*Transparency of security ownership and the accountability of capital markets participants. "Getting to know you... an exercise in frustration" A critical legal analysis of the transparency and accountability of capital markets participants in their role as owners and controlling agents of public companies*

Nick Stansbury

# Transparency of Security Ownership and the Accountability of Capital Markets Participants

"Getting to know you . . . an exercise in frustration"[1]

A critical legal analysis of the transparency and accountability of capital markets participants in their role as owners and controlling agents of public companies.

*Nick Stansbury*





1 Lauren John, CFO Magazine, March 1998
*The problem of identifying beneficial share ownership*

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## 1.1 Introduction

### 1.1.1 The broad issue of control of public companies

> By making ordinary business decisions managers now have more power than most sovereign governments to determine where people will live, what work they will do, if any; what they will eat, drink and wear; what sorts of knowledge, schools and universities they will encourage; and what kind of society their children will inherit. [2]

Public companies exert significant, and growing, influence over the daily lives of individuals all over the world. There is therefore developing concern and awareness of the broad issues of their control, monitoring, transparency and accountability. The increasing frequency with which governments, past and present, have instituted reviews of the exercise by the owners of these companies of their responsibilities of ownership, and of the effectiveness of our systems of corporate governance, accounting, auditing and disclosure, suggests that this concern is both widespread and being taken very seriously. This concern has been particularly marked after numerous manifest failures of control systems in place both at home in the UK and the US, but also in other countries with less developed systems and processes of corporate governance.

The purpose of this thesis is to examine the role of capital markets in the monitoring and governance of these companies, specifically looking at the transparency and accountability of market participants, especially institutional investors, in the governance process.

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[2] Richard J Barnet & Ronald Mueller, quoted in "Corporate Governance", 3rd Edition, Monks & Minow, 37

This thesis is divided into six uneven parts. In this first section the author will demonstrate the importance of the role that market participants play in corporate governance and explain why it is important that they are accountable for the way in which they participate in this process. The second section will focus on transparency of ownership as a crucial component of the overall transparency process – and explain why transparency of ownership is effectively a precursor to effective full market transparency. In addition it will examine a number of non-governance related issues. The third section will attempt to set transparency of ownership in the context of the real world marketplace, by looking at the existing ownership structures, explain the importance and specific problems created by the prevailing trust structures used, and look at the implications of institutional "outsourcing" by pension funds and other key participants to dedicated institutional management firms, and the problems this creates for market accountability. In the fourth section the author sets out a proposed benchmark, taking into consideration all of the issues and qualifications developed in the second and third sections. The last two sections will, respectively, compare existing legal structures in several key markets to the proposed benchmark, and make some tentative suggestions for reform.

## 1.2 The case for market participant involvement in corporate governance

This section will set out a case for, and the importance of, the active involvement of capital market participants in the corporate governance process. It will show that institutional investors play a central role in the governance process, especially in the context of monitoring and oversight. It will also be shown that, given the societal importance of the protection of ownership rights and the natural self-interest and

conflicts of interest of corporate managers, market participants are best placed to protect and enforce such rights. However, it will also be argued that capital markets suffer from similar conflicts of interest and will introduce the second section of this thesis which argues for increased transparency of market participant behaviour, specifically of the securities in which they are interested.

### 1.2.1 What is corporate governance and what role do capital markets and institutional investors play?

> Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance[3]

Institutional investors play a vital role in the allocation of global capital to industry. The author intends to show through this thesis that the accountability of these participants is inadequate given the significant, if under realised, role that they play in the governance of public companies. It is, however, important to understand that, for the purpose of this thesis, a discussion of, and argument related to, corporate governance will be primarily focused on the means by which these providers of capital can be guaranteed, with reasonable and discrete certainty, the means to, but not the realisation of, satisfactory returns on their investments, such that the market is free to compensate investment risk at an appropriate and undistorted rate. In other words, the author takes corporate governance to be primarily concerned with

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[3] OECD April 1999. OECD's definition is consistent with the one presented by Cadbury [1992, page 15]

making sure that investors have adequate realisable protections to enable them to secure a reasonable return on their investments, but is not concerned with ensuring that such returns actually happen. The key to this distinction is recognising that corporate governance concerns itself with the form and process of decision making and not with the substance of those decisions. An example of this distinction is illustrated by examining the issue of dividend policy and payments.

Dividend payments have been the subject of significant legislative attention. Generally, the law has been concerned with ensuring dividends are paid equally, minority shareholders do not suffer prejudice, and that shareholders' rights to a dividend are not exercised at the expense of other capital providers[4]. However, it is very rare to find legislation concerned with the levels of payout ratios, other than in certain specific industry-systemic cases, such as US state utility companies. Donald C. Cook, Commissioner of the SEC in 1951 stated that "Of course, dividend policy must vary for each company and must take into consideration numerous factors such as capital ratios, the nature and volatility of the company's load, size and history of the company..."[5] In other words, the returns available in dividends to investors are not a matter of regulation of governance systems, but are down to the circumstances of each individual company and its investors. Thus, primarily due to time and length constrictions, this thesis will not consider issues related to comparative analysis of capital costs or capital returns under various markets and governance systems.

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[4] C.f. s.830(2) of the Companies Act 2006 (Replacing s.263(3) of the Companies Act, 1985) , provides that "a company's profits available for distribution are [only] its accumulated realised profits", which particularly provides protection for a company's creditors.

[5] Excerpt taken from address entitled "The Current Utility Scene", made by Commissioner Donald C. Cook of the SEC on March 29, 1950. Quoted in "Security Analysis", Graham & Dodd, 1951, 592 & 736

1.2.1.1 The importance of the protection of owner's rights.

The protection of owners'[6] rights is essential for economic prosperity and development, for without it not only will capital flow to more secure regions, but capital that is invested in regions with lower protection will have a higher cost as the suppliers of capital demand to be compensated for the higher risk[7].

This is a well established academic position, with the author's case well summarised in Copeland's work on shareholder value:

> Regardless of what you think about the merit of stakeholder claims relative to each other, one thing is certain: if suppliers of capital do not receive a fair return to compensate them for the risk they are taking, they will move their capital across national borders in search of better returns. If they are prohibited by law from moving their capital, they will consume more and invest less. Either way, nations who don't provide global investors with adequate returns on invested capital are doomed to fall farther behind in the race for global competitiveness and suffer a stagnating or decreasing standard of living [author's emphasis]...It is easy to see how capital flows when we look at the world from an investor's point of view. If ROIC [Return on Invested Capital] is less than zero, a company cannot generate enough cash to stay in business...if the ROIC is greater than zero but less than its weighted average cost of capital (WACC) the company may be "profitable" but it will not provide an adequate return to the suppliers of capital...the company is destroying value...when capital is not earning the required rate of return the market decreases its value until the rate of return reaches competitive levels. Value is destroyed.[8]

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[6] For the purpose of brevity, where the term "owners" is used in this thesis, the author is referring to the owners of all instruments, derivative or otherwise, where the underlying security is a public company or subsidiary thereof.
[7] See A. Maddison, Dynamic Forces in Capitalist Development, London Oxford University Press, 1991
[8] Copeland, Koller and Murrin (McKinsey & Company, Inc.), "Valuation : Measuring and Managing the Value of Companies", 1995, 27-28

1.2.2 Managers, when left entirely to their own devices, will generally act to further their own interests rather than the interests of investors.

If the suppliers of capital do not either put in place themselves, or, arising from a legal and regulatory regime, have structural measures already in place, managers will, generally speaking, use their positions of control and authority to act primarily in their own interest. These self concerned activities have been dubbed the "private benefits of control"[9] and the forms they take and how they are exercised have been adequately covered by existing research that does not need to be repeated or summarised here[10]. The costs of these private benefits are significant – not only to investors who will see a reduced return on their invested capital, but to the economy and society as a whole – where capital is allocated and used inefficiently, products will inevitably become less competitive and providers of labour will suffer as their jobs disappear. Market participants are best placed to monitor the managers and directors of firms; given the impact that self-interested behaviour may have on individual economies the accountability of those market participants is vital.

1.2.3 Managers should act with the primary aim of maximising long term return on equity, except under very specific legally defined circumstances.

Otherwise known as the doctrine of shareholder primacy, it is generally accepted that the concerns of shareholders are the primary concern of managers. In the UK, directors have

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[9] Grossman, Sanford and Oliver Hart, 1988, "One share-one vote and the market for corporate control", Journal of Financial Economics, 20, 175-202

[10] For examples see : Baumol, William, 1959, "Business Behaviour, Value and Growth", Macmillan (New York). Jensen, Michael, 1986, "Agency costs of free cash flow, corporate finance and takeovers", American Economic Review, 76, 323-329.

fiduciary duties, a concept developed in the law of Trusts, to the company itself, which has in practice been taken to mean the members. In the US, the case law is equally clear: "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes."[11]

In the UK, the issue might have been blurred by s.309 of the Companies Act 1985. This amendment appeared, on its face, to require a company's directors to consider the interests of a company's employees. The CLR, in its strategic framework, has ruled out a "dualistic" approach and come down in favour of an "enlightened shareholder" approach[12]. This uncertainty has been fully resolved in the Companies Act 2006, under s. 172, which lists a number of factors and considerations that directors should note, but only for 'strategic' reasons. This recognises that the interests of the "enlightened" shareholder are best served, for example, where employees are developed and satisfied in their labour and when the consumer's interests are recognised. Adam Smith stated that "[a businessman] intends only his own gain [but] he is...led by an invisible hand to promote an end which is not his intention...by pursuing his own interest, he frequently promotes that of society more effectively than when he really

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[11] Dodge v. Ford Motor Co. 170 N.W. 668 664 (Mich. 1919)
[12] See Ch. 5.1 and Ch. 2 para's 3.20 – 3.31

intends to promote it"[13] (this author's emphasis). Berle & Means whilst disagreeing in their conclusion recognised that

> Organization under the system of private enterprise has rested upon the self-interest of the property owner – a self interest held in check only by competition and the conditions of supply and demand. Such self-interest has long been regarded as the best guarantee of economic efficiency[14]

Furthermore, the great unperceived irony of counter-arguments to this position, is that those groups who are often most audible in their insistence for other interests to govern managerial decisions are the providers of labour, and it is precisely this group that has the most to gain out of managers running public companies in the interest of shareholders.

