and
- report to their clients how they have executed their voting responsibilities.

Proxy voting agencies will need to introduce electronic voting capabilities for 2004 if they have not already done so.

Custodians will need to:

- introduce electronic voting capabilities for 2004;
- when voting through CREST, complete the necessary details of source;
- offer all customers the choice of a nominee company with a specific designation; and
- include the voting process in FRAG 21/94 reports.

Investment consultants will need to advise their clients on:

- the voting process, ensuring that they are better skilled in understanding and questioning the manner in which their shares are registered;
- determining a voting policy;
- including enquires about electronic voting in any "Request for Proposal"; and
- questioning their investment managers on their reports as to how they have discharged their voting responsibilities.

In addition, the various trade associations have been supportive of this initiative and I invite them to ensure that their members are informed of the key conclusions of the review and their association's response. Various other parties should also take specific measures. In particular, the Government will need to consider the introduction of various legislative changes to:

- change the time limit for the appointment of proxies under the Companies Act and the record date in the Uncertificated Securities Regulations so that:
  - the current 48 hour limit is amended to two clear business days to take account of bank holidays and week ends; and
  - it is standardised by issuers as the close of business on the day that is a clear two business days before the day the meeting is held;
- give more rights to proxies so that they can speak at meetings and vote on a show of hands as well as a poll;
- allow corporate members to appoint more than one corporate representative (each for a specified number of shares); and

- provide that sufficient shareholders could require an independent scrutiny of a poll.

Furthermore, the Financial Services Authority will also need to consider amending the Listing Rules to make it a listing requirement:

- for the full results of polls to be disclosed; and
- that quoted companies publish their annual reporting documents on the Internet as soon as they have been published.

I now pass this report to the Shareholder Voting Working Group and its sponsor organisations for their consideration.

CONTENTS

1. INTRODUCTION

1.1 The issue of "lost votes"

I was invited in October 2003 by the Shareholder Voting Working Group (SVWG) to act as the Chairman of the Group, to lead a review of the impediments to casting proxy votes successfully at company meetings, and to develop a programme of action to remove them. My terms of reference are set out at Appendix 1.

Over the years there has been continuing concern that the system for recording[4] proxy votes in company meetings is not as efficient as it should be. It is complicated by the number of different participants involved and by confusing lines of responsibility. For example, while it is generally considered to be the role of the investment manager[5] to exercise voting[6] rights on behalf of investors, the achievement of this is not straightforward because the shareholder recorded on the company's register (and thus the person who is legally entitled to exercise the voting rights), is not the investment manager, nor even the ultimate beneficial owner, but normally the custodian's nominee company. Other parties in the process include the registrar acting on behalf of the issuing company and the various proxy voting agencies available to custodians, investment managers and others.

This multiplicity of parties, in a system that is not fully automated, inevitably creates inefficiencies. For many years, there have been anecdotal stories about investment managers submitting votes which appear not to have been recorded; in other words the votes are "lost". At the end of last summer, there were reports in the press about "lost votes", first as a result of an ad hoc analysis by Unilever plc into voting for its 2003 Annual General Meeting and then, during evidence to the Trade and Industry Select Committee[7]. In summary, Unilever wrote to ten of its major institutional shareholders who appeared to have voted 50 per cent or less of their holdings to establish why they had not voted their entire holding. This revealed that three had given instructions to vote which were never received by the issuer. There were a number of reasons why this occurred which appeared to be generic to the wider process rather than to involve one specific structural weakness. Whilst it should not be necessary for such analysis to become routine, it was very helpful and I would encourage such exercises when there are concerns about the completeness of the vote.

There are also periodic suggestions that voting levels are too low. Patricia Hewitt, the Secretary of State for Trade & Industry, is looking for progress in improving the number of votes cast at company meetings and considers that solving the problems in the voting process would be a major step in achieving this. If major improvements are not forthcoming, the Government might feel obliged to introduce further legislation or regulation. To quote Patricia Hewitt's speech to the Hermes Stewardship and Performance Seminar on 3 November 2003 "voting levels need to be raised…so I was pleased to hear the Shareholder Voting Working Group has appointed Paul Myners as its new chairman. We look forward to hearing about their progress and will be looking to see if future legislation is required to secure appropriate levels of shareholder engagement."

[4] In this report "recording" or "registering" proxy votes refers to the receipt of the proxy appointment and the acknowledgement of its validity and eligibility.
[5] Technically, this is a matter for contractual agreement between the investor and his investment manager.
[6] In this report the term "voting" is taken to refer to the process whereby investors appoint proxies and submit voting instructions which may be implemented (often only if a poll is called) at a shareholders' meeting even though the investor is not physically present.
[7] Evidence given by the Investment Management Association to the Trade & Industry's Select Committee on the DTI's Consultation Document, "Rewards for Failure", on Tuesday, 1 July

In this respect, while increased voting levels would undoubtedly be welcome, I would caution against over-ambitious expectations of what is achievable. There are good reasons why some shareholders do not vote: many overseas shareholders choose not to do so (overseas shareholders owned 32.1 per cent of UK companies' ordinary shares as at the end of 2002[8]). Stock lending (it is estimated that currently this amounts to 3 per cent of outstanding capital in the FTSE100 but can be significantly higher for individual issuers), which is discussed later, can also have an impact. It would be wrong, therefore, to set targets for levels of voting to be achieved. However, it is important that institutional investors take their stewardship responsibilities seriously, particularly on contentious issues, and see that their voting intentions are clearly translated into practice.

1.2 Why voting is important

At the heart of our economic and financial system lie quoted companies. One way or another we all have a stake in their success and effectiveness. It is therefore a matter of public interest that the accountability of quoted companies' boards to their shareholders – ultimately ourselves – works efficiently and effectively. That accountability rests on the principle that shares come with voting rights. The stewardship of quoted companies is ultimately exercised through those rights. It cannot be stated too forcefully that institutional investors in the voting process have fiduciary duties to their beneficiaries to preserve and enhance value through informed and effective corporate governance of the companies in which they invest. Voting is the bedrock of governance and should not be approached lightly. The process must be efficient, effective and transparent.

The significance of this has long been recognised. The Cadbury Report in 1992, commissioned in response to continuing concern about companies' standards of financial reporting and accountability and to controversy over directors' pay, clearly stated that "given the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance"[9].

There is research that suggests that good corporate governance enhances shareholder value. Although it is far from provable, and independent research papers have been contested by some, I refer to some of this research below.

- In 1997, Robert Carlson of CalPERS cited an exercise which looked at the performance of 62 companies between 1987 and 1995 "during the five years immediately before our first contact, these companies under-performed the Standard & Poor's 500 Index by an average of 85 percent. But with CalPERS first contact five years later, the companies outperformed the Index by an average of 33 per cent"[10].
- McKinsey, in its 'Global Investor Opinion Survey'[11] of over 200 institutional investors undertaken in 2000 and updated in 2002, found that 80 per cent of respondents would pay a premium for shares in well-governed companies. The size of the premium varied by market, from 11 per cent for Canadian companies, 12 per cent for UK companies, 14 per cent for US to around 40 per cent for companies where the regulatory environment was least certain (those in Morocco, Egypt and Russia).

[8] The Office for National Statistics, Share Ownership 2002, Beneficial Ownership of UK shares: end 2002.
[9] The Report of the Committee on the Financial Aspects of Corporate Governance, The Cadbury Report, December 1992, paragraph 6.10
[10] International Corporate Governance Network, Managers and Shareholders: Bridging the Gap Using Corporate Governance to Increase Portfolio Returns, 9 July 1997, Paris, France, Presented by Robert F Carlson, Roundtable Chair Board of Administrations, California Public Employees' Retirement System
[11] Coombes & Watson (McKinsey) 2000, 2002, 'Global Investor Opinion Survey'

- The Financial Times recently reported that a study by Paul Gompers and Joy Ishii of Harvard and Andrew Metrick of Wharton had found "US companies with stronger shareholder rights enjoyed higher market to book valuations. There is also evidence that share prices of well-governed companies tend to perform better over the long run"[12].

The UK recognises the importance of voting in the expression of shareholders' rights and in ensuring transparency for investors. Shareholders' authority in the UK is enshrined in law, which gives shareholders more significant rights of engagement and determination than in most other jurisdictions. It is notable that the US is only just starting to debate issues around shareholders' rights to call meetings and demand votes – rights which have long existed in the UK.

To take a particular example, the UK is one of the few European jurisdictions that has detailed listing rules that reinforce shareholders' rights when their interests could potentially be diluted. The class test provisions extend these rights to major transactions which are graded into four classes depending on their size. For class 1 transactions, which includes a major acquisition or disposal, and reverse takeovers, shareholder approval must be obtained and the matter must be voted on. I strongly support the class test regime (the Financial Services Authority has recently consulted on proposals to amend it[13]), as it gives shareholders the opportunity to exercise, through voting, an active influence over an issuer on a matter which could significantly affect the value of their investment.

1.3 Approach to this review

The issue of "lost votes" has long been known and, in undertaking this review, I first looked at the two major studies that had been undertaken over the last few years as set out below. They both produced comprehensive and rigorous analyses of the issues surrounding voting, but their recommendations have been slow to be taken up.

- *The Newbold Inquiry*

In 1998/9, the National Association of Pension Funds sponsored an independent inquiry into proxy voting, the Newbold Inquiry, which examined the system for voting by institutional shareholders and sought to make recommendations to raise voting levels.

The Newbold Inquiry identified major impediments, including:

- multiplicity of participants in the voting cycle;
- lack of modern technology in the process;
- absence of transparency and auditability;
- doubt over exact roles and responsibilities; and
- scope for delegation without firm accountability.

The final report made the following recommendations:

- regular, considered voting should be regarded as a fiduciary responsibility;
- voting policy ought to be specifically covered by agreement;
- the UK's voting system should be modernised;
- issuing companies should actively encourage voting;
- member associations should offer help and guidance;
- registrars should support electronic voting arrangements;

[12] The Financial Times, Wednesday, 31 December 2003, the Lex Column "Talking in Codes", page 16
[13] The Financial Services Authority, Consultation Paper 203, Chapter 9, October 2003

- voting in the context of stock lending should be re-examined; and
- the custodian should actively assist in the voting process.

