Review of the impediments to voting UK shares

Report by Paul Myners to the Shareholder Voting Working Group - an update on progress

November 2005

I reported to the Shareholder Voting Working Group (SVWG)[1] in January 2004 on my Review of the Impediments to Voting UK Shares. For several years there had been persistent concerns that the system for voting UK shares was not operating as it should be in that votes were "lost". In the report I outlined a comprehensive action programme to address the inefficiencies and obstacles in the process by which votes are transmitted. One year later, I reported on the progress made and was encouraged by the improvements achieved. However, there was still a certain amount of work to be done in that the system was by no means perfect and I continued to hear stories of votes being lost. This report is a further update.

Undoubtedly the momentum gained in 2004 in implementing my recommendations and improving the voting process appears to have continued in 2005. The process is getting better. Moreover, not only has the process improved but voting levels, that is to say the number of eligible shares voted, have also increased.

In 2003, the Secretary of State for Trade and Industry stated that the aim should be to increase voting levels at UK Annual General Meetings (AGMs), which at the time were around 50%. In this respect, an analysis this year by RREV[2] of the AGMs of 401 companies to July 2005 (approximately 80% of the FTSE All Share AGMs fall into this period) showed that voting levels were on average 61.06% of eligible votes[3]. The highest voting levels were at the AGMs of the FTSE 250 companies at 63.63% with the FTSE 100 and small cap companies marginally below this. I believe this differential reflects the fact that FTSE 100 companies are likely to have more dispersed share ownership, and have more of their shares owned by overseas investors and more shares lent (the lender loses the right to vote).

Figures from Manifest[4] support this trend and demonstrate that voting levels, in terms of the percentage of eligible share capital voted, in the FTSE 100 have increased over time as set out below.

Year to 2001	50.63%
Year to 2002	52.08%
Year to 2003	53.84%
Year to 2004	57.82%
Eight months to August 2005	58.84%[5]

[1] The SVWG was established in September 1999 under the chairmanship of Terry Pearson, an experienced investment custodian. It was the first industry-wide body to address the issue of improving the voting process in the UK and brought together all the relevant participants.

[2] The National Association of Pension Funds (NAPF) joined Institutional Shareholder Services in January 2004 to form Research, Recommendations and Electronic Voting (RREV) a research and proxy voting agency.

[3] RREV's Voting Review 2005.

[4] Manifest Information Services Ltd, a research and proxy-voting agency.

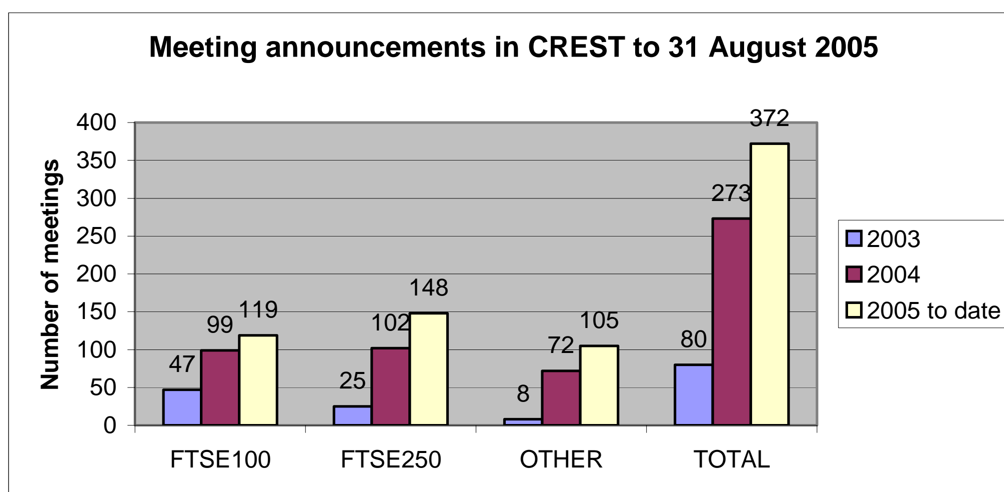
[5] Manifest's Agenda: 23/09/05, Volume 3 Number 38.

I hope that the UK's success in raising voting levels can be replicated in other EU Member States and, to this end, I welcome the steps being taken by the EU Commission to improve the process for voting shares throughout the EU[6].

My brief was not to promote increased voting levels but to address impediments in the voting process. That said, a more efficient and effective process should encourage confidence in the integrity of the process and further improvement in voting levels. I set out below the status of the key recommendations in my initial report and matters that need to be addressed if these improvements are to continue.