> Shortly before the year 2000 there will be more workers in companies that are more than 15 percent employee held than in the entire US trade union movement. The property rights of workers will dwarf labor laws as an option for influence in corporations. For the first time since the 1930's America will see a new wave of employee activist...but this time unions will be joined by company-wide employee associations – ad hoc and co-ordinated – asking for a say because they are either the dominant shareholder or the second major shareholder in the firm[15]

There are however some qualifications to this position. As a company approaches insolvency, this position does change and directors' duties shift somewhat from the shareholders to the creditors[16]. The only other circumstances where this position changes is where there is a specific relationship between one or more directors and one or more shareholders where

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[13] Adam Smith, Wealth of Nations, at 423

[14] Berle & Means, "The modern corporation and private property", 1991, at 8.

[15] Blasi & Kruse, "The new owners: The emergence of Employee Ownership in Public Companies and What it means to American business", New York, 1991 at 3. Also see Drucker, "The Unseen Revolution, How Pension Fund Socialism Came to America", New York, 1976, esp. at 1.

[16] Note s. 172(3) Companies Act 2006, and also West Mercia Safetywear Ltd. V. Dodd [1988] B.C.L.C. 250 CA and Re Welfab Engineers ltd. [1990] B.C.L.C. 833

specific additional duties may apply[17]. Given that the above position is generally applicable to small or family run companies it can be set aside from consideration, except in the context of takeover bids[18], although for public companies in the UK this issue is fully dealt with under the City Code on Take-overs and Mergers.

### 1.2.4 A company, whilst being a separate legal person, does not have interests of its own – merely those of its members.

Some commentators, academic and professional, have argued passionately that corporations exist as separate entities with discrete interests and objectives[19]. Some have compounded this discussion with the issue of the interests and objectives of the corporation with the consequence of relegating the interests of the shareholders to below those of other members of society:

> For the corporation is merely the way of doing things...The special interests or needs of individuals who occupy some place in the corporate structure are inferior in importance to the functional effectiveness of the corporation itself. What, then is the true status of the stockholder? If the corporation will survive only should it continue to prove itself the best way of meeting society's need for expansion of the means of production, does not this leave the stockholder in a somewhat questionable position? Of course it does. It subordinates the interest of the individual partial proprietor to the larger social interests of which the corporation is the most important organic unit.[20]

The author does not accept any argument that a company exists as a distinct entity with independent objectives and interests – except under legal "fiction" as a distinct legal

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[17] See Peskin v. Anderson [2001] 1 B.C.L.C. 372 at 379 also see Coleman v. Myers [1977] 2 N.Z.L.R. 255 NZCA

[18] See Re A Company [1986] B.C.L.C.

[19] C.f. Concept of the Corporation, Peter F. Drucker, New York, 1946. Drucker writes a total of 290 pages on the subject, without mentioning shareholders, stockholders or owners once, nor do these words or equivalent appear once in the index.

[20] Jackson Martindell, "The scientific appraisal of management", 1950, at 136-138

person with its own discrete set of interests and objectives. Nourse L.J. states, "The interests of a company, as an artificial person, cannot be distinguished from the interests of the person who are interested in it".[21] The objectives of the owners of a company are the objectives of the company, and hence of management – and nothing else. Whilst accepting this is a contentious issue, the author takes the generally accepted position and does not consider it appropriate to defend it in detail here, save to quote Graham and Dodd's response to these arguments.

> We disagree with this view of the public stockholder's position. To our mind it has dangerous implications not only for investors but for the cause of free enterprise as well. It has led, on the one hand, to the suggestion of Berle and Means that the large corporation be controlled in the interest of the "wider public" rather than of the public stockholders; on the other hand, to James Burnham's prediction that, just as the public stockholder has abdicated control of large business to their managements, so the citizen is certain to abdicate control of the state to the managerial class. If stockholders act as intelligent ***owners*** they will serve society adequately, in the same way as the merchant serves society by running his business skilfully and the worker serves society by doing his job well and being paid for it well. Any other concept of the function of corporate ownership is likely to result in confused standards, in the exploitation of stockholders, and in the discouragement of investment in equity securities[22]

1.2.5 Just as managers are essentially self-interested, so are capital market participants. These participants are not only self-interested but are also subject to a variable, complex and opaque web of inter-related conflicts of interest. Their accountability is therefore absolutely crucial just as it is with company managers.

No one, however professional or experienced, is immune to either self-interested behaviour, or to conflicts of interest. There has been a lot of criticism, particularly recently, of company managers for both conflicts of interest as well as for their self-interested behaviour.

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[21] See Brady v. Brady [1988] B.C.L.C. 20 at 40, CA – dictum by Nourse L.J.

[22] Graham & Dodd, "Security Analysis", 3rd Edition 1951, New York, at 610 (their emphasis as quoted).

This is important and valid, but ignores the fact that those who are often pointing the finger, market participants, are also subject to exactly the same sort of conflicts and self-interests, even though they manifest themselves in different ways.

> "I believe there is now a fundamental imbalance between the obligations of openness and transparency which are laid on the corporate sector and those of the financial institutions and the banks... Companies enjoy some flexibility in the policies they apply and how they report against them; and observers and stakeholders are expected to make an overall judgement in the light of this as to whether a company is living up to the spirit rather than simply the letter of a code... [which] builds and rewards trustworthy behaviour...[however] turn the spotlights onto the financial markets [and] frankly I do not see the same quality of governance or transparency in all of its dealings. Nor do I detect a strong will to tackle the problem effectively"[23]

The best way to approach this discussion is to divide market participants into two discrete groups, the institutional buyers and sellers of securities (commonly known as the "buy-side") and the arrangers, agents, advisers and "transact-ors" (this group *includes* those often referred to as the "sell-side"), and to look at their position entirely separately.

### 1.2.5.1 The "buy-side"

This group are obviously the most important group to consider in this process. They include managers of pension funds, unit-trusts, o.e.i.c.s, insurance companies, hedge funds and private-client wealth managers, among others. A breakdown showing funds under management between these groups is show in table 1.3.5.A below. The single largest problem in analysing the transparency of this group is its diversity. The set of objectives and behaviour, for example, of pension fund managers differs wildly from those of unit trust managers.

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[23] John Sunderland, speech given 21st April 2005 (the author is grateful to Mr. Sunderland, and to Liz Atkins of Cadbury-Schweppes, for making a printed version available to the author on request). Speech originally reported in the Financial Times 22nd April 2005 edition, page 1.

Table 1.3.5.A - extract from the Myners report on Institutional Investment

| | End Year | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Institution | 1963 (%) | 1975 (%) | 1981 (%) | 1989 (%) | 1994 (%) | 1997 (%) | 1998 (%) | 1999 (%) |
| Pension funds | 6.4 | 16.8 | 26.7 | 30.6 | 27.8 | 22.1 | 21.7 | 19.6 |
| Insurance companies | 10.0 | 15.9 | 20.5 | 18.6 | 21.9 | 23.5 | 21.6 | 21.6 |
| Unit trusts, investment trusts & other financial institutions | 12.6 | 14.6 | 10.4 | 8.6 | 10.1 | 10.6 | 9.0 | 9.7 |
| Banks | 1.3 | 0.7 | 0.3 | 0.7 | 0.4 | 0.1 | 0.6 | 1.0 |
| **Total UK institutions** | **30.3** | **48.0** | **57.9** | **58.5** | **60.2** | **56.3** | **52.9** | **51.9** |
| Individuals | 54.0 | 37.5 | 28.2 | 20.6 | 20.3 | 16.5 | 16.7 | 15.3 |
| Other personal sector | 2.1 | 2.3 | 2.2 | 2.3 | 1.3 | 1.9 | 1.4 | 1.3 |
| Public sector | 1.5 | 3.6 | 3.0 | 2.0 | 0.8 | 0.1 | 0.1 | 0.1 |
| Industrial & commercial companies | 5.1 | 3.0 | 5.1 | 3.8 | 1.1 | 1.2 | 1.4 | 2.2 |
| Overseas | 7.0 | 5.6 | 3.6 | 12.8 | 16.3 | 24.0 | 27.6 | 29.3 |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

Source: ONS, 'Share Ownership. A Report on the ownership of shares at 31/12/99', p8.

Furthermore "hedge funds" can differ so widely in terms of their behaviour, nature and size that it is hard to compare any two with each other. The following general observations can however be made:

1) In general, the fund management industry has performed extremely badly over both the short and medium term to the extent that the average fund manager would have performed better had he not changed his holdings even once over the past 10 years[24]. However, fund managers still compare their performance primarily to index-based benchmarks and are rewarded according to their gains or losses relative to this index over a short term period.

2) There are few legal means available to obtain information on either the performance of fund managers as owners (i.e. their voting records, time spent in meetings with management, feedback processes to management etc.) or the terms of their remuneration - or even a general remuneration policy or framework.

[24] Quoted by Paul Myners in his speech at the 2005 IIRF Conference in Amsterdam, a recording is available at http://www.iirf.org/calendar/conferences/2005amsterdam

This is in very sharp contrast to the reporting duties that are laid upon the management of public companies in both the UK and the US. Concerns have also been raised over the fees charged by certain sectors of the industry: "The hedge fund industry is remarkable. They seem universally to charge 2% commission and 20% of the alpha. It looks a lot like retail price maintenance...or perhaps there is another name for it?"[25]

3) Fund managers are subject to serious conflicts of interest with regard to the way they behave as owners.[26] Monks characterises the fund management industry as a "Web of mutually self-supporting interests" and subject to "conflicts of interest that envelop the institutional ownership world"[27] It has been argued that the heart of these conflicts are a misalignment of corporate direction and shareholder interests as well as issues of stewardship and wealth creation[28]. It is regularly argued that, in general, these conflicts result from problems of agency[29], most importantly the conflicts between internal management and outside owners that result from the separation of ownership and control[30]. Ingley and Van Der Walt argue that :

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[25] John Sunderland, supra.