- *The Shareholder Voting Working Group*

To take the recommendations from the Newbold Inquiry forward, the Shareholder Voting Working Group (SVWG) was established in September 1999 under the chairmanship of Terry Pearson, an experienced investment custodian. This established the first industry-wide body to address the issue of improving the voting process in the UK and brought together all the relevant participants. It focused on the process of lodging proxies so that institutional investors could have confidence that their voting intentions would be translated into practice. In 2001, the Group produced a report which made recommendations on how this process could be streamlined so as to improve the level and quality of voting in the UK by both domestic and overseas shareholders.

Although the UK is acknowledged to have a highly developed corporate governance structure,[14] I also sought to establish whether there was a superior model elsewhere in the world where the voting process works more efficiently and which we could replicate in the UK. Some of those I consulted considered that the US could provide such a model. However, the US is significantly different from the UK in a number of important respects.

- The system is predominantly electronic in that shares are voted through Proxy Edge, albeit that this is a modem-based system. (I understand that shares voted electronically in 2003 - telephone, Internet and Proxy Edge - accounted for 82.9 per cent of all shares returned[15]).
- Shares are materialised, that is to say, evidenced by a physical certificate, but are immobilised in that virtually all are held through the Depository Trust Company, a non profit making co-operative owned by brokers and dealers.
- There is no meaningful share register, so companies typically employ brokers (called solicitors) to determine the identity of their shareholders.
- A record date sets voting entitlements some 30 to 60 days in advance of the meeting date.
- Generally the majority of shares in issue must be voted in favour of a resolution for it to be passed as opposed to the majority of the votes cast as is the case in the UK (although company law is state, not federal, specific and so whether a resolution is carried by a majority of shares in issue, or simply a majority of votes cast, can vary according to the nature of the proposal and the issuer's state of incorporation). The US protocol effectively places considerable onus on issuers to pursue votes.
- In the US, 90 per cent of institutional shares are voted through Automatic Data Processing, Inc, which is appointed by the issuer. Investment managers pass their voting instructions to Automatic Data Processing, Inc, which passes them on to the issuer.

There are fundamental differences in the systems for recording and voting shares between the UK and the US. In particular, the record date means that there is a risk that the right to vote stays with someone who has ceased to have an economic interest in the shares many weeks before the vote. I found no support for the UK requiring a majority of shares outstanding to be voted in favour for a resolution to be passed. In addition, in the UK the majority of shares are now dematerialised which has benefits when compared with the physical certificates that are still used in the US. In summary, the case has not been made to me that the UK's systems should be altered so that the voting process can be modelled on that of the US.

[14] PriceWaterhouseCoopers, Primary Market Comparative Regulation Study, Key Themes, April 2002.Section 6.1
[15] Source: ADP Investor Communication Services, 2003 Proxy Season Statistics

As noted, one of the key recommendations of both the Newbold Inquiry and the SVWG was that electronic voting should be implemented so as to improve the speed and efficiency of the voting process. The UK Government responded to this and the Companies Act 1985 (Electronic Communications) Order 2000 (effective from 22 December 2000) provided companies and their shareholders with the option of communicating electronically.

Thus shareholders can appoint proxies electronically, thereby enabling them to overcome delays and inefficiencies within a paper based system. However, the take up of electronic voting has been disappointingly slow and votes continue to be "lost". It was, therefore, recognised that the SVWG needed to move from being an "advisory body" to one that took responsibility for developing clear recommendations and pressing for their implementation. I was pleased to be given the opportunity to examine these matters afresh and to consider what now needs to be done to turn the recommendations of the previous studies into reality.

My understanding of the existing process for voting UK shares and my recommendations on how it can be improved are set out in sections 2 and 3 of this report, respectively. My recommendations relate to the process whereby UK institutional investors appoint proxies to exercise their votes on the shares of UK issuers. They do not relate to UK institutional investors voting their shares in overseas companies or to overseas shareholders voting their shares in UK issuers. My recommendations do not expressly address the interests of private investors. I have no reason to believe that "lost votes" as defined is an issue for the private investor and do not believe that any of my recommendations are injurious to the interests of the private investor.

1.4 Acknowledgements

I am most grateful to all who gave up their time to assist me in this work, but would single out two people in particular.

The first is Terry Pearson, whose energy and commitment led to the establishment of the SVWG in the first place, and who has done so much to promote the importance of efficient voting procedures. His wisdom and experience have been invaluable to me throughout this study and I am in his debt. The second is Liz Murrall of the Investment Management Association, who provided immense support to me in this work and without whom this report could not have been produced.

2. THE EXISTING SYSTEM

2.1 Introduction

The main contributory factor to "lost votes" is the complexity of the voting process and the large number of participants through whom information and votes must pass. For a vote to be recorded, the voting decision has to be communicated effectively by all participants in the voting chain. A simple diagram summarising the voting process is set out in section 2.2 below. The diagram reflects a typical arrangement under which a beneficial owner has appointed an investment manager to manage, and a custodian to provide custody services for, its portfolio of investments. There are, however, other arrangements, for example, pooled funds and collective investment schemes, where, although the voting process may be similar, different parties may be responsible for the appointment of participants such as the investment manager or custodian.

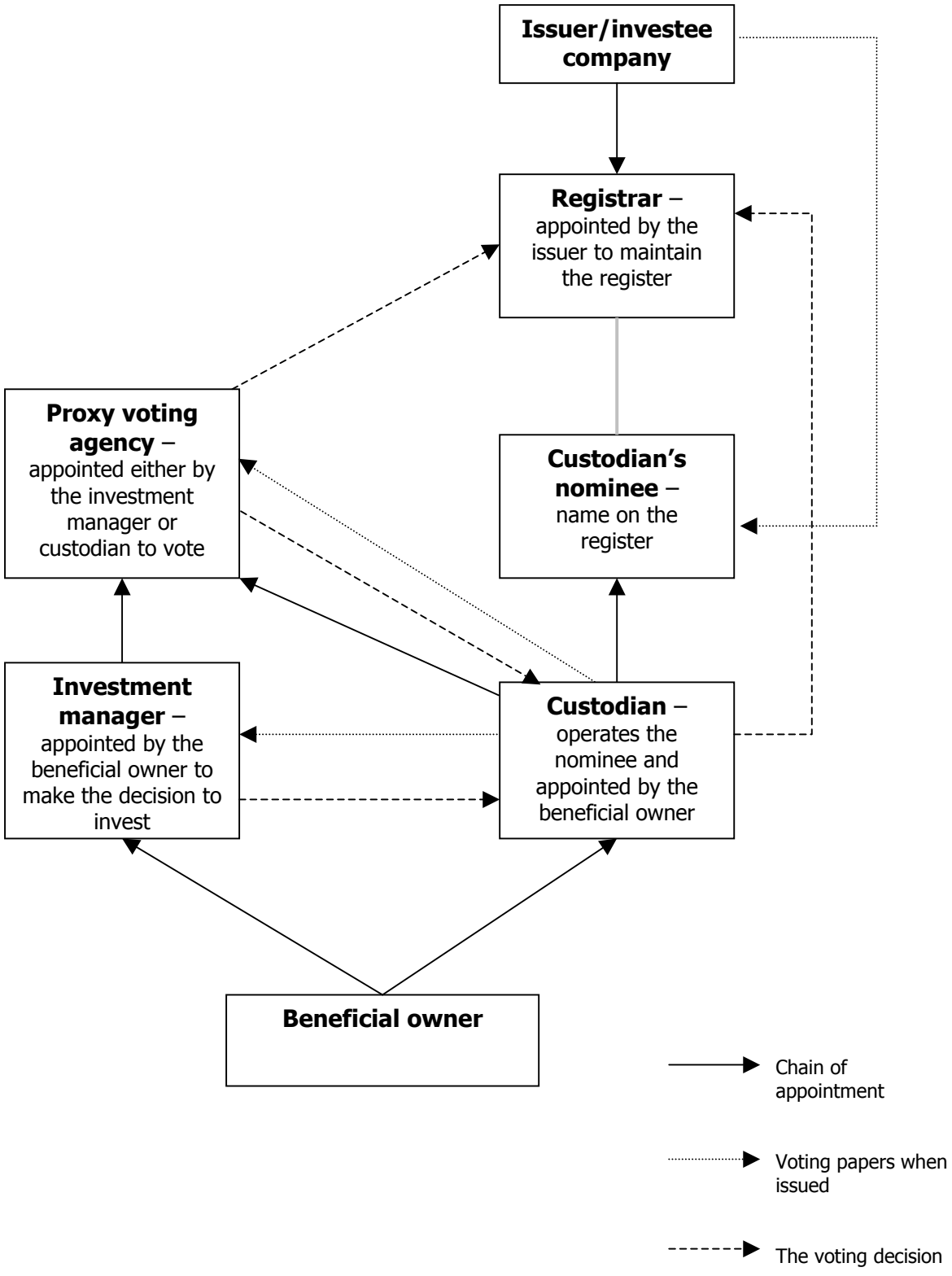
There is little transparency in the process. Where a custodian is appointed, the registered or legal owner of the shares (and hence the person recognised by the issuer's registrar as entitled to vote) is normally the custodian's nominee company. The registrar may well not be aware of the identity of the beneficial owner nor will it necessarily know who is the person responsible for the voting decision (in many cases the investment manager).

The process is manually intensive, thereby increasing the risk of errors. It is also largely paper based and data has to be printed and re-entered at multiple points. This is compounded by the fact that issuers' Annual General Meetings tend to take place in April, May or June and thus voting tends to be concentrated in a relatively short period.

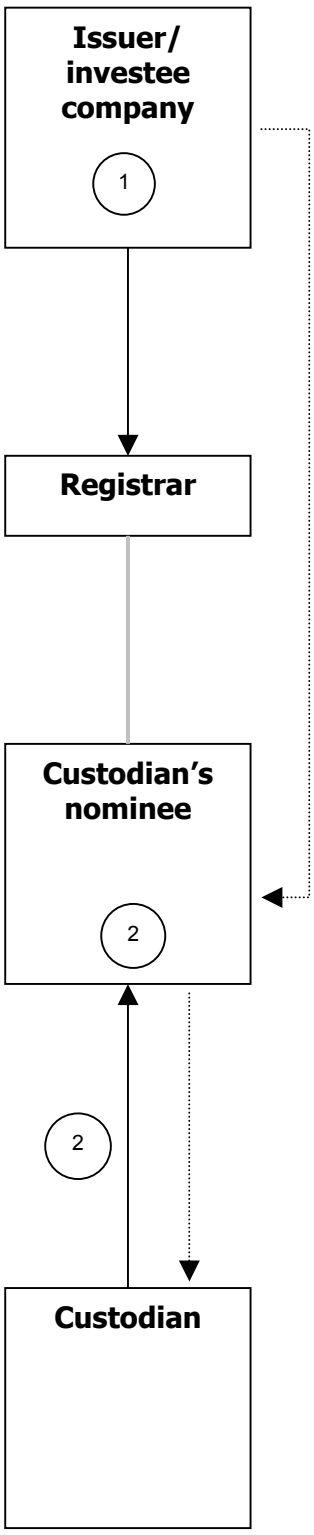
In addition, to some extent due to the split of responsibilities between the participants involved and the processes used, it is generally difficult to follow an audit trail (for example, to trace votes or understand why and where votes are lost). There are only limited procedures which require confirmation of action taken.