Electronic voting

One of my main recommendations was that electronic voting, whereby instructions are transmitted electronically straight from the person making the voting decision to the person recording the vote, is the key to a more efficient voting system. More than a year and a half after my first report, it is apparent that the voting system has undoubtedly become more automated. According to CREST, the number of issuers that facilitate electronic voting has increased as evidenced by the dramatic number of meeting announcements on CREST. In the eight months to 31 August 2005, 372 meetings of companies in the All Share were announced on CREST as compared with 273 for the whole of 2004. I understand that only two companies in the FTSE 100 did not allow electronic voting this year and that both will do so in 2006.



Source: CREST

A system which allows electronic voting is not enough on its own, it is important that the system is used. The Institute of Chartered Secretaries and Administrators (ICSA) noted that, in the six months to 30 June 2005, there was a marked increase in electronic voting and a drop in paper voting in that 42% of the FTSE

[6] The Internal Market Directorate issued a Consultation Document on Fostering an Appropriate Regime for Shareholder Rights in 2004 and a draft Directive is expected shortly.

100's issued share capital was voted electronically and 16% with paper, as compared with 22% electronically and 40% with paper in 2004. I am confident that we will see this trend continue.

In conclusion, I am firmly of the view that an automated process is the key to a more efficient voting system. I would like to see all institutional votes being cast electronically and all issuers in the FTSE 350 facilitating electronic voting. To help in this, the Investment Management Association (IMA) and the Association of British Insurers have agreed to circulate a list of those issuers in the FTSE 350 that still do not allow electronic voting to their Members so that, as agents of the beneficial owners, they can raise the matter with companies at meetings. I welcome this move which highlights the importance of the agent's role in ensuring that electronic voting is used. I will also be looking to the beneficial owners and their advisers to drive the standards in the voting process in this respect. I consider that electronic voting, whether it be through CREST or other provider, is so important that I will continue to monitor the situation.

Designation and an audit trail

At the outset of my review, many put it to me that one of the weaknesses with the system for voting shares was the absence of a clear audit trail showing that voting instructions were received and acted upon.

One of my recommendations was that registering title in the name of a nominee company with a separate designation for each client, as opposed to being pooled and registered under one name in an omnibus account, has benefits when it comes to voting in that it provides a transparent audit trail of ownership and accountability. In this respect, I understand that three of the seven main custodians offer designation as standard and the other four will offer it at the client's request. However, the main issue is not whether designation is available, but whether clients wish to have their holdings registered under a specific designation and have sought to do so. My conclusion, therefore, remains that investors should consider the benefits of designation against the costs involved when choosing their custody arrangements. This is a matter of judgment for the beneficial owners and it is important that custodians help ensure that this judgment is informed.

Furthermore, I understand that registrars will cast all voting instructions received unless they are received late or are invalid in some way. In the one year progress report, the ICSA Registrars' Group committed the registrars to advising the registered holder when electronic proxy voting instructions had not been registered because they were invalid for some reason. Thus participants would have good reason to assume receipt signified registration unless advised to the contrary.

I understand from the registrars that this has been effective in practice and, probably as a result of the fact that more votes are now transmitted electronically, the error rate has been low. For example, out of 247 CREST proxy instructions received by one registrar, an error was noted in only one instance where a holder of over 57 million shares over-voted 50,000 shares. In addition, I understand it

is now much easier to trace the source of the instructions in that more of those initiating the instruction are giving the correct contact details, a trend which I hope will continue. In summary, I welcome the steps taken by the registrars and those that initiate instructions and consequently do not believe that a formal confirmation facility, which could be costly, needs to be developed.

Stocklending

The number of shares an investor votes should be in proportion to that investor's economic interest in the company. Stocklending is one market practice that affects this in that, when shares are lent, the voting rights transfer from the lender to the borrower. Thus one of my initial recommendations was that this is something that participants need to be alert to in order to ensure that economic interest and voting activity are aligned rather than subverted. Furthermore, when a resolution is contentious, I considered that the lender should recall the stock unless there are good economic reasons for not doing so. At the very least, lenders or those considering lending, should be alert to this hazard and the consequences of "selling" their votes.

At the time of the one year progress report, I noted that there had been an increase in stocklending. In recognition of the impact this could have on voting, I strengthened my recommendations on stocklending such that:

- clients should be aware that there is potential conflict between being able to vote and the economic interests of those that manage the lending who may be rewarded by a share of the lending fees;
- those responsible for initiating voting instructions should anticipate contentious votes and recommend to beneficial owners that the related stock should not be lent; and
- beneficial owners should satisfy themselves as to the arrangements between the custodian and the person initiating the voting instruction to ensure there is no disconnect and the correct number of shares are voted.