[26] See Gunther, "Investors of the World Unite!", 2002, Fortune Magazine, 145, 78

[27] Monks, "Creating value through Corporate Governance", Corporate Governance : An International Review, 2002, 10, 116-123

[28] C.f. Healey, "Corporate Governance & Wealth Creation in New Zealand", 2003, Palmerton North, NZ

[29] Kose & Senbet, "Corporate Governance and Board Effectiveness", 1998, Journal of Banking & Finance, 22, 371-403

[30] See Paris, "A compound option model to value moral hazard", Journal of Derivatives, 2001, 9, at 53-62 Kostant, "Exit, Voice and Loyalty in the course of corporate governance and counsel's changing role", Journal of Socio Econonics, 1999, 28, at 203-247. Brown Jr., "What do institutional investors really want?", Corporate Board, 1998, 17, 5-10. Kose and Senbet, "Corporate Governance and Board Effectiveness", Journal of Banking & Finance, 1998,

Separation of ownership and control has resulted in managerial dominance and concentration of power among corporate elites. Contribution to this asymmetry of power and control is the abdication by shareholders of their responsibility as owners through passivity and absence of voice in the affairs of the corporations in which they invest...Since different types of capital contributors and other stakeholders have different types of utility functions from the firm, the conflicts of interest that develop and the agency problems they cause are dissimilar. The utility function of different classes of stakeholders also varies and the degree of alignment of interests with those agents in the firm who control the major decisions is also different. This gives rise to conflicts among stakeholders and these "Incentive" conflicts have become known as agency (principal-agent) problems. Uninhibited, each class of stakeholders will pursue its own interests...at the expense of the other stakeholders [31]

Much of this thesis is concerned with examining some of the impacts of just this principal agency problem. However the author believes that there are three additional areas of conflict that are often overlooked.

a. It is an accepted fact that some categories of fund managers (in technical terms *active, non-quantitative, fundamental* managers) depend upon meeting the management of companies on a regular basis in order to make informed investment decisions. This is often termed "corporate access" – (the making available of senior management to meet in person with fund managers). The author's own experience working on both sides of this process[32] as well as currently running IIRF research suggests that this process is governed largely

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22, at 371 – 403. Also see Shleifer and Vishny, "A survey of Corporate Governance", The Journal of Finance, 1997, 52 at 737-783

[31] Ingley and N.T. Van Der Walt, "Corporate Governance, Institutional Investors and Conflicts of Interest", Corporate Governance, 2004, 12, 4, at 535

[32] The author has worked in both Investor Relations, and currently, as a buy-side investment analyst regularly attending such meetings.

by corporate brokers and investment bankers, who collectively organise the vast majority of all meetings organised by these groups[33] Access to management depends upon being a client of whichever broker is organising the meeting. Put more plainly, fund managers have to pay a non-independent third party for the privilege of meeting with the very people who they indirectly employ to run the companies that they own. This access is dependant not just on size, or even on ownership status, but is largely based on the amount you pay to the organising broker in terms of trading commissions. Fund Managers are therefore under a systemic pressure to trade high-volumes at high-commission rates in order to gain essential insights to outperform the rest of the market. This is in conflict with the interests of the client – namely paying low transaction costs and trading less frequently. Furthermore if access to management is limited, fund managers are also encouraged not to stir up too much trouble; if a fund manager asks questions that are a little too probing, or too awkward, not only can management refuse to answer them, the individual concerned could simply not be invited to the next set of meetings. The structure in place actively dissuades investors from playing too active a role as owners – for fear of being cut-off from the access to management on which they depend, not just with the company in question, but far more broadly.

[33] The IIRF is currently working on what the author believes to be the first piece of comprehensive research on the extent of the control of the corporate meeting process by corporate broking arms of investment banks. It is as of the date this thesis goes to print still unfinished and no firm results are available for reference to, however preliminary findings would seem to support this hypothesis. See http://www.iirf.org/research for further details. Other than this research there appears to be no documented evidence of this aspect of the authors argument, which must be taken into account when considering its' merit.

b. The free-rider problem : Fund managers also face a conflict of interest in terms of taking an active role as owners of companies they invest in. Whilst active involvement in companies has brought significant returns to some investors (well known examples include Erik Knight, of Knight Vinc Asset Management and CalPERS[34]) there is a general disincentive to engage as active owners individually because of what is generally known as the free-rider problem. An activist will, whilst paying the full cost of his activism, receive only a small part of the benefits, as well as there being an equal and opposite disincentive to act because of an expectation that someone else will act instead. It becomes cheaper for a shareholder to sell-out (possibly justifying his actions by arguing that he is enabling the market for corporate control to take effect and that if the share price falls low enough the incumbent management will be replaced by takeover) than it is for an individual fund manager to take direct action against management.

c. Even those self-proclaimed "activists" investors often engage in conflicted behaviour. Tom Donohue, CEO of the US Chamber of Commerce, has dubbed this "ugly...anti-value" activism. He sets out his thoughts in an article in 2006 Equities magazine :

A small minority of these investors spends a lot of time pressuring management to do things that are unethical, unnecessary and a value killer. Some push to take on lots of debt so the companies can pay special one-time dividends. Some press for spin-offs...Sometimes rumour campaigns are started that drive down stock value to benefit a very small number of abusive short holders...Not all

[34] CalPERS is an infamous U.S. pension fund, covering public employees in California – see "c" below.

proxy battles are created equal. Some are about value. But many times, proxy battles represent a power grab that hurts every other investor in the company. Here's a particularly glaring incident. In 2004 CalPERS, the huge California public pension fund attacked Safeway, its chairman and two of its board members. At the time CalPERS said its sole concern was to eliminate conflicts of interest and improve corporate governance. But CalPERS had its own conflicts of interest. **The chairman of CalPERS, at the time, was the chairman of the union that had that long strike against Safeway. And he lost his shirt because he didn't win**...[35] [Author's emphasis]

> Furthermore, Monks has pointed out that many institutional investment firms have failed to act on behalf of their investors because they want to manage corporate pension money[36].

If the managers manage a company pension fund, anything less than unquestioning support for that company's board may lead to loss of the business, since a majority of the trustees are usually directors or former directors of the company. If the fund manager is part of a banking or financial services group, the company management may threaten to terminate banking or other relationships...But the most common agency problem arises from fund managers' own business interests. At any time some sponsoring companies of pension fund clients may be underperforming. Directors are unlikely to welcome shareholder activism from the manager. Even those doing well may be hostile to such activism as future discipline.[37]

> It is clear that when fund managers are not independent actors, free from the same interrelated web of interests and activities that the rest of us have, that just like any other group that wields significant power with the potential to impact upon us all, they need monitoring.

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[35] Tom Donohue, "The Good, The Bad and the Ugly!", Summer 2006 Equities Magazine, 4 2006, at 63
[36] Monks, cited in Gunther, 2002, supra.
[37] Modern Company Law, "Completing the Structure", 2000, at 72

1.2.5.2 Other market participants

It has not just been the buy-side who have been responsible for "pointing the finger" in recent discussions on corporate governance. Whilst these groups of actors are not as relevant to this thesis, the following general observations should be noted:

1) A large portion of buy-side investment managers are owned by large "bulge bracket" multi-function investment banks. Asset management functions are not only less glamorous but less profitable than advisory, capital markets and trading operations (to the extent that many have been selling their asset management functions). The interests and objectives of these other actors are widely conflictive with the interests of the asset management operations – particularly where the company in question is a client of the bank in question. Whilst banks theoretically have "Chinese walls" in place between the various functions, it is naïve to assume that those on the asset management side do not come under conflicting pressures during the day to day course of their activity.

2) This group of market participants do exert significant influence over buy-side managers, and because of their positions relative to those managers it is important that not only are the fund managers monitored to determine the extent of that effect, but the transaction-orientated market participants should also be carefully monitored. Because these participants are generally rewarded on a transactional basis (i.e. through transaction related advisory fees, transaction commissions or through the investing of proprietary stakes) we need to be particularly cautious. They are generally not interested in providing the best objective advice, but in

generating deal-flow or trading, and especially given the influence they hold over buy-side investment managers (for example through the provision of corporate access or investment research) a particular degree of caution is required,

1.2.6 Capital market participants are not merely the recipients of the benefits of corporate governance structures, but are independent actors with discrete sets of responsibilities and obligations.

Discussions of corporate governance regularly focus on the enforcement of investors' rights. This is obviously a central issue. However, an analysis of the functioning of governance processes in isolation of the responsibilities or obligations of the providers of capital will be incomplete. There is a complex, and often contentious, matrix of legal, factual and competitive obligations and responsibilities that act to significantly affect the behaviour and motivations of investors – whether to each other, to ultimate beneficial owners (i.e. a unit trust fund manager to his subscribers), to legal bodies (i.e. money laundering reporting duties to the FSA or other body) and possibly obligations to society as a whole in common with the responsibilities of all other owners of property. In the same way as a detailed consideration of the rights investors currently enjoy is compared to the rights that, for reason of sound legal argument, one believes they should enjoy, so a proper discussion of this issue should include a comparison of the current obligations on investors and obligations that, for reason of sound legal argument, one believes they should have. In short one can divide these obligations into three categories

1.2.6.1 Obligations to regulatory bodies.

All investment managers are subject to reporting and behavioural duties to regulatory, standard setting or industry bodies in just the same way that other professional groups are. For example, in the UK, the Financial Services and Markets Act 2000, gives the FSA the power to administer and enforce the registration of companies

covering regulated activities, as well as giving it the power to de-authorise and fine authorised companies. The FSA has set out, in its conduct of business (see the FSA handbook for detail on the full C.O.B.) a series of guidelines which are considered best practice and followed by the majority of authorised firms at least in part.

1.2.6.2 Obligations as fiduciaries or contractual obligations to best performance.

The clear position, on full consideration of the evidence, is that active ownership *combined with* active investing is the key to consistent superior returns[38]. The Gordon Group reported that "A partnership catalyzing such activity...can expect to provide a return substantially above the baseline"[39], and argue that such abnormal returns might, in 1992, have been in excess of 30%. Interventions do not even have to actually be successful to deliver returns[40] and some commentators have argued that the mere act of observation can have a significant impact[41]. The impact does not have to be restricted to one or a small set of companies, as Stapledon sets out in some detail the positive impact that UK institutions have

[38] See Nesbitt, "Study Links Shareholder Proposals and Improved Stock Performance", Wilshire Associates, 1992, Nesbitt "Long Term Rewards from Corporate Governance", Wilshire Associates, 1994, Gordon & Pound, "Active Investing in the US Equity Market: Past Performance and Future Prospects", Gordon Group Inc., 1992, Jacobs "Break the Wall Street Rule", Addison-Wesley, 1993, "Audience with Bob Monks", LSE IR Insight Magazine, 2005, Bernard S. Black, "Institutional Investors and Corporate Governance: the Case for Institutional Voice", Journal of Applied Corporate Finance, Fall 1992, Michael T. Jacobs, "Short term America: The causes and cures of our business myopia", Harvard Business School Press, 1991, Michael E. Porter, "Capital choices: Changing the way America invests in Industry", Harvard Business School, 1992

[39] Gordon Group report, Ibid.

[40] See Nesbitt, "Long term rewards from Corporate Governance", Ibid.

[41] "Directors are like sub-atomic particles. They behave differently when observed", Nell Minows, quoted in Corporate Governance, Ibid. at 183

had on the UK system of corporate governance, and the ways in which this has resulted in value creation for those same institutions, in his paper on the subject in 1996[42].