2.2 THE VOTING PROCESS

2.2.1 The participants

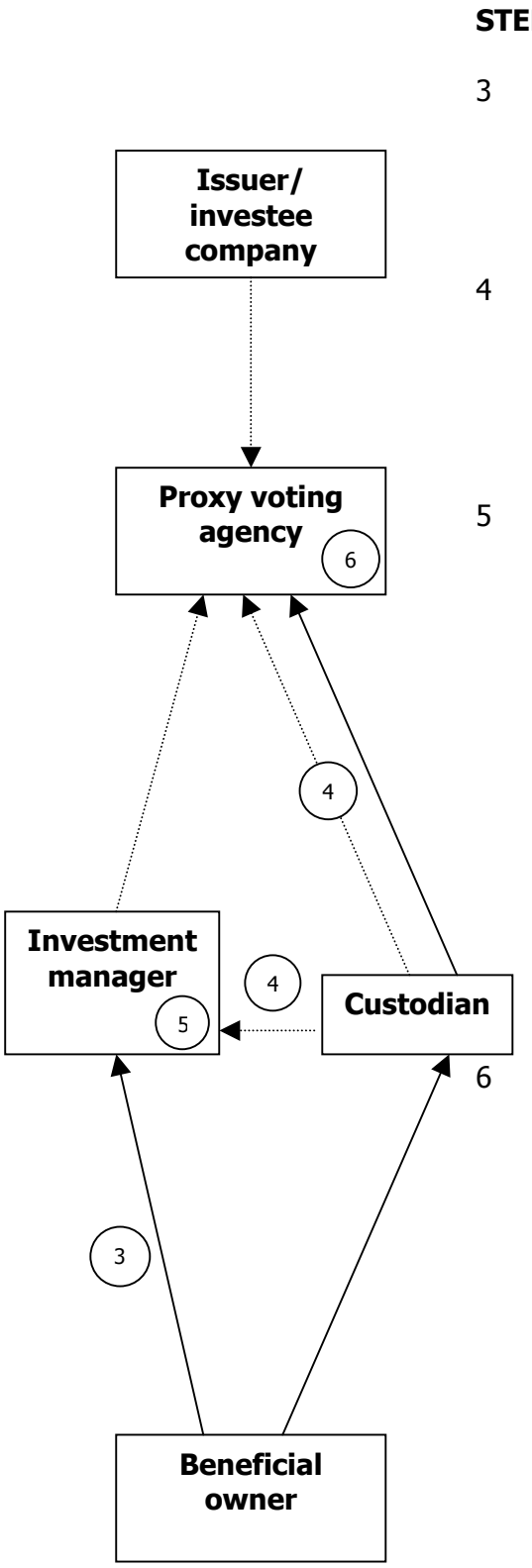


2.2.2 Issuing voting papers to the registered owner



STEP	DAY	
1		The issuer has to comply with the provisions of the Companies Acts when issuing and distributing voting material. The issuer sets the resolutions for the meeting(s) and produces the proxy card and meeting material.
	-23	The registrar, appointed to maintain the issuer/investee company's share register, puts together the tape of addresses. The issuer or registrar organises mailing. In accordance with the Companies Act, 21 clear days' notice is required for an Annual General Meeting and either 14 or 21 clear days' for an Extraordinary General meeting. The Combined Code states in provision D2.4 that "the company should arrange for the Notice of the Annual General Meeting and related papers to be sent to shareholders at least 20 working days before the meeting". The issuer sends out the notice and proxy material to the legal owners i.e. those registered on the register – normally the custodian's nominee company.
2		Most beneficial owners of shares, for example pension fund trustees, will appoint another party, a custodian, to safeguard their shares under the terms of a custody agreement. In the UK, shares are mainly registerable investments where legal (as opposed to beneficial) title is recorded in the register of shareholders. To ensure segregation and compliance with regulatory requirements, shares are normally registered in the name of a nominee company rather than in the custodian's name. Often shares are "pooled" meaning that shareholdings of several beneficial owners are registered in the name of one nominee company in an omnibus account.
		It is the nominee's name that is recorded by the registrar on the register of shareholders. The nominee holds the shares as bare trustee, i.e. it owns the assets in law but holds them on trust for the custodian, which in turn holds its rights for the benefit of a third party, the beneficial owner. When the voting papers are sent to the registered owner, i.e. the nominee company, it is not necessarily known who the true beneficial owner is. The nominee, as registered owner, will receive any benefits from the investments, such as dividends and voting papers, but is obliged to pass these on to the beneficial owner or its agents.

2.2.3 Forwarding voting papers to the decision maker and making the decision



Most beneficial owners, for example pension fund trustees, appoint an investment manager, under an investment management agreement, to manage their investments i.e. the manager makes the decision to invest or otherwise.

The custodian will know if a beneficial owner client has appointed an investment manager or other agent. The custodian forwards the voting material to the investment manager, proxy voting agency or other third party to make the voting decision.

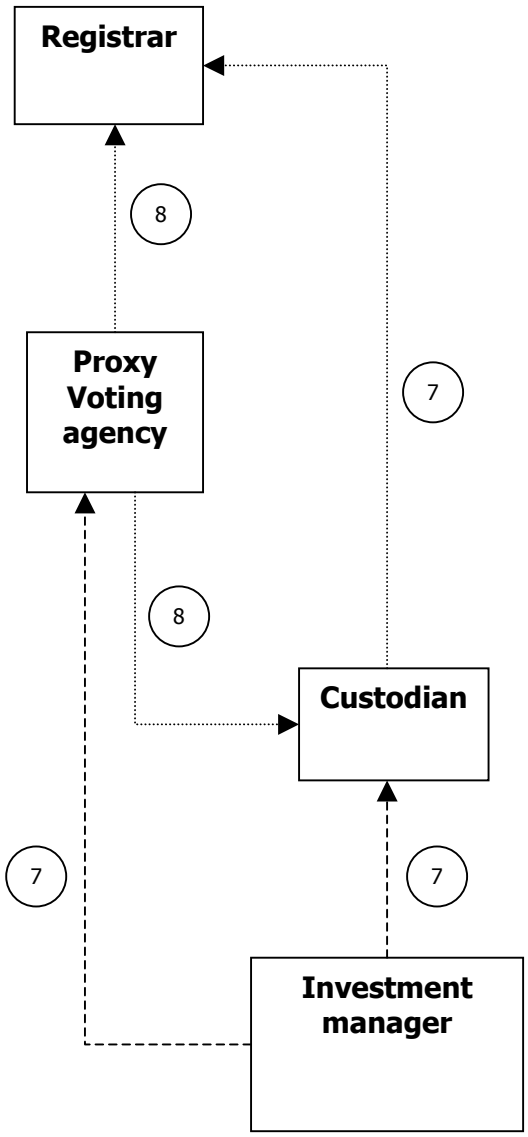
If the beneficial owner has given the investment manager discretion, the manager will make the voting decision. Some beneficial owners may reserve voting decisions for themselves, in which case the investment manager will revert to the owner who will instruct him/her on how the votes should be cast.

Some beneficial owners will require the investment manager to follow the recommendations of a particular proxy voting advisory service, for example, Pensions & Investment Research Consultants Ltd or RREV (Research Recommendations and Electronic Voting). The arrangements will be set out in the agreement between the manager and its client.

Proxy voting agencies prepare detailed analyses of company meeting papers. To enable them to do so, many such agencies have a nominal holding in the main issuers, thereby ensuring that they receive notification of company meetings. Investment managers using voting agencies will generally only make voting decisions once the analysis has been received.

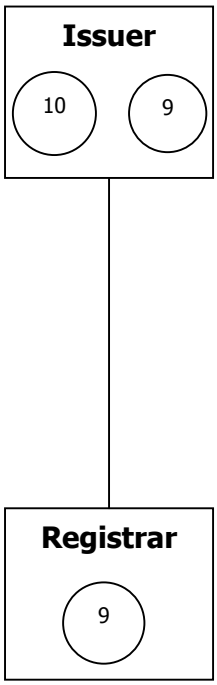
As well as giving recommendations, proxy voting agencies can be appointed by an investment manager or custodian to process voting instructions on their behalf. If this is the case, the custodian will send the proxy voting agency the voting material and also a file of holdings, in respect of which the agency is appointed to vote, which the agency regularly reconciles with the custodian.

2.2.4 Informing the registrar of the voting decision



STEP	DAY	
7	-5 to –10	The investment manager instructs the custodian or proxy voting agency as to how the votes should be cast. Where a manager controls shares in an issuer on behalf of a number of clients, it must deal with a number of different custodians and cast votes differently in respect of different clients.
8	-4 to -8	The agency will complete the proxy cards either manually or electronically, taking instructions from the investment manager or completing them in accordance with standing instructions. If the agency has a power of attorney then it will send the card to the registrar either electronically or in paper form, otherwise it will send the proxy card to the custodian for it to be signed and passed on to the issuer/registrar. Some agencies will complete the proxy cards received from the company and others will generate their own. If no agency is appointed, the custodian (taking instructions as appropriate) will complete the proxy appointment and forward it, either electronically or in paper form, to the registrar.