As regards the third bullet above, I welcome the Institute of Chartered Accountants in England and Wales' Exposure Draft on a revised FRAG 21/94 which includes a control objective covering the systems for communicating to the entity initiating the voting instruction, stock positions and whether any stock has been lent, as well as controls over the voting process. I expect custodians and fund managers alike to expand their FRAG 21/94 reports to address these issues where they do not do so already.

I do not believe that the issues that surround stocklending necessarily stop here. In particular, as well as a general increase in stocklending, it was reported to me that stocklending could be particularly high around the time of a company's AGM. I understand this is due to shares being temporarily borrowed so that the Advance Corporation Tax attached to dividends due can be offset against corporation tax liabilities. In July 2005, the International Securities Lending Association issued a publication, Securities Lending and Corporate Governance[7], which explored how

[7] http://www.isla.co.uk/sl_corp_governance.asp

securities lending can be aligned with good corporate governance. One of the report's recommendations is that the gap between the record date for dividends and for voting should be widened in order to boost voting levels. Although not supported by all members of the SVWG, I am in favour of this proposal and hope that the market will respond accordingly.

Furthermore, stocklending is not the only type of transaction/instrument that can result in ownership and voting rights being misaligned. American Depositary Receipts (ADRs) frequently involve a facility that, in effect, means that voting rights accrue to the issuer and not to the holder of the Receipt. The operation of contracts for difference (CFDs) and hedge funds can also have an impact. This is currently being reviewed by the Takeover Panel.

Going forward, I intend looking at these types of transactions/instruments and their implications for voting. To this end, I am inviting the London Investment Banking Association, which has a particular interest in CFDs, and the Alternative Investment Management Association for hedge funds to join the Group.

Voting joined up to the investment process

I believe it is important that voting is part of an institution's wider ownership responsibilities and that it should be integrated into the investment process. I was, therefore, pleased to see, in the IMA's annual survey of fund managers' engagement[8], that the final decision on a contentious issue is taken at a senior level in the organisation in 16 of the 34 managers surveyed, and by or with the active involvement of the fund managers in a further 17; in only one is the decision reserved to the corporate governance specialist.

Shareholder meetings

Much of the foregoing concerns the processes that lead up to the actual shareholder meeting where the votes are registered or cast. I made various recommendations relating to the meeting itself in my initial report and am pleased to note that a number of them have been adopted by Government in its Review of Company Law and included in the clauses for the new Company Law Reform Bill as set out below.

- The rights of proxies are to be expanded and put on a statutory footing such that proxies will be able to vote on a show of hands and, if a member appoints more than one proxy, each proxy will have a vote (clause 299[9]). The Bill also allows multiple corporate representatives (clause 298). In addition, the enhancements to the rights of proxies should enable a corporate representative to appoint more than one proxy or designee to exercise meeting rights against the shares held.

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[8] The Investment Management Association's Survey of Fund Managers' Engagement with Companies for the year ended 30 June 2004. In aggregate, as at 30 June 2004, these managers managed £52billion of UK equities or 55% of all UK equities managed.

[9] Company Law reform Bill [HL], HL Bill 34-1.

- An independent scrutiny of a poll of quoted companies is to be provided for in that shareholders, representing not less than 5% of the total voting rights who have a right to vote on the matter to which the poll relates, will have the right to require a scrutiny of a poll (clause 316). The scrutiny report will have to be disclosed on the company's website (clause 325).

- Quoted companies are to be required to disclose on a website the results of polls and votes for and against at general meetings (clause 315).

- Weekends or bank holidays are not to be included when calculating the 48-hour time limit for the receipt of proxy appointments (clause 302).

  However, the clauses do not set two working days before the day the meeting as a minimum, as recommended in my original report. That is, under the new law issuers will continue to be able to set a shorter time frame. I understand that the Uncertificated Securities Regulations will be amended similarly to exclude weekends or bank holidays in relation to the time limit for setting voting entitlements after the changes to Company Law have been made.

- Quoted companies will be required to put the preliminary announcement of their annual result and their annual reports on their website (clauses 406 and 407, respectively).

I believe some of my other recommendations would best be implemented through the Combined Code, as opposed to Company Law. The Financial Reporting Council's (FRC) current review of the Code is a suitable opportunity for it to be amended and the areas that I believe need to be addressed are detailed below.

- In the interests of transparency and equity and on the basis that attendance at meetings can be unrepresentative, in my report I recommended that best practice should be to call all resolutions on a poll.

  I understand that there has been little change in this regard. Figures from RREV show that of those companies that disclosed voting levels for 2005, all resolutions were taken on a poll in 42% of FTSE 100 company meetings (2004: 36%) and 8% of FTSE 250 meetings (2004: 11%) to 31 July 2005.