The key question should not now be whether they do, but why they do. James Downling explains that "The public funds now have so much money that they find it's harder to find new companies to invest in than to try and turn around poorly performing ones"[43]. This explains this only in part – whilst the efficient market hypothesis has been largely discredited[44], it is also the case that a large part of the problem is that the majority of assets in the market are reasonably priced – even in Graham and Dodd's day when the number of financial analysts was far smaller, they were quick to admit that suitable "margin of safety"[45] investment opportunities were few and far between[46]. Forty years later, of course, this problem has been intensified as the number of analysts, professional and amateur, who are studying the market has significantly increased, and under-valued investment opportunities must logically be far fewer in number. Thus, it is immediately obvious that if under-valued companies are few and far between, and a pension fund manager needs divestment for risk-management purposes, he is going to be left with problems generating "alpha" returns.

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[42] See Stapledon, "Institutional Shareholders and Corporate Governance", Oxford, 1996, chp. II-4. Also see L. E. Linaker, "'The Institutional Investor--Investment from M&G's Viewpoint'" at 110.
[43] Monks & Minow, "Watching the Watchers", Cambridge, MA, 1996 at 120
[44] C.f. Graham, "The Intelligent Investor", 1973, New York, at 351, 380. Also, Buffet, "The Superinvestors of Graham-and-Doddsville" 1984, published in Hermes, Magazine of Columbia Business School.
[45] i.e. Assets which the market was mis-pricing (specifically under pricing) by such a degree as to offer a sufficient margin of safety against, among other things, their own errors.
[46] Ibid at 351-352

Furthermore, there are generally considered to be very few institutional investors engaged in this "active" ownership[47]. This may in part explain why activism can deliver these returns. In fact, active *investment* has, on average, produced neutral or even in many cases negative returns, relative to the market over most historical periods one could care to measure. Ben Graham, in 1973, in his analysis of the performance of the mutual fund industry concluded that, whilst retail investors would probably have been better off investing in mutual funds than in individual stocks[48], in general such funds did "no better than the market as a whole"[49]. Warren Buffet points out that [index funds] "are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals"[50]. Lipper Inc. conducted research in 1998 that demonstrated the following out performance statistics : One year, 1,196 of 2,423 (48.9%), Three years, 1,157 of 1,944 (59.5%), Five years, 768 of 1,494 (51.4%), Ten years 227 of 728 (31.2%), Fifteen years 125 of 445 (28.1%), Twenty years 37 of 248 (14.9%). These statistics are in gross terms – so fail to account for the reality that most funds charge "1.5% in operating expenses and 2% in trading costs"[51], and fail to compensate for the "survivor bias" of funds – namely the trend that under-performing funds are generally closed or merged after one or more years. Also,

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[47] "There not really much more than a dozen public pension funds involved...in fact if you took [a small number of funds] out of the equation...you might have very little activism at all", Regan, Quoted in "Watching the watches", supra, at 122

[48] "most likely his choice would have been between succumbing to the wiles of the doorbell ringing [mutual fund] salesman...[or the] much more dangerous peddlers of second and third rate...offerings", Graham, "The Intelligent Investor", 1973, 229

[49] Ibid at 229 – measured over five years and ten years, from 1961 and 1966, even the largest (and logically the funds that should be the best performing) the average performance was +- 10 basis points with either the S&P 500 or the DJIA.

[50] http://www.berkshirehathaway.com/1996ar/1996.html

[51] Jason Zweig, comment on "The Intelligent Investor" (Ibid.) at 249

research has indicated that as small funds grow the chance of out-performance shrinks[52]. (This argument must be qualified, because active management of money is crucial to the efficient allocation of capital, thus the performance of the market as a whole is dependent to a certain degree on active managers. "As an investment strategy passive investing seeks to free-ride off the more or less efficient capital allocation of active fund managers"[53] Investors in index-linked funds are "freeloading" onto the work of the active management industry by simply mirroring their behaviour as a whole and enjoying the benefits that they reap. This is, for obvious reasons, very hard to quantify, and does not change the substance of the argument that follows.)

So if, as shown above, a pool of actively managed money quickly grows beyond the scale at which best returns can be generated by pure active investment, are money managers under any duty to act as active owners? The difficulty with this approach is that different classes of institutional investors manage different sized pools of money, with different resources, different objectives, different duties and different limitations. They vary from pension fund trustees (of a defined benefit fund) who have a clear set of fiduciary obligations with discrete and well defined capital requirements stretching out far into the future, to arbitrage focused hedge funds, who operate under strict mandates and are handsomely motivated by the terms of their own remuneration to achieve the best performance within strict behavioural limits. However, in general, all classes of institutional investors, operating

[52] Ibid at 248.

[53] The Myners Report, at 83, http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf

outside of strict behaviour limiting mandates[54], are interested in delivering the best performance to their clients or beneficiaries. If it is true that the best performance can be achieved by exercising their rights as owners, then they should recognise this and alter their behaviour accordingly. However, all surveys of this matter show that, in general, the free-rider problem creates a mis-pricing in the market for corporate control, such that most institutions do not correctly value their rights. This needs to be recognised and corrected.[55] The extent to which a legal duty lies on each category of manager depends on the nature of the pool of funds being managed, and a number of those management groups whose position is relatively clear in English law are covered below.

1.2.6.2.1 Pension fund trustees have strict fiduciary duties to manage, or supervise, their assets in a conservative but wealth-maximising manner.

There is significant case law on this subject in England and Wales, most relevant of which are Cowan v. Scargill[56], Martin v. City of Edinburgh District Council[57] and Bishop of Oxford v. Church Commissioners for England[58], all of which generally exclude "ethical" factors from consideration (except in Church Commissioners where an exception was granted under circumstances of express provision being made in any trust deed), because of a fiduciary duty to focus on maximising the risk / reward balance of

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[54] For example CSR or "ethical" funds, which are required to deliver performance only within the confines of objective (or subjective) ethical or socially responsible targets.
[55] See Nesbitt (second study), Ibid. where he demonstrates that, at CALPERS, a programme costing a mere $500, 000 generated $137 million extra-ordinary (or above market) returns over 1992.
[56] [1985] 1 Ch 270; [1984] 2 All ER 750
[57] [1988] SLT 329.
[58] [1992] 1 WLR 1241; [1993] 2 All ER 300.

the fund with a view to wealth maximisation. Similar case law exists in the US, for example see Board of Trustees of Employee Retirement System of the City of Baltimore v. Mayor and City Councillors of Baltimore[59], where an exception was established only where the cost of "ethical" investing could be considered to be de minimis. Thus, whilst environmental, ethical and social concerns must generally speaking be put aside by pension fund trustees, their fiduciary duties thus extend to exercising their rights as owners in the interests of long term value maximisation.

1.2.6.2.2 The insurance sector is governed in the UK by general company law, particularly under the Companies Act 2006, but more notably under the Financial Services and Markets Act [FSMA] 2000 (formerly via the Insurance Companies Act 1982). Fund managers working for the insurance sectors are arguably under the following sets of duties and obligations.

1) Fiduciary duties of the directors to their shareholders of long term value maximisation. If, as argued above, fund managers will achieve best performance through a combination of efficient and skilful capital allocation and active ownership, then the directors are under a duty to ensure that their fund managers are behaving in the above manner.

2) In addition, the insurance sector also has a separate set of legal obligations under the FSMA 2000 towards prudential management of assets to ensure adequate cover of policy holders' potential claims. Fund managers are

[59] 562 A.2d 720 (Court of Appeals of Maryland, 1989)

therefore probably limited in the ways in which they can invest and engage in the above strategy of active engagement, if it can be seen to have the potential for either higher volatility or higher risk.

1.2.6.2.3 Charity trustees are in a similar position to pension fund trustees. Charities are governed by the Charities Act 1993 and also by the Trustee Act 2000 in the course of their investments which supersedes the 1961 Act in its restrictions on investments. Sections 4 and 5 of the Act sets out requirements for diversification (in recognition of modern portfolio theory) and requires trustees to carefully consider the suitability of asset classes and specific investments to the need of the trust. The charities commission has set out, in official guidance, that "the trustees must be particularly clear that their decisions will not place the charity at risk of significant financial detriment due to under performance by the preferred investments or by the exclusion from consideration of forms of investment to which the trustees are opposed"[60]. In other words, even where the substance of the charity is threatened by a specific class of investments, avoiding that class of asset or specific investment can only occur where there can be shown to be very careful consideration so that the financial interests of the trust will not be overly inhibited.

1.2.6.2.4 Other investment institutions, such as professional fund management firms managing funds on mandate from trusts or pools of funds, unit trust or OEIC

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[60] http://www.charity-commission.gov.uk/publications/cc14.asp#p32 at section 36

managers or private client fund managers, are generally under fiduciary obligations as managers of beneficiaries funds :

> Fiduciary obligations rest upon any investor in a position of trusteeship, be it formal via the legal establishment of a trust (such as a pension fund) or simply by holding assets on behalf of others (as with a bank holding someone's deposits). The principal duties of fiduciaries arise under trust law, and are regulated for some categories of trustee under specific legislation, such as the Pensions Act 1995. The general fiduciary obligations of a trustee (or someone in a position of trust) were set out by the Occupational Pension Board in a guide to the duties of trustees (OPB 1997). Beyond following the rules of the particular pension scheme in question and obeying the law, the general duties of trustees are 'To act prudently, conscientiously and honestly and with the utmost good faith; to act in the best interests of the beneficiaries and strike a fair balance between the interests of different classes of beneficiary.' In principle these duties apply to all analogous situations such as life funds, investment trusts (where the 'beneficiaries' are shareholders), and unit trusts (where the beneficiaries are the unit holders).[61]

The duty of fiduciaries to intervene in the running of companies in which they hold shares was tested in Bartlett v. Barclays Bank Trust Company[62], which restated the position held in Speight v Gaunt[63] and Brightman J. distanced the court from Re Lucking's Will Trusts[64] with regard to board seats for majority shareholders, although acknowledged that a seat on the board would be one way to protect the beneficiaries' interests. In Bartlett, Brightman J. stated that:

> ...the trustee was bound to act in relation to the shares and to the controlling position which they conferred, in the same manner as a prudent man of business. The prudent man of business will act in such a manner as is necessary to safeguard his investment. He will do this in two ways. If facts come to his knowledge which tell him that the company's affairs are not being conducted as they should be, or which put him on enquiry, he will take appropriate action. Appropriate action will no