2.2.5 Registering the vote



STEP	DAY	
9	-2	To be valid, the proxy card must normally be lodged in the correct format with the issuer (or a registrar) not less than 48 hours before the meeting. In addition, for shares eligible for CREST settlement, entitlements to vote may be determined at a time specified in the notice of the meeting but these can be specified no more than 48 hours before the meeting. Thus the registrar will typically compare the instructions received to its record of shareholdings 48 hours before the meeting. Difficulties may arise if the number of shares in respect of which instructions have been received and those on the register do not match, particularly if the number on the register is the lower. Issuers/registrars do not have to notify shareholders if their instruction is invalid, although some do. There is also no requirement to confirm to institutional shareholders/investment managers that their votes have been lodged correctly. Issuers are not required to put any resolutions to a poll although the chairman should call a poll if the proxies are at variance with the show of hands. The Combined Code recommends that issuers publish a breakdown of votes cast.
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3. RECOMMENDATIONS

3.1 The importance of the beneficial owners in the process

The complexity of the voting process and the multiplicity of participants through whom information and votes must pass are significant contributors to "lost votes". When shares in UK companies are voted, the instructions have to pass through the various participants through whom instructions are held and managed. This is described in section 2 above.

However, I was struck during the course of this review by the fact that the routing of corporate actions, for instance rights issues, can involve the same chain of participants as does voting, but appears to be more effective and efficient. This would suggest that, although the complexity of the system is an issue, voting on corporate governance issues, or other matters on a meeting agenda, is not always given the importance and resources it deserves and the standards operated may be deficient in some way. Ultimately, it is for the beneficial owners, as the end beneficiaries of shares, to drive standards and ensure that this deficiency is addressed.

First, as owners of UK companies, beneficial owners should be responsible for ensuring that there is a clear chain of responsibility for voting their shares in those companies and that this is comprehensively documented in the various agreements between the participants in the voting chain. Importantly, each participant should be clearly accountable to those on whose behalf they act and should be required to explain how they have discharged their obligations with respect to voting.

Second, as the drivers of the voting process, beneficial owners should have a clear voting policy and should engage with both investment managers and custodians to ensure that it is implemented. They should be aware of the implications of other activities and arrangements, including stocklending – see section 1.4 below - on their ability to exercise voting rights. This means that they may need to seek advice and develop delegated authorities. It seems to me that in the past this may not have received the attention it deserves from beneficial owners or their advisers.

Recommendation. *Beneficial owners should determine a voting policy and engage fully in ensuring that it is implemented. They may need to take advice and/or delegate within clear guidelines.*

Beneficial owners should take steps to ensure that the agreements between the various participants who are accountable to them:

- *include specific service standards for voting;*
- *establish a clear and coherent chain of responsibility for voting and an information flow which enables all parties involved to meet their responsibilities; and*
- *provide for those responsible to report back on the discharge of their obligations.*

Voting is a service issue. The ultimate sanction, if requirements are not met, is for beneficial owners to take their business elsewhere.

3.2 Improving operational efficiencies

3.2.1 Electronic voting

In an ideal world, instructions from the person making the voting decision should go straight to the person recording the vote. In this respect, electronic proxy appointment (electronic voting) provides an efficient means for shares to be voted in a direct, efficient and timely manner. Where voting entitlements are clear, voting intentions are transmitted to the registrar with ease and voting is observable.

The Newbold Inquiry recommended that electronic voting should be adopted to improve the speed and efficiency of the voting process. In June 2001 the Institutional Shareholders' Committee[16] (ISC) wrote to CRESTCo Ltd (CREST)[17] urging it to develop an electronic voting message facility. CREST responded by introducing a facility and in December 2002 the ISC wrote to the FTSE 100 companies encouraging them to put electronic voting arrangements in place for 2003.

This appears to have had some effect. It is disappointing, however, that there are still a significant number of participants that have not invested in systems that facilitate electronic voting. I understand from CREST that only 47 of the FTSE 100 had introduced electronic voting capabilities by the end of 2003, although I am told that this is expected to rise in 2004. The percentage uptake among smaller companies is even lower. Similarly, few custodians, investment managers and proxy voting agencies had comprehensive electronic voting capabilities in place in 2003. In this respect, the main proxy voting agencies, including Automatic Data Processing, Inc, RREV (Research Recommendations and Electronic Voting), Manifest and Pensions & Investment Research Consultants Ltd, are all now committed to offering electronic voting facilities for 2004.

A number of reasons were given to me to explain the poor take up in 2003. These included:

- for those that hold shares in CREST, CREST introduced the software in January 2003 - too late for some participants to have the necessary systems in place to vote in 2003;
- there had been insufficient critical mass and a "Catch 22" situation had developed with issuers waiting for the institutional investors to use electronic voting and investors waiting for a bigger take up by the issuers;
- costs, particularly development costs, were an issue for some, although most accepted that ongoing costs would be lower;
- investors had failed to invest in the necessary systems and the economic incentive to do so was not apparent; and
- there had been little pressure from beneficial owners and their advisers, particularly consultants, for investment in electronic voting capabilities.

Recommendation. *I firmly believe electronic voting will greatly enhance the efficiency of the process for voting UK shares and reduce the extent to which votes are "lost". The slow take up of electronic voting in 2003 was unsatisfactory. It would be disappointing if this did not improve significantly in 2004. Issuers in at least the FTSE 350, investment managers, custodians and proxy voting agencies should all have introduced, or introduce, the necessary system changes so that electronic voting capabilities are universally available as soon as practicable. Furthermore, beneficial owners should over the next three months make direct and specific enquiries of their*

[16] The members of the ISC are: the Association of British Insurers; the Association of Investment Trust Companies; the National Association of Pension Funds; and the Investment Management Association.

[17] CREST is the Central Securities Depository for the UK market and Irish equities. Operated by CRESTCo, CREST provides low-cost, electronic, real-time settlement for a wide range of corporate and government securities, including those traded on the London and Irish Stock Exchanges and virt-x.

agents and others to establish the extent to which they have, or will have, introduced electronic voting capabilities to be used this year. The status of provision for electronic voting should emerge as a standard element in "Request for Proposals" addressed to investment managers and custodians.

Given the importance I attach to electronic voting, I propose to revisit this subject in a year's time to assess the extent to which the relevant participants in the voting process, particularly the proxy voting agencies and custodians, have introduced electronic voting capabilities.

3.3 Clarifying voting entitlements

3.3.1 Registering title to shares

The great majority of UK shares are registered in the name of a custodian's nominee company. This arises from fundamental principles of investor protection. Since June 1997 it has been a statutory requirement[18] that any organisation that provides custody of investments in the UK needs to be authorised and subject to client asset rules[19], which seek to ensure a clear distinction between assets belonging to the custodian and those belonging to the client.

The rules require that clients' investments are segregated, at least collectively, from the custodian's own. They permit a custodian to register clients' investments in the name of a nominee company as opposed to the clients' own names. The nominee holds the investments on trust for the custodian, which in turn holds its rights for the benefit of a third party, the beneficial owner. As the registered owner, the nominee receives any benefits from the investments, including dividends, but has an obligation in law to pass these to the custodian, which in turn must pass them to the beneficial owners who are identified within the custodian's records.

Custodians register the shares they hold on behalf of clients in one of three principal ways:

- in the name of a nominee company with an omnibus account, where the shares of multiple clients are registered under one name, for example, XYZ Nominees Limited;
- in the name of a nominee company with a designation that can be unique and exclusive to each individual client, for example, XYZ Nominees Limited – AB Pension; or
- in the name of a separate nominee company incorporated as a separate legal entity for each client, for example, ABC Pension Nominees Limited.

Market practice in this area developed when title was evidenced by a physical certificate. In a materialised environment, registering shares in the name of a nominee company with an omnibus account helped reduce the cost and administration of holding them. The introduction of share settlement in CREST in July 1996 heralded the emergence of dematerialised holdings for the majority of UK shares. This has provided an opportunity to revisit current practices relating to omnibus accounts. With a paperless system, a simple electronic instruction can effect the transfer of shares from an omnibus nominee into a nominee with a specific designation. There is no need for share certificates to be sent to the registrar for re registration and re-issue.

Registering shares in the name of a nominee company with a specific designation for the beneficial owner facilitates a transparent audit trail of ownership from the registrar to the individual owner.

[18] The Financial Services (Extension of Scope Act) Order 1996 (SI 1996/2958), made on 25 November 1996, introduced a new paragraph 13A in Schedule 1 to the Financial Services Act 1986, under which custody of investments became an authorisable activity. The relevant provisions came into force on 1 June 1997 and are now included in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI/2001/544), Part II Chapter VIII, safeguarding and administering investments.
[19] The Financial Services Authority's Client Assets Sourcebook.

It has been put to me that the advantages for voting of having a nominee with specific designations include:

- it achieves certainty as to the number of shares to be voted on behalf of a particular beneficiary;
- it enables the issuers to determine who has voted and who has not - if there are 500 designated accounts and 400 accounts are voted, it is clear whose votes have either been " lost" or not voted;
- it makes the lodgement of voting instructions with the registrar speedier;
- it may render reconciliations to ensure the correct shares are voted unnecessary;
- it can provide clarity as to attendance rights at meetings;
- it reduces the risk of a vote failing due to reconciliation failures; and
- the CREST facilities enable each owner to appoint a separate service provider for voting purposes, distinct from its custodian.

In addition to these benefits, it has also been suggested to me that a nominee company with a specific designation:

- may give issuers greater transparency about ownership and the identity of those with whom they should engage and enter into an active dialogue (however, if shareholders do not want to disclose their identity, this can still be concealed by virtue of the designation used);
- can reduce the need for the issuance of section 212 notices[20] under the Companies Act 1985;
- facilitates the processing of corporate actions, withholding tax receipts, and the payment of dividends; i.e. individual payments are received and allocated;
- assists in the identification of the principals to a stocklending arrangement in accordance with the Stock Lending and Repo Committee's Code of Guidance[21] section 2.4.1 which states that "where the lender is an agent, the parties should agree appropriate arrangements for the identity of the principals on whom the risk is taken to be established before each deal is done, at least by means of an agreed identification code";
- facilitates the identification of shares that are not to be lent;
- reflects the reports prepared for individual clients; and
- enables owners to identify their shares on the register.

On the other hand, others proposed to me that a nominee company with an omnibus account:

- may be cheaper to establish and maintain – since for both the custodian and the issuer designations tend to be offered at a cost;
- preserves confidentiality about the number of shares held by an owner, which may be necessary for good reasons; and
- avoids the costs involved in transferring holdings to separate designations and in dismantling and re-engineering existing processes and IT programs.

A number of those I consulted put it to me that the costs of moving from a nominee company with an omnibus account to a nominee company that is designated would be small. On the other hand,

[20] Under Section 212 of the Companies Act 1985, a public company may in writing require a person who has, or whom the company has reasonable cause to believe has had, at any time during the three years immediately preceding the date on which the notice is issued, an interest in shares comprised in the company's relevant share capital to confirm the fact or to indicate whether it is not the case and to give such further information requested as specified in the Act.