  I have written to the FRC suggesting that the Combined Code is amended to clarify that, at the minimum, the Chairman's duty is always to demand a poll when he is aware that the outcome would be different from that reached on a show of hands, regardless of whether the vote is binding on the company. In addition, although on the grounds of cost and the extra administration involved, one or two members of the SVWG have reservations, I personally believe there is a case for considering a provision in the Combined Code that it is best practice for all resolutions to be voted on a poll.

  It has been put to me that voting by a poll disenfranchises the private investor and eliminates the theatre of the AGM. Both assertions are flawed. Those private investors attending AGMs tend to account for a small minority of a

company's private shareholders. I am confident that the majority of private shareholders indicate their voting intentions by proxy. Their expressed intentions will count for nothing unless there is a poll. As for the theatre of the AGM, the authority of the private investor lies in the right to openly challenge and express views, far more powerful for them than the act of voting. Taking votes on a show of hands is inconsistent with the fundamental principle of one share, one vote and cannot be said to accurately reflect the weight of the proxies submitted. The system developed by the registrars of electronic polling with instantly reportable results obviates the economic case that previously supported voting by a show of hands on the basis of cost.

Furthermore, the Company Law Reform Bill includes a clause (clause 866) that gives the Treasury power to make regulations to require institutional investors to disclose how they have exercised the voting rights attached to the shares they own, or have an interest in. I express no view on this matter other than to observe that the issues involved are complex and precision is required in determining what is meant by exercising a voting right and in particular, whether submission of a proxy would be recorded as exercising a vote. Another reason why I favour the end of voting by show of hands.

- Another of my recommendations was that companies should disclose the results of polls, or where a poll is not called, the level of proxies lodged, on a web site and in summary in annual reports. As noted, the Government has issued the relevant clauses in the Company Law Reform Bill so that quoted companies will be required to disclose on a website the results of polls and votes for and against at general meetings. However, not all resolutions are necessarily taken on a poll and there is no consideration of votes consciously withheld.

  Both RREV and Manifest reported a wide variation in the disclosures made by companies. To quote RREV "a number of companies adopt minimal compliance and merely announce or display such figures at the AGM itself" or just announce "whether each resolution proposed at the general meeting was passed or not". There is a provision in the Combined Code for companies "except where a poll is called, [to] indicate the level of proxies lodged on each resolution, and the balance for and against the resolution and the number of abstentions after it has been dealt with on a show of hands". However, this does not require companies to announce the results in public nor does it require the results to be disclosed when a poll is called.

  To address these limitations, I have written to the FRC proposing that the Combined Code is amended to require companies to disclose on a web site the results of polls at general meetings and, where a poll is not called, the level of proxies lodged on each resolution, including votes for, against and consciously withheld.

- Lastly, I recommended that companies should provide a vote withheld option and, when declaring results, publish the number of votes or proxies for and against, and consciously withheld.

According to RREV, for 92% of company meetings of the FTSE 100 in 2005 and where results were disclosed either publicly or to RREV, voting forms had an abstention/vote-withheld option. This is an increase from 2004 when I understand it was 85% for the FTSE 100. The FRC has specifically asked for views on whether companies should be directed by the Code towards providing a "vote withheld" box on proxy voting forms and to publish the number of votes withheld in the same way as votes for and against. I have written to the FRC encouraging it to address this as part of its review.

Future steps

In conclusion, I am encouraged by the progress made by the participants in the voting chain over the last eighteen months in adopting my recommendations and in the apparent improvements in the efficiency and effectiveness of the system for voting UK shares. That said, this momentum needs to continue in that there are still a number of recommendations where more could be done. Furthermore, the landscape is changing and other factors and issues arise that impact on the voting process and which merit attention going forward. I, therefore, consider the SVWG should continue to have a voice and address these issues. In the immediate term, the matters I intend focusing on include those set out below.

- Electronic voting and the transmission of instructions electronically straight from the person making the voting decision to the person recording the vote remains the key to a more efficient voting system and I will continue to monitor the extent to which issuers facilitate electronic voting and the take up by institutional investors.

- It is important that ownership and voting rights are aligned. I have looked at the implications of stocklending and will continue to monitor the situation. However, other types of transactions are gaining increasing prominence and the stamp duty regime provides an incentive to enter into CFDs as opposed to making an outright purchase of shares. I will be looking at transactions/instruments such as CFDs, hedge funds and ADRs, and their effect on voting.

- Lastly, it is critical that progress continues to be monitored and reviewed to see whether the system is operating effectively or whether votes continue to be lost. To this end, I will be encouraging issuers to trace votes, such as the exercise undertaken by Unilever, to determine whether votes are lost and if so why, and, importantly, to publish their findings. Corporate governance requires a high level of confidence in the integrity of the voting process. Voting failures are not acceptable