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[61] Jonathan Charkham, and Anne Simpson, Fair Shares: The Future of Shareholder Power and Responsibility (Oxford: Oxford University Press, 1999) 141.
[62] 1980, CD at Ch. 15
[63] (1883) 9 App Cas 1
[64] [1968] 1 WLR 866 (at 874)

doubt consist in the first instance of enquiry of and consultation with the directors, and in the last, but not unlikely resort, the convening of a general meeting to replace one or more directors. What the prudent man of business will NOT do is content himself with the receipt of such information on the affairs of the company as a shareholder originally receives at annual general meetings. Since he has the power to do so, he will go further and see that he has sufficient information to enable him to make a responsible decision from time to time, either to let matters proceed as they are proceeding, or to intervene if he is dissatisfied...[65]

The position is thus reasonably clear. Not only do fiduciary duties give rise to an obligation to take an active role in the governance of companies in which the legal owners invest to protect the interests of the beneficiaries, there is also a duty to engage in active ownership because of the statistical likelihood of best performance. David Ball provides an excellent summary:

> When institutional investors don't vote, or vote without paying close attention to the implications of their vote for the ultimate value of their holdings, they are hurting not only themselves but also the beneficiaries of the funds they hold in trust.[66]

### 1.2.6.3 A general legal duty to engage as active owners to society as a whole.

> To my mind there is no such thing as an innocent purchaser of stocks. It is entirely contrary, not only to our laws, but to what ought to be our whole attitude towards investment, that the person who has a chance of profit by going into an enterprise, or the chance of getting a larger return than he could get on a perfectly safe mortgage or bond – that he should have the change of gain without any responsibility...When a person buys stock in any of those organizations of doubtful validity and of doubtful practices, he is not innocent; he is guilty constructively by law and should be deemed so by the community and held up to a responsibility...Stock holders can not be innocent merely by reason of the fact that they have not personally had anything to do with the decision of questions arising in the conduct of the business. That they have personally selected gentlemen or given their proxies to select gentlemen of high standing in the community is not sufficient to relieve them from responsibility.[67]

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[65] Surpa, at 63 at Ch. 15

[66] David George Ball, Former Head PWBA, quoted by the Investor Responsibility Research Center at http://www.irrc.org/company/12071999handbook.html

[67] Supreme Court Justice Louis D. Brandeis, extract from "The public papers of Justice Louis D. Brandeis", Document 128 at 1146-91, 1911

In general, when considering the concept of private property, Monks and Minow highlight three aspects of property ownership common across all types of property[68]. Firstly, property ownership generally gives the right to uninhibited usage of said property according to the owners wishes. Secondly property ownership gives the rights to allow others to enjoy the property in whatsoever way the owner chooses to. Thirdly, the owner of property has the right to transfer and or divide the interest in said property as he chooses. Finally, property ownership also carries with it a responsibility to enjoy said property only so far as to not impact upon other individuals, such that the rights to enjoyment of property are limited by the concerns of society as a whole. Does this final limit apply in the context of security ownership? Berle and Means, in their seminal coverage of this question concluded that:

> ...if property is to become...liquid it must not only be separated from responsibility but it must become impersonal, like Iago's purse: 'Twas mine, 'tis his, and has been slave to thousands'"[69]

The contrast between these positions is clear. What, if any, of these responsibilities do the owners of securities have? However can this be stretched to a normative case for this general duty? Is there any evidence for such a duty already existing? Again, there is some debate on the subject, and this is not the place to reproduce much of it. The author's position is that shareholders owe no duty to society as a whole, and that this is clearly demonstrated in recent reviews on the subject of institutional ownership. The Myners report and the subsequent government paper both recommend action, albeit in different forms, that focused on the

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[68] Corporate Governance, 3rd Edition, at 98-99

[69] Berle and Means, The Modern Corporation and Private Property, at 249,250

duties, fiduciary or otherwise, of an investor to underlying beneficiaries. For example the Myners report states:

> If fund managers are truly to fulfil their duty of seeking to maximise value for their shareholders, then there will be times – certainly more than at present – when intervention is the right action to take. Of course there are many occasions when simply selling an entire holding is the appropriate response. But this is often difficult where holdings are large, where the share price is already depressed, or where a zero holding cannot be adopted for other reasons...**The case for action does not rest on a public interest argument about shareholder responsibility but on the basic duty of the manager to do their best for the client**[70].

Not only does the Myners report not acknowledge the existence of a general duty, it explicitly argues that any case for action should depend not on the creation of a general duty but on the specific duty that already exists to funds' beneficiaries. The CLR's response proposed a requirement that managers disclose their voting records to trustees for the benefit of a pension funds beneficiaries[71], not for the good of society as a whole. Clearly, if a general duty existed then these reports would have merely recommended that such a duty was enforced, rather than focusing on the harder to enforce and specify duty to beneficiaries.

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[70] http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf at p. 13, (this authors' emphasis).
[71] See the Final Report, I, paragraph 6.39, available as above

## 2 Section B – the importance of transparency of ownership.

> A company, its members and the public at large should be entitled to be informed promptly of the acquisition of...voting shares...in order that existing members and those dealing with the company may protect their interests and that the conduct of the affairs of the company is not prejudiced by uncertainty over those who may be in a position to influence or control the company.[72]

Having set out the context of the market participant's role in corporate governance and their role in both monitoring of public companies and their duties to engage as active owners as well as active allocators of capital and having looked at the role of capital markets in this process, the next section of this thesis looks at the importance of transparency of ownership of securities in this process. It takes the three groups outlined in the Companies Act, the company, its members and the public, and examines each group in turn, with the aim of demonstrating not only that transparency of ownership is an essential precursor to satisfactory market transparency, but also that it has importance in its own.

### 2.1 "A company"

2.1.1 It has already been noted that a company, whilst a discrete legal person, has no interests of its own[73]. When one talks about the needs of a company to identify the owners of its securities (as opposed to talking about the needs of other owners, employees, or other stakeholders) the focus must be the appointed management of said company - appointed to look after the interests of the owners - and the board

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[72] Department of Trade, Disclosure of Interests in Shares (1980) p.2.
[73] Supra., at 1.3.4

appointed to monitor the chosen management. There are two main elements of the need for a company to be able to identify the owners of its securities, firstly the need for owner-agent dialogue, and the second for regulatory and compliance purposes.

### 2.1.2 The importance of "private" owner-agent dialogue – the managerial efficiency argument

The major argument within the context of owner-agent dialogue is that of managerial efficiency – because of limited management time it is important that market participants are transparent as to their holdings, both past and present, so as to be able to allocate rare management resources to the essential process of owner agent dialogue.

It has already been noted that management are to run the company in the interests of shareholders, except under legally prescribed circumstances, specifically to maximise long term returns to equity[74]. However, what form should this take? How should management go about maximising returns on equity? What degree of leverage should be used to maximise equity returns? Should management pursue acquisitions? Of what size? How should they be financed? Are shareholders willing to suffer equity dilution in the course of pursuing these acquisitions – and should management hold back "cash" reserves (diluting equity returns and reducing dividend payouts) to provide a buffer, smooth dividend payouts and finance acquisitions or should cash be returned

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[74] Supra., at 1.3.3. Return on Equity, or R.O.E. The author takes R.O.E. to be defined as either Net Margin x Inventory Turnover x Balance Sheet Leverage, or Net Income / Equity, both of which are mathematically equivalent (see James English, "Equity Analysis" at Chapter 3)

to shareholders? As Ryder & Register put it: "the company needs to know who owns its shares and the objectives[75] of its owners"[76].

This is by no means a universally accepted position. For example, it has been argued that :

> The ability of fund managers to direct fundamental reform in corporate governance practice lies primarily with their control over investment capital. Such managers act as surrogate owners for the large block of individual shareholders they represent. They are therefore primarily concerned with firm performance rather than governance process and are less likely to intervene to change management procedures, preferring instead to exercise exit rather than voice when dissatisfied with company performance. As Margaret Blair[77] notes, **activist investors** that meet regularly with company management to review strategic and operational plans are in fact **doing what the boards of directors are supposed to do, and such activism is not needed in properly governed companies**. The formal activity of fund managers will likely be limited to motivating rather than directing corporate governance reform. [This authors' emphasis][78]

The author believes that activist owners have a permanent role to play in the governance of public companies that is not merely the result of systemic failures. The counter-argument to Blair's position can be divided into two.

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[75] One can assume that the "objectives" of owners vary with time and size – in a listed company the objectives of any given set of owners may be considerably different from the objectives of the "Owners" as a body.
[76] Ryder & Register, "Investor Relations" (Random House Business Books, 1990)
[77] Margaret Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century (Washington, D.C.: Brookings Institution Press, 1995), p. 190. Quoted in Detomasi, citation given below. See also Margaret Blair, "Rethinking assumptions behind corporate governance", Gale Challenge, 1995 at p. 12
[78] David Detomasi, "International Institutions and the Case for Corporate Governance: Toward a Distributive Governance Framework?," Global Governance 8.4 (2002), Questia, 18 Sept. 2006 <http://www.questia.com/PM.qst?a=o&d=5000600648>.

2.1.2.1 Firstly, the process of dialogue, monitoring and engagement with management alluded to above is of a fundamentally different nature than the regular business of a board by legal prescription.

In both the UK and the US the powers available to shareholders are restricted (generally, excluding special resolutions in the UK) to matters outside of the course of ordinary business decisions.

Shareholder rights are not unlimited, however, as the SEC only allows 'resolutions going beyond ordinary business which are therefore suitable subjects for shareholder review through the proxy process'. Probably the most high-profile SEC decision in this regard was over Cracker Barrel in 1992. Cracker Barrel was a US store chain that was alleged to have a policy of not employing homosexuals. In 1992 the New York City Employee Retirement System attempted to file a shareholder resolution requesting the company 'to implement non-discriminatory policies relating to sexual orientation and to add explicit prohibitions against such discrimination to their corporate employment policy statement'. The SEC ruled that this was a 'personnel' matter, and as such was part of the 'ordinary business' of the company, meaning that the resolution could not be filed.[79]

The position is similar in England and Wales, with resolutions falling within the course of general business requiring a special resolution, where a company's articles follow Table A:

> ...Subject to the provisions of the Act, the memorandum and the articles *and to any directions given by special resolution*, the business of the company shall be managed by the directors who may exercise all the powers of the company.[80] [This authors' emphasis]

Monitoring by activist investors is incapable of replacing monitoring by the board – they do not have the same powers and exist to serve different purposes. It may be true that boards of directors are subject to both systemic and specific conflicts of interests and failures

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[79] Russell Sparkes, Socially Responsible Investment: A Global Revolution (New York: Wiley, 2002) 31
[80] Table A 1985 art. 70, superseded by s.19 of the Companies Act 2006

that may create an economic incentive for active investors to engage with company management – but that doesn't mean that "properly governed companies" do not need or would not benefit from active engagement with shareholders.