[21] The Code was drawn up by the Stocklending and Repo Committee, a committee of market practitioners and sets out guidance on the basic procedures which UK participants in stocklending and borrowing of both UK domestic and overseas securities observe as a matter of good practice.

some custodians claim that the costs of giving all clients designated status would be significant, and that the move would negatively impact established working practices in the institutional and retail investment community in the UK. Therefore, I invited a consultancy firm, Epona[22], to investigate the issue of costs in more detail.

Epona observed that the costs of running a nominee company with a specific designation were relatively small, and that all custodians already provide this facility, at little (if any) additional charge, if requested by institutional clients. However, Epona's analysis demonstrated that the costs of full designation would be too high for me to recommend a wholesale move, however, it also showed that a move to designation, at say, the level of the top 200 pension funds and similarly other investment vehicles would yield considerable benefits in terms of voting transparency, audit trail and corporate governance for little incremental cost.

Epona also pointed out that there is concern by some about the level of designation. Overall, there is a balance of arguments for and against, but in conclusion Epona did not, given the costs involved, find a totally compelling reason for a mandatory wholesale switch to designation. However, it did conclude that designation that identified the person responsible for the voting decision, such as the investment manager, would improve the audit trail without imposing significant costs.

Epona's work represents a best estimate in a developing context. Market practice and demand would ultimately determine the extent of any price differential, and I am not recommending a universal and immediate move to designation. An executive summary of Epona's report is set out in Appendix 3.

Recommendation. *I conclude that, for institutional owners, registering title in the name of a nominee company with a specific designation has benefits in terms of the identification of ownership rights. Whilst it may be more costly, it also delivers advantages to the process for voting UK shares and is consistent with promoting quality dialogue and transparent governance. I, therefore, find myself disposed to designation from a governance and voting perspective, but accept that this is not a simple matter of black or white and that other issues have to be taken into account when clients choose the form of custody most appropriate to their requirements.*

The private investor's position is somewhat different. Given the vastly greater number of private investors and the small scale of individual shareholdings, registering title in a nominee company with a specific designation for each investor is unlikely to be practical on cost grounds from the investor's perspective. If a private investor wants shares registered in the name of a nominee company with a designated account, but his custodian only operates a nominee company with an omnibus account, he is at liberty to change to a custodian that does.

I conclude that those who are keen to establish a direct relationship between the registrar and the person making the voting decision should give careful consideration to registering their shares in the name of a nominee with a specific designation that identifies that person. In this respect, investment consultants can play a helpful role in educating their clients on the voting process, ensuring that they are better skilled in understanding and questioning this aspect of effective governance. Whilst registering shares in the name of a nominee company with specific designation has evident benefits in terms of identification of ownership rights, beneficial owners will wish to take account and manage effectively any consequential costs.

3.3.2 A date for the appointment of proxies and for setting voting entitlements

[22] Epona Consulting Limited

Currently, the UK Companies Act 1985 effectively stipulates that the time limit for receipt by the issuer of appointments of proxies (whether in writing or by electronic means) cannot be more than 48 hours before the meeting. In essence it is not possible under current law to extend this period but it is possible to shorten it.

A "record date" for voting is defined as the date voting entitlements are set and the point at which the eligible registered owners are identified for the purposes of voting and attending meetings[23]. For issuers with shares in CREST this record date, similarly, is not allowed to be more than 48 hours before the time of the meeting. This is set out in the Uncertificated Securities Regulations which state "for the purposes of determining which persons are entitled to attend or vote at a meeting, and how many votes such persons may cast, the participating issuer may specify in the notice of the meeting a time, not more than 48 hours before the time fixed for the meeting, by which a person must be entered on the relevant register of securities in order to have the right to attend and vote at the meeting"[24].

International practices around record dates vary both in whether there is a record date and when it is set. This is summarised for certain countries below[25]:

Country	**Record date - days before meeting**
Australia	None
France	None
Germany	None
Japan	At close of fiscal year – 31 March for the majority of companies which tends to be 90 days before the meeting.
UK	Not more than 48 hours before the meeting.
US	30 to 60 days before the meeting, depending on State law, although in practice 35 days tends to be used.

Some see advantages in having a record date in advance of 48 hours. It was felt that currently there was an issue as proxy appointments are expected to be with the registrars 48 hours before the meeting requiring, in effect, that shares have to be voted before voting entitlement is set. Those that supported a record date in advance of 48 hours did so on the basis that it:

- enables notification of the exact number of shares to be voted so that discrepancies can be identified and resolved;
- enables custodians to identify earlier those who have purchased shares since the notice was circulated and to send them necessary copies and supporting documentation; and

[23] Companies Act 1985, section 372 (5) states "a provision contained in a company's articles is void in so far as it would have the effect of requiring [the appointment of a proxy or any] document necessary to show the validity of, or otherwise relating to, the appointment of a proxy to be received by the company or any other person more than 48 hours before a meeting or adjourned meeting in order that the appointment may be effective". A similar provision is made in Table A Article 56.
[24] The Uncertificated Securities Regulations 2001, Statutory Instrument 2001 NO 3755, Section 41(1).
[25] From Report of the Committee of Inquiry into UK Vote Execution, National Association of Pension Funds, July 1999

- reduces difficulties over when reconciliations should be completed with consequential cost benefits.

The main objection to an advanced record date is the very real risk that the right to vote remains with someone who has no continuing economic interest in the shares - a person may vote but then dispose of his shares and not have an economic interest in the company when the vote is registered. It also disenfranchises new shareholders when a purchase settles between the record and meeting date. In this respect, I found no support for share blocking, a provision that prohibits trading between the record date and the date of the meeting.

Among those I consulted, those in favour of an advance in the record date appear to agree that voting entitlements should be determined five business days before the meeting. There would still be the same time limit for appointing a proxy, save that the current 48 hour limit should be amended to two business days before the meeting. (This would remove bank holidays and weekends, which can cause difficulties.) With an advanced record date, there could be no change to the number of shares voted thereafter, only the direction in which the vote is exercised, which could be deferred until the time of the meeting.

There is possibly a greater need for an advanced record date if shares are registered in the name of a nominee company with an omnibus account. As noted above, a nominee company with specific designations would appear to facilitate effective voting in as much as it is likely to be easier to determine voting entitlement and votes can be cast as soon as instructions are received.

In my view, if shares are registered in the name of a nominee company with a specific designation, an advanced record date is not necessary. However, it could take some time for clients and custodians to effect the necessary transition and it was suggested to me that introducing an advanced record date could help in the transition. This would require secondary legislation, at least to amend the Uncertificated Securities Regulations. It would not reflect well on participants in the voting process if it was necessary to seek a legal change to accommodate changes in a process which is technologically simple.

Recommendation. *I have given very careful consideration to recommending the introduction of an advanced record date for voting entitlements. An advanced record date has merits and few of those I consulted were opposed to an advanced record date of five business days. In particular, I can see the argument that it could be a helpful interim solution to facilitate voting and minimise the number of "lost votes" until the institutional voting process becomes largely electronic.*

Introducing an advanced record date would require legislation: secondary legislation if it is to apply only to classes of shares held in CREST through an amendment to the Uncertificated Securities Regulations and primary if it is to apply to all shares through an amendment to the Companies Act. This would take time to put into effect and in the time required I anticipate, hopefully with some justification, that all parties in the voting process will have developed electronic voting capabilities. Thus, I have concluded that the other recommendations in this report will be sufficient and that an advanced record date should not be necessary.

That said, there are limitations with the existing time limit for the receipt of appointment of proxies under the Companies Act and the record date in the Uncertificated Securities Regulations which cause practical difficulties which should be addressed. These are:

- *the current 48 hour limit should be amended to two business days to take account of bank holidays and week ends; and*

- *the time limit should be standardised by issuers as the close of business on the day that is two business days before the day the meeting is held. Issuers should not be able to set a shorter time frame.*

I have written to the Secretary of State for Trade and Industry and the Financial Secretary to the Treasury with a recommendation as to the above.

3.3.3 Confirming receipt of instructions, whether they are valid and the vote will be registered.

With the current paper based system, once the custodian receives the investment manager's instructions on how to vote, the proxy cards are completed and delivered to the registrar, usually by courier or post. The only confirmation that the votes have been received is from the courier or when registered mail is used. Proof that a vote has been received and recorded is not available from issuers or registrars, although I have been told that some registrars will confirm voting instructions received on an exceptions basis.

Confirmations are automatic when electronic voting is used: a powerful reason in itself for introducing electronic voting. When voting using CREST's electronic messaging, a formatted and auditable electronic message is received. The message is time stamped so that it is clear when an instruction has been 'received' by CREST and is deemed received by the issuer/registrar. Also, the Institute of Chartered Secretaries and Administrators' Registrars' Group Common File Format, developed and launched by the registrars in March 2001, provides for automatic electronic confirmation that instructions have been received (although I believe that this has not been much used to date).

Electronic voting does not, however, address the situation where instructions have to be queried when, say, investors vote shares in excess of their holding and the vote has to be queried at best or invalidated at worst. In this respect, there is no obligation on the registrar to query instructions received.

***Recommendation**: Where electronic voting capabilities are used registrars should offer participants the facility of checking that their instructions have been received and their votes recorded correctly. Issuers should ensure that registrars have the facilities to so do.*

The receipt of electronic voting instructions should be confirmed either by the registrar or the electronic voting platform.

As a matter of best practice, registrars should report the late receipt of instructions, or if the instruction will not be accepted and the reasons why. They should use best endeavours to query those instructions they receive which they believe to be incorrect or invalid by reverting to the source, and maintain their impartiality in promoting integrity in the vote when doing so. Not all those voting through CREST have been completing the necessary details of source. This is a weakness in the process that should be addressed.

3.4 Stocklending

As noted in section 1.1 above, a factor that affects voting levels is stocklending. Stocklending is governed by standard legal documentation. The legal nature of the transaction is an absolute transfer of title against an irrevocable undertaking to return equivalent securities[26]. Lending is an unhelpful way of describing what in practice is a sale and forward purchase. Stocklending, the term I have used throughout this report, affects the voting rights attached to the shares in that the lender does not retain the right to vote. Thus, whereas the borrower is obliged to pay an amount equivalent to any dividend received during the period of the loan, the same cannot apply to votes. A vote cannot be cast more than once.