2.1.2.2 Boards of directors are subject to systemic conflicts of interests and purposive complexities that leave them unable to satisfactorily complete their task of monitoring, reporting and governing without monitoring from shareholders, specifically from engagement with active investors.

The author believes there to be essentially two parts to these objections, both of which are well stated by Monks and Minow, which is quoted liberally below. Firstly, boards are not independent. In general, this probably does not present too serious a problem. If active involvement with outside shareholders can be relied upon to provide the independent monitoring required (given all of the provisos already mentioned with regard the independence of some of the bulge bracket banks' investment management divisions) – "Directors are picked because the CEO knows them...even those termed "outside" directors by the New York's Stock Exchanges definition...[many]...have some business or personal relationship with the CEO[81]...a nice, cozy arrangement"[82]. The author does not necessarily believe this to be a serious problem – boards surely need to function as a cohesive group and foreknowledge of character, personality and experience probably gives a CEO or Chairman the ability to pick such a group.

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[81] Monks is referring to ISS studies indicating that over 20% of so-called "independents" have quantifiable business relationships with the company or CEO.

[82] Robert Monks & Nell Minow, "Power and Accountability", 1933, HarperCollins, at 77

However, it is not a recipe for impartiality or objectivity – which does beg the question of whether any company will ever have sufficiently adequate governance to eradicate the need for monitoring and engagement with active investors? Secondly, directors are often selected not as objective outsiders but highly skilled and experienced individuals, professionals or academics (even business journalists[83]), with the aim of bringing expertise and insight to a board's decision making and supervision: "Directors are not picked for their ability to challenge management. On the contrary, they are more often chosen for their business or personal ties, or for their ability to add symbolic luster"[84]. Monks concludes by reminding the reader that "since they are selected by management, paid by management, and - perhaps most importantly – informed by management, it is easy for directors to become captive to management's perspective"[85]. Setting aside the issue of adequate information, these issues, whilst concerning, are not fatal, if the outsider can rely on the actions of active owners to monitor both management and the board – providing an independent and objective review of performance, strategy and decision taking as well as issues falling within the broader governance context.

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[83] See the announcement (FT, September 10th 2006) of FT journalist Lucy Kellaway's appointment to the board of Admiral Group plc. - http://www.ft.com/cms/s/72e06188-40dc-11db-827f-0000779e2340.html - although she herself does raise the question of her suitability by writing that : "After all, one of the more important tasks of a non-executive is to speak up if faced with an executive emperor wearing no clothes. And the story tells us who does that task best: a child"

[84] Monks, Supra., at 77

[85] Monks, Supra., at 78

Thus, having concluded that outside review and engagement by active investors is not simply something that need take place only in poorly governed companies, but has a universal application to all public companies, the next key question to address is whether transparency of ownership is essential to effective dialogue and relationship building with such owners. Before doing so, however, there is a more pressing question to discuss that must be addressed.

### 2.1.2.3 Is this sort of "private briefing" legal? If not, should it be?

> ...dialogue between investors and corporate managers in listed companies is currently subject to: (a) criminal offences related to "insider dealing" and "misleading statements" which are mainly governed by the Criminal Justice Act 1993...(b) the new "market abuse" regime; and (c) the new regime covering "financial promotion", (the latter two are organised by the FSMA 2000). Moreover the FSA has recently announced that selective briefing is unfair, indicating its intention of pursuing listed companies that do not apply rules of fair disclosure.[86]

The position in the US is now similarly unclear:

> With regulation FD, the commission is attempting to level the informational playing field by barring companies from releasing market-sensitive information to Wall Street insiders before announcing the news to the general public. Basically, corporations whose senior executives provide market-moving information to a few professionals must make the news public at the same time for intentional disclosures, or promptly for unintentional disclosures. The regulation is designed to address the problem of selective disclosure made to those who might buy or sell the stock based on the information or advise others to do so. (See "Highlights," JofA, Oct.00, page 8 and the SEC Web site, www.sec.gov.)[87]

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[86] Ahmed Al-Hawamdeh and Ian Snaith, "Is 'Private Briefing' Illegal in the United Kingdom?", Corporate Governance, Blackwell, Volume 13, No. 4, 2005 at 489

[87] Ed Mccarthy, "After Regulation FD: Talking to Your Constituents," Journal of Accountancy 191.2 (2001): 28

The legal question is surprisingly straightforward. If analysts and fund managers view private or small group meetings with management as important (and show a distinct preference for private meetings), which they do, then they must see themselves as obtaining some sort of advantage from attending these meetings. If they are obtaining some sort of competitive advantage, then private meetings fall foul of both the intentions of both sets of regulations of "levelling the playing field" for private investors. If the information gained in these meetings is not price sensitive, then why would analysts continue attending these meetings (and why would investment banks continue to make large profits from corporate broking operations)? If the information is price sensitive then it must be material and fall foul of both sets of regulations[88]. The counter-argument usually given is that the information conveyed in these meetings is of a "softer" kind,

> Investment managers should not seek to obtain price-sensitive information. This is because price-sensitive information would, unless other measures were arranged...restrict institutional investors...ability to deal with shares...what investment managers and institutional investors aim to obtain is soft information. Soft information gives investors an edge over other market participants. Institutional investors...employ highly sophisticated financial analysts to monitor corporate managers, including taking part in dialogue with corporate managers, which is a costly process. Hence, it was suggested that the sophistication and skills of such analysts and investors allow them to mix public information with unpublished soft information.[89]

Coffee argues that such "soft" information "is desired by institutions that trade actively in order to outperform the market – in effect dumping shares if the information

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[88] C.f. S. 402 FSMA and M. Dickson, "The Clock is ticking as ground force meets the city", Financial Times, 5th May, 2001, at 13

[89] Al-Hawamdeh and Snaith, above, at 494

provided to it suggests a downturn in earnings that the market has not yet anticipated"[90] If this view is correct, that "soft" information is merely unquantifiable unpublished material data, then as Eaglesham[91] notes, the definition of soft information under the FSMA 2000 needs clarification. Either way, just because the only sort of information being exchanged in such private meetings is "soft", the information conveyed is no less material a concern than if managers were engaging in wholesale selective briefing on plain financial or quantifiably "inside" data. The only real counter-argument is that both Coffee and Al-Hawamdeh have misunderstood the nature of the dialogue involved, and that the purpose of such meetings is different with a much less sinister form of information conveyance. One can argue this from two perspectives. Firstly, it can be argued that the information needs of sophisticated investors are different from the information needs of private investors[92]. This argument has some validity in the author's opinion – professional investors use complex valuation methodologies which require complex multi-period financial models. Producing these models requires detailed understanding of the financial impact of corporate strategy, macro-economic effects, and an in-depth understanding of the subject company's income, cash flows and balance sheets. The very nature of this process requires management "face time" to ensure accurate valuations and the dedicated time given to such investors and analysts is justifiable on this basis (to allow time for questioning management on fine details and to

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[90] J. Coffee, "Liquidity versus Control: The Institutional Investor as Corporate Monitor", 1991, Columbia Law Review, 91(6), at 1277

[91] J. Eaglesham, "The bright lights of regulation", 2001, FT, 12th November, at 18

[92] See D. Bence, K. Hapneshi and R. Hussey, "Examining Investment Information Sources for Sophisticated Investors Using Cluster Analysis", 1995, Analysis and Business Research, 26(1), 19-26

clarify written guidance etc.). It is a somewhat weak argument, however, as there are a number of amateur investors who use similar methods but who are excluded from such meetings, and it fails to provide a justification for the more common "private" dialogue which the author is advocating[93]. The second counter-argument is that these private dialogues, aside from any monitoring and governance element, are more about enabling investors and analysts to make judgement calls and with management taking the opportunity to get their investors "on-side" with their plans.

Unfortunately, both of these counter-arguments fail to deal with the underlying issue, which is that, even if many other investors "not invited" would not benefit from attending, many who aren't invited would (not to mention the arbitrary fashion in which attendance at such meetings is decided, largely based on which broking firm institutions obtain research from). If there is a benefit to be had from private briefing, under the reasoning of both the SEC and the FSA, it should be open to all – and carried to its logical conclusion all private briefing should be brought to a halt. However, Al-Hawamdeh and Snaith argue that "restricting informal relations between institutional investors and companies does not seem to go in harmony with the Government's line of encouraging shareholders to make corporate managers accountable"[94]. Having considered the position of the legality of private briefing, and concluded that such briefings operate, at best, in a distinctly "grey" area legally, the next issue to address is

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[93] There is, however, possibly a justification here on the basis of efficiency – typical analysts on the so-called "sell side" distribute their research to a large number of institutional investors, such that time spent with five or six analysts typically results in information flows to a far larger number of ultimate investors. Also, it could be argued that professional analysts are better placed to make use of face time because of their expertise and sophistication, in ways that private investors are not. Both of these additional arguments are somewhat weak.

[94] Ahmed Al-Hawamdeh and Ian Snaith, above, at 489

whether such a blurred position is advisable, and whether selective private briefing is in fact beneficial, not just to the individual participant, but to the market as a whole.

1) Selective private briefing reduces price volatility[95]. This is largely self-evident, both in terms of practical analysis and financial theory. C. Batchelor, in his article on this issue in 2002, covers the practical side of the discussion excellently:

Critics of the new rules claim that far from improving the flow of information to shareholders, they will discourage full reporting and increase the volatility of share prices. They fear the new regime will add to red tape and cramp the informal relationships that allowed companies to guide City opinion and avoid sharp movements in share prices..."It is very difficult for a company like us that has had an open relationship with analysts," said Peter Tom, chief executive of Aggregate Industries, a building materials supplier..."There are fund managers and analysts who would phone to ask about the impact of the weather on trading or to ask if something another company was doing was relevant for us. We won't be able to have those conversations . . . It will shut down the flow of information."...William Underhill, a partner at Slaughter & May, the City law firm [says]..."When do you have enough information to make a forecast or disclose accounting irregularities? These things don't appear in a file on the chief executive's desk. They emerge in bits and pieces,"[96]

Little needs adding to the above argument – communication without private briefing is likely to be "bitty", with the resulting increase in volatility. One does not, however, need to rely solely on practical concerns, as academic theory reinforces this concern. The relevant doctrine is known as the Efficient Market Hypothesis[97] (EMH) :

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[95] For further detail on why lowering price volatility is a good thing, see section 2.3.3 below

[96] Critics fear FSA curbs on market abuse will discourage full reporting and increase volatility, writes Charles Batchelor, ft.com site Jan 18, 2002 http://search.ft.com/searchArticle?id=020118007643

[97] Probably first used by E.F. Fama, see : Fama, "Efficient Capital Markets: a

In finance, the efficient market hypothesis (EMH) asserts that financial markets are "efficient", or that prices on traded assets, e.g. stocks, bonds, or property, already reflect all known information and therefore are unbiased in the sense that they reflect the collective beliefs of all investors about future prospects.[98]

Whilst there has been widespread discrediting of what is sometimes referred to as strong market efficiency[99], the general academic consensus tends towards a weak market efficiency theorem[100] - which means that whilst markets price securities fairly, most of the time, sentiment and human error can lead to systematic mispricing. Whichever view is taken it must be recognised that:

no other theory in economics or finance generates more passionate discussion between its challengers and proponents. For example, noted Harvard financial economist Michael Jensen writes "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis," while investment maven Peter Lynch claims "Efficient markets? That's a bunch of junk, crazy stuff"[101]

Nonetheless, one can rely on the general principles enshrined in the theory without embracing its full implications. The basic tenet of EMH is that security prices fully discount all available information and market expectations. In other words, the price of any given share is generally nothing more than the discounted

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Review of Theory and Empirical Work." Journal of Finance, May 1970. Followed by : Fama, E.F., "Efficient Capital Markets: II," Journal of Finance, December 1991 & Fama, E.F, "Market Efficiency, Long-term Returns, and Behavioral Finance,"Journal of Financial Economics, September 1998

[98] http://en.wikipedia.org/wiki/Efficient_market_hypothesis

[99] W. DeBondt and R. Thaler, "Does the Stock Market Overreact," Journal of Finance (July, 1985), Bernard V. and Thomas J.,' Evidence that stock prices do not fully reflect the implications of current earnings for future earnings,". Journal of Accounting and Economics 13, 305, 1990. , Jegadeesh N and Titman S., 'Returns to buying winners and selling losers: implications for stock market efficiency," Journal of Finance 48:65-91, 1993.

[100] C.f. J. Lakonishok, A. Shleifer, and R. Vishny, "Contrarian Investment, Extrapolation, and Risk," Journal of Finance, December, 1994. For an excellent summary of the existing literature see Clark, Jandik and Mandelker, "The Efficient Market Hypothesis". available at http://comp.uark.edu/~tjandik/papers/emh.pdf

[101] Clark, Jandik and Mandelker, above, at p. 1

present value of the consensus financial impact of all available news, data and information[102]. It is only logical that if information has to build up into the sort of blotches described above, then the price of shares will change sharply as news is released, rather than being trickled out to the market through a smoother and more gradual process:

> ...as companies wrestle with Regulation FD, two things will happen. First, they will decide not to disclose information that could be construed as either a warning or a prediction. This will lead to bigger swings in their shares when they finally do make an announcement...in the case of Apple, its share fell more than 50 percent in one day as analysts said they were caught completely unaware. Now that's volatility. Second, in an effort to show they are disclosing more information, some companies will trumpet minor stuff...The result could be more trivial press releases, less hard news, and more sudden warnings. That's a recipe for volatility[103]

The clear irony of course is that in an environment with high price volatility, it is again the individual investor who loses out, probably by much more than the inside information conveyed to institutions "cost" them – as it is institutions who have been best placed to profit from increasing price volatility through the adoption of

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[102] Although the Henry McVey, Chief U.S. Equity Strategist at Morgan Stanley has found compelling evidence that prices do regularly depart from the present value of consensus expectations. He and his colleagues used a residual income valuation technique to model projected book values, earnings per share, dividends, and returns on equity using I.B.E.S. analyst consensus estimates for 7 years, and then projected a 5 year return on equity fade to long run (1986-2006) sector averages, generating valuations based on starting book values, projected present value of future projected supernormal profits, and a relatively small approximate terminal value (computed as the gap between costs of equity and historic sector averages – in his model generally less than 15% as opposed to DCF valuations where terminal values can be up to 75%). They then ran the model on the S&P 500 constituents and back tested to 1996 (which generated over 100 basis points of annual market out-performance each year except 2000). The effect of the model is to approximate the net present value of consensus future expectations in such a way that even a weak form of EMH suggests that outperforming the market by following this form of purely quantitive process should be impossible. Regardless, even this sophisticated a model has some flaws which appear difficult to work around with a quantitive process. It is difficult to draw a firm conclusion from this process – but it does serve to call into at least some doubt the idea of Jensens (above at fn. 101) that EMH is a proven theorem. See "Intrinsic Value: A Safe Haven?", P. Gandhi & H. McVey,, Morgan Stanley U.S. Equity Research, April 2006.

[103] David Callaway, Executive Editor, CBS.MarketWatch.com "New SEC Rule a Boon to Investors But Expect More Volatility", www.prnewswire.com/financial/irreview/html/102300.shtml

short term trading practices that individual investors are unable to compete with due to inequalities in time, experience, training and available equipment.

2) It is sometimes argued that because institutions and private investors share the same interests, and have the same underlying rights, the supposed "cost" borne by individual investors in allowing institutions privileged access can be effectively considered de minimis.[104] Surely, as all investors largely share the same interests[105] institutions are best placed to engage on behalf of all investors to further the owner's interests – and if in the process of this engagement and dialogue they have to bear the costs of institutions gaining inside knowledge at their expense, do the two costs not balance out somewhat with the added benefit of reduced price volatility?

2) Thurber goes even further in his analysis of the free-rider problem as it applies to institutional monitoring[106]. He strongly advocates a relaxation of the insider dealing rules to allow a modified insider dealing contract to exist between select institutions and companies – whereby institutions agree to adopt monitoring roles in exchange for access to inside information. Whether or not one agrees with the somewhat radical idea of contractualising such an arrangement, the argument that institutions should be rewarded for engaging in the monitoring process through continued access to management in these "private briefings" is fairly compelling.

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[104] See Al-Hawamdeh, Ibid. at 495

[105] For the contrary argument that individuals and institutions often have very different objectives, see P. Coggan and N. Cohen, "A cautionary culture: Performance Pressures Faced by Fund Managers, Financial Times, 3rd June 1995 at 8

[106] S. Thurber, "The Insider Dealing Compensation Contract as an Inducement to Monitoring by Institutional Investors", George Mason University Law Review, 1, 119, 1994

One can therefore conclude that whilst "private briefing" operates within a grey area of the law, at least in the UK, but that there is a serious inconsistency between the stated legislative objectives of increasing institutional involvement in corporate governance and the recent restrictions on these private meetings. Furthermore, it can also be concluded that "private briefings" also bring net benefits to the market as a whole, reducing volatility and creating incentives for institutions to create long term relationships with the management of firms they invest in (as well as providing management with a useful forum for vital feedback on strategy and direction[107]). The author, therefore, agrees with the conclusions of Al-Hawamdeh and Snaith:

> In an ideal world, private briefing may be wrong. Yet the market is by no means perfect. Hence it is probably unwise to press against private briefing, arguing for more involvement of insignificant shareholders, when they themselves do not wish to be involved. Insignificant shareholders are not interested in the GM [General meeting] and therefore why would briefings...be any different? **Analysts and institutions thrive on obtaining an information advantage. That would mean more monitoring of corporation managers and hence benefit for all, including insignificant investors.**[108]

2.1.3 Given that on-going dialogue between owner and agent is so important, is transparency of ownership a crucial part of such dialogue? Whilst the author believes that there are several reasons, arguably the most crucial is that management have limited time resources available and need a non-arbitrary way to allocate time to meetings with analysts and investors that ensures that the scarce resource of their

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[107] C. Marston, "Investor relations meetings: Views of companies, Institutional Investors and Analysts", 1999, The Institute of Chartered Accountants of Scotland (http://www.icas.org.uk)
[108] Marston, above, at 502

time is best utilised. The author believes the only truly fair and efficient way of such a division is on the basis of both vertical and horizontal ownership transparency. There is a significant cost to management in conducting these meetings :

> The companies were aware of costs and benefits when choosing to devote time and effort on communications with institutional shareholders and analysts. These costs and benefits included the purpose of the meeting and the circumstances facing the company. The companies operated in a competitive market for reputation and credibility in corporate communications... [they] had little choice but to have expensive corporate communications because they were not prepared to tolerate the perceived costs of poor communication. However, they did identify opportunities for economy and efficiency. These companies concentrated their corporate communications on core institutional shareholders and other influential parties. By restricting access in this way they sought to save on managerial time. [109]

Management time is extremely costly, argues Holland, as it is a highly scarce commodity, and not limiting their availability for private briefings may negatively impact corporate performance[110]. Marston concluded that, if correctly managed, the cost of management meetings are within reasonable limits for most companies he surveyed[111]. If the argument is that management time is limited, but private dialogue with long term investors who are going to engage in the monitoring process has a high positive utilitarian value, both in terms of governance, management accountability, then it is vital that management have a way of identifying not just the most suitable market participants to invest in dialogue with but more importantly an equitable method of allocating their own time to the identified owners..

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[109] J. Holland "Corporate Communication with Institutional Investors", 1997, The Institute of Chartered Accountants of Scotland. http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=2295 also see J. Holland, "Private disclosure and Financial Reporting", Accounting and Business Research, 1998, 28(4), 258-269

[110] J. Holland, "Voluntary disclosure, Financial intermediaries and Market Efficiency", Journal of Business Finance and Accounting, 1998, 25(1) at 29

[111] Marston, supra.

Institutional investors are also not a homogenous class and many institutions are not suitable candidates for the intimate dialogue discussed above. Not only is a significant portion of the available market index linked (Barclays Global Investors has more than £618 billion in index linked equities alone[112]), but a portion is also managed by purely quantitative active managers, who use purely mathematical screening processes to allocate holdings[113]. Management need to be able to identify significant shareholders and then eliminate those institutions which are not suitable candidates for the private briefing process. The process of Investor "targeting", or identifying which institutions are suitable candidates, and how priority should be assigned between different individuals is highly complicated. There are numerous commercial companies offering such services (Georgeson Shareholder, DF King and numerous others). The various methodologies used in industry and a discussion of their relative merits is beyond the scope of this thesis.

2.1.4 Alongside the importance of ongoing shareholder dialogue, ownership transparency is also vital for the so-called market for corporate control to function effectively.[114] The market for corporate control is thought to function through price signals that create management incentives for performance through the threat of takeover[115]. If

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[112] http://www.barclaysglobal.com/about/what_sets_apart/indexing.jhtml

[113] Exactly how large this portion is would appear difficult to calculate – especially given the number of funds or managers using blended approaches, and the propensity of quantitative holders to use shorter term algorithms.