Not all beneficial owners are aware that when shares are lent the vote is transferred with the shares. It is important that beneficial owners focus on this issue and are aware of the consequences. In this respect, the Stock Lending and Repo Committee's Code of Guidance[27] states in section 2.5.1 that lenders should ensure that their clients have a copy of the Code and in section 2.5.4 that lenders should make it clear to their client that voting rights are transferred. In meeting with pension trustees and their advisers, I have not always been convinced that this elementary but critical point has been grasped. In addition, I am aware that on occasion shares can be borrowed for the express purpose of acquiring votes.

A balance needs to be struck between the importance of voting and the benefits derived from stocklending. In reality, the custodian is only acting on its client's instructions and it is important that the different arms of investment managers responsible for voting, and for maintaining positions and stocklending are co-ordinated. Currently, there is a risk that the individual who makes the voting decision at the investment manager may not always be aware that the shares have been lent.

Standard stocklending agreements provide for the recall of shares lent and also highlight the fact that the vote is transferred. If all shares were recalled it would affect market liquidity in a share. Furthermore, when shares are lent, the collateral received may include other equities so votes in other companies are received. In holding collateral, voting rights may accordingly be acquired in shares when the lender has no economic interest. This may sound curious but there is no harm or hazard that cannot be addressed satisfactorily by full disclosure between knowledgeable participants.

Recommendation. *Stocklending is important in maintaining market liquidity but borrowing of shares for the purpose of voting is not appropriate, as it gives a proportion of the vote to an agent which has no relation to the agent's economic stake in the company. Symmetrically, the holders of collateral should not be expected to vote shares held at collateral. It is important that beneficial owners are fully aware of the implications for voting if they agree to their shares being lent. In particular, when a resolution is contentious I start from the position that the lender should automatically recall the related stock, unless there are good economic reasons for not doing so. Failure to take such action could be extremely detrimental.*

[26] The shares lent are unlikely to remain with the borrower, as the agreements are clear that equivalent shares, i.e. those bought in the market, can be returned. In the rare event that equivalent shares are not available then the borrower will provide cash to the value of the shortfall and take back his collateral.

[27] The Code was drawn up by the Stock Lending and Repo Committee, a committee of markets practitioners and sets out guidance on the basic procedures which UK participants in stock lending and borrowing of both UK domestic and overseas securities observe as a matter of good practice.

3.5 Systems and controls at custodians and investment managers

In recent years, as part of the due diligence process undertaken in the appointment and monitoring of custodians (and in some cases investment managers), it has become common practice for clients to request sight of a FRAG 21/94[28] report relating to the custodian's control environment. Indeed, it is particularly important for pension trustees (and others who act in a similar fiduciary capacity) to receive such reports if they are to exercise reasonable skill and care in the appointment of service providers.

A FRAG 21/94 report is a report by the directors of the service provider, in this case usually the custodian, confirming the controls that have operated during the reporting period and including a report on the controls by reporting accountants. FRAG 21/94 provides guidance to reporting accountants on communicating to a custodian's customers on the internal controls operating at the custodian.

Thus where custody of assets has been outsourced to a custodian, a FRAG 21/94 report can be a valuable tool and can give considerable comfort to trustees and investors concerned to ensure that the custodian has adequate controls over the custody services provided. It has become common practice for custodians to receive requests to provide such reports, not only to customers, but also to their customers' auditors and advisers.

There is no specific regulatory requirement for custodians to produce a FRAG 21/94 report nor are the control areas in the voting process to be covered in the report specified. As such there is no requirement to cover controls governing the voting process in the report, albeit that voting is frequently addressed. In this respect, SAS 70[29] reports (the nearest US equivalent) are usually more detailed and do tend to refer to voting.

***Recommendation**. As a matter of best practice custodians and investment managers should include controls over the voting process in the production of FRAG 21/94 reports and customers should make clear their expectations in this respect.*

3.6 Enhancing institutional investors' procedures

3.6.1 Informed and "joined up" voting

The main duty of institutional investors to their clients, the beneficial owners, is to secure shareholder value.

In pursuing their clients' objectives with regard to voting, it is vital that when institutional investors determine a voting intention they do so in an informed and judicious manner. In this respect, I consider institutions have made considerable progress. However, there are concerns that, on occasion, those responsible for voting issues are presented to the issuers as the institution's voice on the issue, when they might not necessarily represent the views of the portfolio manager or analyst responsible for establishing the position and with whom the issuer's management have been encouraged to communicate. This can and does cause confusion within issuers: within the investing institution the left hand appears to be disconnected from the right hand. It is critical that

[28] The Financial Reporting and Auditing Group (now the Audit Faculty) of the Institute of Chartered Accountants in England and Wales periodically issues guidance to its members. One such guidance note was FRAG 21/94, Reports on Internal Controls of Investment Custodians Made Available to Third Parties, which the Audit Faculty updated in 1997.

[29] Statement of Auditing 70, Service Organizations, is an auditing standard developed by the American Institute of Certified Public Accountants. SAS 70 is known for the independent audit report that is issued to the service organisation following a SAS 70 audit. It gives guidance to auditors in issuing an opinion on a service organisation's description of its controls.

voting is fully integrated into the investment process as part of the institutions' wider ownership responsibilities.

In addition, as recommended in the ISC Statement of Principles on the Responsibilities of Institutional Shareholders and Agents of October 2002, institutional investors should have "a stated and regularly reviewed policy on voting UK shares which is public".

Some have voiced the case for introducing compulsory voting. I do not support this. In the US, the Employee Retirement Income Security Act of 1974 (ERISA) is equivalent in certain respects to the UK Pensions Act. It is a complex law that governs the administration of private sector occupational pension funds. The relevant aspect of ERISA with regard to voting is the Department of Labor Interpretive Bulletin 94-2[30], which was promulgated in 1994. It clarifies the responsibilities with regard to voting the shares held by pension funds. In summary, it treats votes as an asset of a pension fund, and places a fiduciary duty on the trustees (and investment managers as their agents) to treat the vote with care.

Interpretative Bulletin 94-2 states "the fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock".

As noted in my review, "Institutional Investment in the UK: a review", I did not consider that this meant "compulsory voting in all cases; nor was it the intention of that review that managers should invariably exercise votes on all their shares, however unthinkingly"[31]. In essence, my concern was that compulsory voting might dilute the impact of voting decisions taken after careful consideration. I have not altered my position.

***Recommendation**. Voting should be fully integrated into the investment process, as it is part of the institution's wider ownership responsibilities and, indeed, should be recognised, along with other aspects of governance, to be an essential service, with appropriate resourcing and the potential for meaningful benefits for clients. Institutional investors should actively exercise the votes in shares they hold or manage for beneficial owners, where this responsibility has been delegated to them, and have a stated and regularly reviewed policy on voting UK shares, which is public.*

3.6.2 Accountability

As noted above, whereas I do not believe there is a case for compulsory voting, I do consider that institutional investors should report to their clients, the beneficial owners, on how they executed their voting obligations and that this should be in a form and manner that is helpful. Indeed the ISC Statement of Principles recommends "those that act as agents will regularly report to their clients details on how they have discharged their responsibilities. This should include a judgment on the impact and effectiveness of their engagement. Such reports will be likely to comprise both qualitative as well as quantitative information."

I interpret the use of the term qualitative to include an explanation of how a voting decision has been reached, particularly where the issue is contentious. Page upon page of statistics and tables will not suffice. Explanation is required. I support and endorse the ISC's position on this matter.

***Recommendation**. Institutional investors should report to their clients, the beneficial owners, on how they have executed their voting responsibilities and do so in a form and manner that is helpful*

[30] Interpretive Bulleting relating to statements of investment policy, including proxy voting policy or guidelines, Code of Federal Regulations Table 29, Chapter XXV, 2509, 94-2, 1994
[31] Institutional Investment in the UK: a review, HM Treasury, paragraph 5.93, 2001

and informative to the client. Investment managers' representatives who meet their clients should be as knowledgeable about this aspect of their management of the client's portfolio as they are about other aspects. In addition, clients should ask questions about the report and hold their manager to account for the manner in which the votes have been cast. The clients' advisers should assist them in meeting this challenge.

3.6.3 Individual voting decisions

In the US, Interpretative Bulletin 94-2 obliges trustees and their agents to:

- recognise that the voting rights attached to equity shares managed on behalf of pension fund clients may have economic value and must be treated accordingly;
- vote equity shares on issues that may affect the value of the clients' investments;
- have a documented policy or guidelines in place for voting on issues; and
- maintain accurate voting records.

As a consequence, since 1994 most investment managers in the US have been obliged (either indirectly via ERISA or directly via the investment management agreement with each institutional client) to disclose information regarding voting activity to ERISA clients. Most investment managers operate ERISA standards for all their institutional clients and thus make reports available to those institutional clients who want them.

The US Securities and Exchange Commission's (SEC) recently adopted mutual fund proxy vote disclosure rules[32] take things a step further and will require all US registered management investment companies to disclose publicly all votes cast in respect of voting shares held within mutual funds.

Some have asked whether there should be a similar requirement in the UK and whether individual investment managers' voting decisions should be matter of public record.

The Government's White Paper, "Modernising Company Law", states in paragraph 2.47 "the Government…believes that, in principle, it would be in the public interest for institutional shareholders to be required to disclose publicly how they have voted in respect of their shareholdings in British quoted companies. However, as noted above, this is a complex area and there may be practical difficulties in implementing the review's proposal through companies' legislation".

***Recommendation**. I have reflected with care on the case for a requirement that investment managers should disclose publicly how they have voted. Some investment managers have already seized the opportunity of disclosing how they have voted, treating it as an integral part of the service provided. I commend their initiative. The Internet has opened up possibilities in this respect of which we could not have dreamt less than a decade ago.*

As noted above, I consider it essential that the beneficial owners should know how their shares have been voted. I am not yet persuaded that public disclosure should be made mandatory but believe that the market will increasingly expect such disclosure and would expect advisers and consultants to show an interest in this aspect of service when recommending a service provider to their clients.

[32] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities and Exchange Commission, 17 CFR, Parts 239, 249, 270 and 274, Release Numbers 33-8188, 34-47304, IC-25922; File No S7-36-02, RIN 3235-A164

3.7 Enhancing procedures at company meetings

3.7.1 Voting resolutions on a poll

Under regulation 46 of Table A to the Companies (Tables A to F) Regulations 1985, a resolution voted at a company meeting is decided on a show of hands (one vote per member for each shareholder actually present or represented in the case of a corporate shareholder, but not proxies unless the articles provide) unless a poll (a ballot of one vote per share) is called.

Table A states that a poll may be demanded by:

- the Chairman;
- two members either present in person or by proxy[33];
- a member or members representing not less than one-tenth of the total voting rights; or
- a member or members with shares on which an aggregate sum has been paid up equal to not less than one-tenth of the total sum paid up.

Most proxy forms name the "chairman of the meeting" as the default proxy and the majority of shareholders will appoint the chairman as their proxy.

The Companies Act 1985 does not address, and few companies' articles cover, the duties of the Chairman as regards acting as a proxy and calling a poll. It was common law that clarified the chairman's duty to: "ascertain the true sense of the meeting"[34]. Where the chairman as proxy is aware that if a poll was called the outcome would be different from that reached on a show of hands, then he has a duty to demand a poll, if able to do so under the company's articles of association.

It has been proposed to me that there would be benefits if all resolutions were required to be voted on a poll in that:

- voting is more exact and equitable in that one vote per share is counted – on a show of hands each shareholder has one vote and it is possible for a group of shareholders owning in aggregate a very small proportion of a company's outstanding capital to influence the outcome;
- voting is more transparent;
- overseas shareholders would be more inclined to vote UK shares as currently some are discouraged by the belief that the result is in most cases determined by a show of hands taken at the meeting; and
- although a show of hands is believed to involve or "enfranchise" the private shareholder, the majority cannot and do not attend the meeting, for reasons of geography or timing, but they do complete proxy cards which they may reasonably expect to be counted.

In addition, it is a provision in the Combined Code that proxies are counted. Thus the additional costs involved in going to a full poll will be incremental.

[33] This is often amended to a greater number, such as 5 members
[34] Second Consolidated Trust Ltd v Ceylon Amalgamated Tea & Rubber Estates Ltd 1942, 2.E.R.567

Against this some argued in favour of maintaining the status quo. They cited:

- those shareholders that do attend the meeting can make a powerful contribution in holding directors to account (the Combined Code states under Principle E.3 that "major shareholders should attend AGMs [Annual General Meetings] where appropriate and practical"; this might give rise to an expectation that in the future AGMs will be enriched by the greater visibility and participation of institutional shareholders – we shall see);
- requiring a poll may be seen to disenfranchise small shareholders who would have no incentive to attend meetings – it is their principal opportunity to exercise a right of determination over the companies in which they have an interest;
- a show of hands enables a company to deal with matters at the time, is quick and will normally result in lower costs; and
- in any event, except where a poll is called, companies are obliged to indicate proxies lodged for and against each resolution under the Combined Code so little additional benefit would be attendant upon a poll.

Nothing in the proposal to call a poll for all resolutions undermines or frustrates the ability of private investors to speak and to challenge at AGMs. The right to speak and the right to vote are both important but different.

Recommendation. *On the basis that attendance at meetings can be unrepresentative and in the interests of transparency and equity, I recommend that best practice should be to call a poll on all resolutions at company meetings. (The Company Law Reform paper stated in paragraph 4.48 "we propose to consider further the case for a regulatory rule requiring listed companies to proceed directly to a poll on any business likely, on the basis of proxies lodged, to prove contentious"[35]). Issuers and registrars should have the capabilities always to proceed to a poll. In this respect, it may be advisable for companies to include a provision to that effect in their articles, to ensure that this is clear and not open to challenge.*

3.7.2 Disclosing the results of polls and "proxy votes"

Companies are expected to disclose "proxy votes" under the Combined Code which states "the company should count all proxy votes and, except where a poll is called, should indicate the level of proxies lodged on each resolution and the number of abstentions, after it has been dealt with on a show of hands"[36]

The Government's White Paper, "Modernising Company Law" proposed in paragraph 2.45 that quoted companies should be required to disclose on their web sites and in annual reports the results of polls at general meetings[37].

Recommendation. *Companies should disclose on their web sites and in summary in annual reports, the results of polls at general meetings and, where a poll is not called, the level of proxies lodged on each resolution. It is also recommended that the Financial Services Authority make it a listing requirement for the results of polls to be disclosed as a regulatory announcement to the market and that there is a common format for disclosure.*

I have written to the Financial Services Authority in this respect.

[35] Company Law Reform, Modern Company Law for a Competitive Economy, Developing the Framework, Volume 5.
[36] The Combined Code on Corporate Governance, July 2003, provision D.2.1.
[37] TSO, Modernising Company Law, CM 5553-1, July 2002

3.7.3 Recognising votes consciously withheld

Listed public companies are required by "The Listing Rules[38]" to issue forms that provide for "two way" voting on all issues. Thus members may instruct their proxy, who is usually the chairman (but may be any person), to vote either "for" or "against" each resolution.

Many of those I consulted considered the conscious withholding of votes a valuable mechanism for communicating reservations about a particular resolution whilst not going as far as voting against the resolution. Institutional shareholders are particularly supportive of this facility. If a shareholder takes the decision to withhold his/her vote for this purpose, it is essential that the reasons for the decision are clearly explained to the company if the full impact of the decision is to be apparent. In this respect, only "for" and "against" votes are counted when deciding whether or not a resolution is carried but the existence of a significant number of votes consciously withheld evidences the existence of concerns.

***Recommendation**. Votes consciously withheld can be a useful tool in communicating shareholders' reservations about a resolution, provided there is a clear explanation to the company as to why the vote has been withheld. In this respect, companies should provide a vote withheld box on proxy forms, whilst retaining the current legal position where only "for" and "against" votes are taken into account when deciding whether or not a resolution is carried. When declaring the results, companies should publish the total number of votes received, the number of votes "for" and "against" the resolution, and the number of votes consciously withheld. It is important, however, that a clear distinction is made between votes withheld and what are simply "no votes". In this one respect, I have reservations as to how this will work in practice and encourage those investors favouring this facility to discuss this with issuers and others with an interest.*

The Financial Reporting Council may want to consider the above as it crosses into the territory of the Combined Code in that provision D.2.1 requires companies to indicate the balance for and against the resolution and the number of abstentions but makes no mention of votes consciously withheld.

I have written to the Financial Reporting Council in this respect.

3.7.4 Improving the powers of proxies

Under Section 372(1) of the Companies Act 1985, any member of a company, the registered or "legal" owner, is entitled to attend and vote at a meeting of the company, and has a statutory right to appoint an agent, called a "proxy", to attend and vote on its/his/her behalf. Every notice of a meeting must state the member's right to appoint a proxy or proxies and that they need not be members.

Unless the company's articles provide otherwise, a member of a private company may only appoint one proxy who may also speak at the meeting. A member of a public company (who may be the nominee company or legal owner on behalf of multiple beneficial owners whose voting intentions conflict) may appoint more than one proxy but this proxy has no right to speak at the meeting (this is possibly to prevent the use of professional advocates at meetings, which appears to me to be a far from challengeable benefit).

[38] The Listing Rules, The Financial Services Authority, May 2000, Chapter 13, Documents not requiring Prior Approval, Proxy Forms, Rule 13.28.

A proxy can only vote on a poll and not on a show of hands (whether it is a private or public company), unless otherwise provided in the Articles. A proxy has the same right as the member represented to demand or join with other members in demanding a poll (section 373).

A company's members cannot always easily attend company meetings. There may be many thousands of individual members from all parts of the UK and many will be resident outside the UK. Thus it may be impractical for more than a minority to attend a meeting on a particular day at a single location in the UK. To address this, the Government's White Paper, "Modernising Company Law", in paragraph 2.18 stated "the Government believes it is important that even when they cannot attend a general meeting, members can exercise their rights, for example by giving instructions in advance to a proxy". Thus the Government proposed enhancing the powers of proxies so that they can speak at meetings of public, as well as private, companies and vote on a show of hands.

There is a further complication in that very often the member is not an individual but a company. In such a situation, section 375 of the Companies Act 1985 enables the company's directors, by resolution, to appoint a corporate representative to attend the meeting, speak and vote on a show of hands on the company's behalf. It may do this instead of appointing a proxy. No notice of the appointment need be given to the company prior to the meeting, although evidence of authority will be needed at the meeting.

Strictly there should only be one corporate representative for each corporate member. However, a nominee company with an omnibus account can hold the shares of multiple beneficial owners. In recognition of this, unless challenged, company chairmen have tended to exercise their discretion with wisdom and allow registered shareholders to appoint a number of 'corporate representatives', each limited to a given number of shares, to enable a number of beneficial owners whose shares are registered in the one name to speak at the meeting. It is very rare, however, that multiple corporate representatives are allowed to vote as this could give rise to very real practical difficulties, especially if the number of shares represented is not clear.

Recommendation. *Company Law should be changed to give more rights to proxies so that they can speak and vote on a show of hands as well as a poll. Pending this, issuers should be encouraged/ recommended to allow proxies to speak and vote on a show of hands recognising that an amendment may be required to the company's articles.*

I recommend that the Government clarifies the position regarding corporate representatives and amends Company Law so that multiple corporate representatives are allowed. My recommendation in this regard is that corporate members should be allowed to appoint one corporate representative for a distinct number of shares held giving that corporate representative the power to attend, speak at and vote on a poll in respect of that defined number of shares.

I have written to the Secretary of State for Trade and Industry in this respect.

3.7.5 Provision for polls to be scrutinised

The provisions for the scrutiny of polls are usually set out in a company's articles. Table A regulation 49 states "a poll shall be taken as the chairman directs and he may appoint scrutineers (who need not be members) and fix a time and place for declaring the result of the poll. The result of the poll shall be deemed to be the resolution of the meeting at which the poll was demanded".

Ordinarily the registrars, as agents of the issuer, act as scrutineers and sign off on the result for the chairman. Otherwise external scrutineers, such as the Electoral Reform Society or an external firm of accountants, which could be the firm's auditors, can be called upon.

The Government's White Paper, "Modernising Company Law", proposed in paragraphs 2.19 and 2.45 that a sufficient body of shareholders should have the right to require an independent scrutiny of any poll. It is clear that the intention is for there to be an opinion on whether the procedures for recording and counting votes (and proxies) was adequate to ensure that the statement of votes cast was accurate. The scrutiny would cover both the issuer's and registrar's activities and examine the procedures for determining whether the votes are admissible, the voting process and the counting of votes. It would be undertaken by a registered auditor, though not necessarily the company's own auditor, and would have to be completed within a month of the meeting and the report sent to the members.

***Recommendation**. Provision for an independent scrutiny of a poll would critically add to confidence in the integrity of the voting process and Company Law should be amended to require a scrutiny if requested by shareholders. In this respect, any amendment should be drafted to be clear that shareholders representing a stated minimum percentage of shares outstanding should require an independent scrutiny in order to avoid frivolous or mischievous intervention.*

I have written to the Secretary of State for Trade and Industry in this respect.

3.7.6 Publicising the notice of the meeting

As regards making information available to shareholders, the Government's White Paper, "Modernising Company Law", proposed in paragraph 4.50 that quoted companies should be required to publish their annual reporting documents on the Internet as soon as practical after they had been approved and within four months of the year end. In fact, I understand that the majority of the FTSE 100's annual reports are already published on their web sites and are readily accessible.

***Recommendation**. Information should be made readily available to shareholders and the Financial Services Authority should make it a listing requirement that quoted companies publish their annual reporting documents on the Internet as soon as they have been published.*

I have written to the Financial Services Authority in this respect.

3.8 The importance of the issuers

Currently, issuers are under no obligation to solicit votes (as can happen in the US) or ensure that the voting process is effective. In this respect, although I do not consider that issuers should be compelled to solicit votes, issuers should have a common interest with their shareholders in ensuring that voting at company meetings fairly reflects the views of the company's owners.

***Recommendation**. Just as I consider that the beneficial owners should drive the standards in the voting process, the issuers should have a similar duty to support the process by ensuring that voting at company meetings reflects the views of the company's owners and that the vote is administered in a fair, professional and truthful manner.*

SHAREHOLDER VOTING WORKING GROUP

PROJECT TO REMOVE FAILURES IN THE VOTING PROCESS

TERMS OF REFERENCE

Overall objective

To establish a publicly credible voting process in the UK, and for there to be a noticeable improvement from the current perceived impediments in voting intentions being translated into practice in time for the next "voting season".

Specific action

For each step in the various voting chains, to identify the nature and scale of each impediment, and to identify solutions that are widely accepted and then implemented. The outcome to be that investors have confidence that their voting intentions are translated into practice through a sound system that incorporates a practical reconciliation capability.

The Working Group should consider all necessary actions to achieve its objective including:

- Any research it considers necessary.
- Identifying and recording:
  - (1) all steps in the voting chains;
  - (2) the current constraints, deterrents and logistical problems which impede the voting process;
  - (3) solutions that will enable these impediments to be overcome; and
  - (4) an indication of the costs and benefits associated with these solutions.
- Promoting the implementation of solutions, as appropriate, in recognition of the core role voting has in responsible share ownership.

Interested parties

As far as possible all parties in the voting chains should be involved with or represented on the project.

Timescale

By the end of January 2004, unless major unexpected problems are encountered, to have identified and agreed those solutions to be implemented. To implement as many solutions as possible in time for the next "voting season", with a target for implementation of all agreed solutions, or an agreed programme of implementation of major tasks, by the end of October 2004.

October 2003

THE SHAREHOLDER VOTING WORKING GROUP

Paul Myners	Chairman
Terry Pearson	Deputy Chairman

The following associations/organisations are represented.

Association of British Insurers
Association of Investment Trust Companies
Association of Private Client Investment Managers & Stockbrokers
Bank of England
British Bankers Association
Countisbury Lodge Ltd
CRESTCO Ltd
Department of Trade & Industry
Institute of Chartered Secretaries & Administrators
Investment Management Association
Investor Relations Society
National Association of Pension Funds
Pension Investment Research Service
Proshare (UK) Ltd
Unilever
University of Birmingham

EPONA'S REPORT

SVWG
'Lost Votes'
Final Report - Executive summary

Cost of Omnibus V Designated

Epona SVWG

Introduction

Epona Consulting Limited (Epona) was asked by Paul Myners to assist in his investigation into the issues surrounding the costs of moving custodial accounts from a nominee company with an omnibus account to a nominee company with designated status in the context of 'lost votes'. This Executive Summary contains extracts from that report. It is structured as follows:

- **introduction**
- **key issues** that emerged
- the **findings** from our investigation, including the pros and cons of each type of account structure and costs analysis
- **recommendations** for changes
- **next steps**

2

Spona SVWG

Findings - costs, manual voting

A move to full designation at client level could incur some £0.8 million extra cost for the notional custodian model - with paper based voting, however, a move to designation at fund manager level is considerably cheaper. The table below shows three models for a notional custodian

- A one omnibus nominee with 5,000 clients with average 200 lines of stock
- B the same nominee but designated down to fund manager level (200)
- C full designation down to client level (5,000)

Changes in costs for the 3 notional models - manual voting		A	B	C
Crest fees				
maintenance		£ 20	£ 20	£ 20
for designation - once in CREST		£ 5	£ 1,000	£ 25,000
messaging fees		£ 25	£ 5,000	£ 125,000
interface charge		£ 5,000	£ 5,000	£ 5,000
total Crest		**£ 5,050**	**£ 11,020**	**£ 155,020**
Custodian/proxy agencies				
Enquiries - of all messages =	0.333	£ 6.7	£ 1,332	£ 33,300
Amendments (to votes) notional		£ 100	£ 100	£ 100
Staff Numbers FTE		*60*	*63*	*75*
change			£ 135,000	£ 675,000
(Staff changes only included)				
Total		**£ 107**	**£ 136,432**	**£ 708,400**
Overall total		***£ 5,157***	***£ 147,452***	***£ 863,420***

3

Spona SVWG

Findings - costs extrapolated across the industry

The model below shows the effects on the (notional) industry of different levels of designation. Clearly total designation (C) is not a practical solution in terms of costs and disruption, however, the costs in scenario 'B' at fund manager level are modest and support a conclusion of designation at that level.

Costs to industry - extrapolated to 15 custodians - manual voting		A	B	C
Crest fees				
maintenance		£ 20	£ 20	£ 20
for designation - once in CREST		£ 75	£ 15,000	£ 375,000
messaging fees		£ 375	£ 75,000	£ 1,875,000
interface charge		£ 75,000	£ 75,000	£ 75,000
total Crest		***£ 75,470***	***£ 165,020***	***£ 2,325,020***
			219%	3081%
Custodian/proxy agencies				
Enquiries - of all messages =	0.333	£ 99.9	£ 19,980	£ 499,500
Amendments (to voting) notional		£ 100	£ 100	£ 100
Staff Numbers FTE		*900*	*945*	*1,125*
change			*£ 2,025,000*	*£ 10,125,000*
(staff changes only included)				
total		***£ 200***	***£ 2,045,080***	***£ 10,624,600***
		£ 75,670	£ 2,210,100	£ 12,949,620

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Spona

SVWG

Findings - costs - with electronic voting

This model shows the same costs as previously for the notional custodian but includes electronic voting costs, (assuming it becomes standard practice)

Changes in costs for the 3 notional models		A	B	C
Crest fees				
maintenance		£ 20	£ 20	£ 20
for designation - once in CREST		£ 5	£ 1,000	£ 25,000
messaging fees		£ 25	£ 5,000	£ 125,000
interface charge		£ 5,000	£ 5,000	£ 5,000
total Crest		**£ 5,050**	**£ 11,020**	**£ 155,020**
Custodian/proxy agencies				
Enquiries - of all messages =	0.333	£ 6.7	£ 1,332	£ 33,300
Voting once pa per stock per a/c		£ 60	£ 12,000	£ 300,000
Amendments (to votes) notional		£ 100	£ 100	£ 100
Staff Numbers FTE		*60*	*63*	*75*
change			£ 135,000	£ 675,000
(Staff changes only included)				
Total		**£ 167**	**£ 148,432**	**£ 1,008,400**

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Spona

SVWG

Findings - costs to custodian industry

This model shows the same costs as previously but includes electronic voting costs, (assuming it becomes standard practice)

Costs to industry - extrapolated to 15 custodians		A	B	C
Crest fees				
maintenance		£ 20	£ 20	£ 20
for designation - once in CREST		£ 75	£ 15,000	£ 375,000
messaging fees		£ 375	£ 75,000	£ 1,875,000
interface charge		£ 75,000	£ 75,000	£ 75,000
total Crest		***£ 75,470***	***£ 165,020***	***£ 2,325,020***
			219%	3081%
Custodian/proxy agencies				
Enquiries - of all messages =	0.333	£ 99.9	£ 19,980	£ 499,500
Voting once pa per stock per a/c		£ 900	£ 135,000 assume 25% discount	£ 2,250,000 assume 50% discount
Amendments (to voting) notional		£ 100	£ 100	£ 100
Staff Numbers FTE		*900*	*945*	*1,125*
change			*£ 2,025,000*	*£ 10,125,000*
(Staff changes only included)				
total		***£ 1,100***	***£ 2,180,080***	***£ 12,874,600***
		£ 76,570	£ 2,345,100	£ 15,199,620

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Key findings

Key findings cont'd: - Other

- in essence the infrastructure is present to **facilitate automation** in the voting chain - but there is little 'incentive' or motivation to use a standard or universal system (several have been developed)

➔ increased **automation would reduce costs** of processing (albeit with some up front investment) and improve robustness

- **100% lodgement** will never be achieved (unless voting were mandatory - not recommended) due to several factors (disinclination to vote, timings, stock lending/collateral, collective schemes and retail holders, high overseas holdings/ADRs etc)...

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Key recommendations 1

Key recommendations are:

Omnibus V designated

a **wholesale movement** from omnibus to designated would be costly and may not necessarily be proportionate to the benefits elsewhere in the chain,

..**designation should be defined** precisely anyway (level) because...

..a move to **designation at fund manager/segregated client** level, however, would improve the voting audit trail without imposing the costs of full designation

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Epona SVWG

Key recommendations 2

Key recommendations cont'd:

The voting process

➔ all institutions should lodge proxies **electronically when their shares are** dematerialised – via approved media. This would considerably reduce the paper in the process, lower costs and improve transparency and…

- **...polling at AGMs** should be best practice to ensure proxy votes matter and generally this would also improve the 'credibility' of the UK corporate governance process in the eyes of overseas investors (30% of holdings)
- all processes from custodian, through fund manager, proxy agency to issuer/registrar should be re-engineered to remove inefficiencies and ensure that the result is **automation not mechanisation, that** there is a clear audit trail and adequate confirmations

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