[114] Richard B. Higgins , "The Search for Corporate Strategic Credibility: Concepts and Cases in Global Strategy Communications", Quorum Books., Westport, CT., 1996 Also see : David H. Downs, "The Value in Targeting Institutional Investors: Evidence from the Five-or-Fewer Rule Change.", Real Estate Economics. Volume: 26. Issue: 4. , 1998. at 613

[115] Jensen, Michael C. and Ruback, Richard S., "The Market for Corporate Control: The Scientific Evidence" . Journal of Financial Economics, Vol. 11, pp. 5-50, 1983 Available at SSRN: http://ssrn.com/abstract=244158

information affects share prices[116], and, as already shown, effective communication through private shareholder dialogue improves price volatility, then the market for corporate control will function more effectively as an incentivisation process if management are able to communicate effectively with the correct investors. Furthermore, management need to be able to use the private briefing process to defend themselves when under threat of takeovers[117], and it is likely that the process will be improved where an ongoing process of dialogue leaves key investors, who would have to part with their stakes in the event of a takeover, "onside" with management's strategy[118]. Management also need to be able to re-approach capital markets for further financing needs and Watts and Zimmerman have shown the importance of maintaining relationships with significant investors in meeting such future needs[119].

2.1.5 Shareholder transparency, or a lack thereof, has a negative impact on the voting process, creating financial and non-financial disincentives for institutions to vote, and blurring the key governance mechanism through systematic dysfunction. In complex holding structures, with split control rights, (see section C, below) improved shareholder transparency would greatly increase the ability of companies to identify

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[116] Myron Scholes, "Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices." Journal of Business 45, Myron, 179-211.
[117] Frank H. Easterbrook, and Daniel R. Fischel. "Takeover Bids, Defensive Tactics, and Shareholders' Welfare." The Business Lawyer 36, 1981, 1733-1750.
[118] See : A. Shleifer, and R.W. Vishny. "Large Shareholders and Corporate Control", Journal of Political Economy 1986. , 94, 461-488. for the importance of large shareholders in context of takeovers.
[119] R. Watts and J. Zimmermanm "Positive Accounting Theory", 1986, Prentice Hall / Eaglewood cliffs (New Jersey).

the holder of the voting rights, and pursue their votes.[120] This view is support by Davies, who argues:

> Clearly...the law is that if the custodian is a bare nominee for a beneficial owner, those rights should be exercised as the beneficial owner thinks best. In order to bring this about, however, the custodian must confer with the fund manager and perhaps, through the fund manager with the trustees. This may not prove to be possible within the notice period for the meeting. The difficulty would be alleviated if the company communicated directly with the beneficial owner.[121]

#### 2.1.5.1 Evidence that ownership structures impact upon institutional investor's incentive to vote

There is some existing evidence that the complexity of the voting process is a significant disincentive to institutions not to vote, some of which has been set out above. The diagram below shows the complexity of the proxy voting process.

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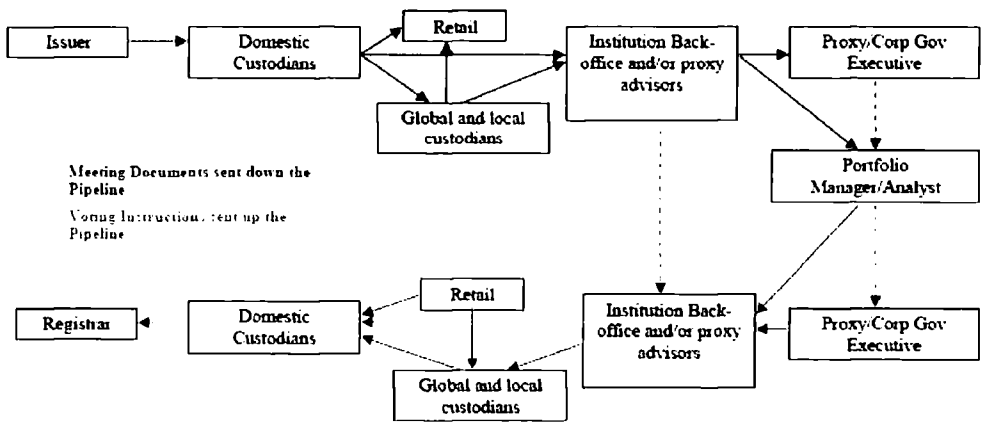
[120] The proxy solicitation process is also one where having excellent knowledge of the shareholder base is essential : see Warren F. Greinenberger, Proxy Solicitation Process Developments in Shareholder Communication (1999 PLI ORDER NON B0-006E), also see Frank H. Easterbrook and Daniel R. Fischel. 1983. "Voting in Corporate Law." Journal of Law and Economics 26, no. 2: pp 395-427.

[121] Gower and Davies, Company Law, p. 342




reproduced from the 2005 summary report on voting practices,, below, at p. 7

In the same survey[122] along with concluding that, of the participants surveyed, less than 1/3 of the portfolio managers or senior analysts were actually involved in the voting process, they also made the following key findings:

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| 66% of institutions have no formal method of checking votes have been received correctly. |
| 76% of institutions believe votes are incorrectly registered, either "occasionally", or more often. |
| Only 53% of companies meet with key institutions to discuss agenda items. |
| 73% of companies have never changed their strategy, policies or disclosure as a result of shareholder pressure. |
| 75% of issuers were dissatisfied with the level of voting participation and intended to increase it. |

The survey quoted an anonymous UK fund manager as saying:

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[122] Survey of Global Voting Trends, Summary Report, 2005, DF King, at http://www.dfking.com

"Another key concern is the impossibility of keeping track of our votes. We have no way of knowing whether a company has received our vote unless we call them directly. We tend to conduct regular audits on a handful of stocks every year and **try to follow our votes down their custodian, sub-custodian and registrar** pipelines to cross check if our voting instructions have been processed and if companies have received our votes" Anonymous UK Fund Manager[123]

The overriding theme of the survey was that the complexity of voting was enormous, with a substantial component of the complexity arising from the archaic web of communication lines between company and participants. Improved transparency of ownership would vastly improve this process.

2.1.6 Less importantly, it is also possible that improved shareholder transparency could result in lowered compliance costs for company management in fields such as reporting and other corporate secretarial duties, as companies would be able to communicate directly with beneficial owners as opposed to nominees[124].

2.2 Institutions need themselves, and other institutions, to be transparent about their own holdings in order for them to be able to function as effective owners. (i.e. "Its members").

2.2.1 One of the most significant obstacles to the correct market pricing of corporate control rights by institutions is the "free rider" problem[125], which has already been discussed. Noe argues, given that a large part of the problem is widely diversified

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[123] Ibid. at p. 17

[124] See transparency in context below for further details on the impact of current ownership structures on this, and other, issues.

[125] C.f. Robert Pozen, "Institutional investors: The reluctant activists.", Harvard Business Review, January-February 1994, at 140-149.

owners are disincentivised to engage in activism and monitoring, that the pooling of investors' interests by a significantly large group[126], shows that a core group of institutional investors with the goal of monitoring the corporation and preventing managers from engaging in opportunism can naturally develop under the U.S. structure of corporate governance. According to Noe, institutional investors are motivated to monitor managers because they can gain from the monitoring, despite the presence of free-rider problems, costly monitoring, and a lack of any initial stake in the corporation.

> ...when insiders lack toehold stakes in the firm, concentrating holdings may actually lower share value. The logic behind this result is that concentrating wealth, although increasing the size of ownership positions and thus mitigating the free-rider problem associated with monitoring, also increases the adverse selection costs to noninstitutional investors. This lowers their demand for shares and thus further increases spreads[127]. Through this process, concentration can lead to spreads so large that institutions cannot profitably acquire shares and monitor. In these cases, a profusion of small institutional investors produces more efficient monitoring than a single large monitor...[but] the lack of a toehold in the firm eliminates any incentive for institutions to monitor based on protecting their initial investment portfolio. Thus, the assumption mitigates against effective institutional monitoring. Nevertheless, it will be shown that, even in this case, institutional activism reduces agency costs. [128]

Thus, intra-participant transparency of ownership could be used as a way of pooling institutional interests, compensating for the impact of the free-rider problem and reducing

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[126] T. Noe, "Institutional Activism and Financial Market Structure," Tulane University Working Paper, 1997 available at : http://papers.ssrn.com/sol3/papers.cfm?abstract_id=36569

[127] Note that the "spread", sometimes called the "bid-ask spread" is the difference between the highest offered bid for a block of shares and the lowest asking price for a block. As demand and supply imbalance grows, the spread widens raising dealing costs. Where demand and supply are balanced bid/ask spreads narrow.

[128] Ibid. at 5

the external costs of dispersed ownership. It would allow groups of institutions to far more easily place pressure on management and allow for a more efficient governance and monitoring process.

2.3 The public in general, and more specifically the market, needs institutions to be transparent over the ownership of shares in order for the market to function effectively. (i.e. "The public at large")

2.3.1 Protection from other owners – the take over context. The market as a whole to be transparent for peer to peer protection in the takeover context.

Shareholder disclosure provides stakeholders in general with a level of peer to peer[129] protection, specifically in the context of hostile takeovers.

> In Kuwait the need to decree [the] Law...on the disclosure of interests...appeared following a group of persons' shrouded and sly gathering of shares in a certain company during a limited period of time until the percentage of their shareholding amounted to a level which enabled them to change the Board.[130]

Andrew Collins argues, as part of a lobbying effort to the EC regarding the upcoming transparency obligations directive[131], that

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[129] "Peer to Peer protection" can in this context be understood to mean the protection of shareholders from the potential transgressions of anonymous majority shareholders – through changes to board structure, articles and undervalued takeovers etc.

[130] Dr. Ahmed Al-Melhem, Comment on the Kuwaiti Law No. 2 of 1999 concerning the disclosure of interests in shares in the light of comparative laws, A.L.Q. (2000), 221

[131] The transparency obligations directive, http://europa.eu.int/eur-lex/pri/en/lip/latest/doc/2003/com2003_0138en01.doc - thanks to the intervention by Chris Huhne, MEP, Articles 9 and 10 have now been appended, amongst other changes lowering the mandatory declarable stake to 5% from 10%. This is still some 3% higher than the lowest level across the EU (Italy)

> ...transparency of ownership by means of the visibility of shareholdings on the register provides greater protection for a company and its shareholders: persons with visible interests can be identified and are less likely to "transgress" or disadvantage other shareholders[132]

Whilst this argument pertains more generally to declarable stakes and systems of mandatory disclosure, it draws out two essential points. Firstly, that it is a real benefit to the body of stakeholders as a whole to have *a* level of transparency. This argument is best understood in the takeover context, and it is in this area that the vast proportion of case law has arisen[133], where the clear finding of the court has always been that Section 212 notices must be responded to in full and in a reasonable time.[134] This demonstrates the courts' understanding of the importance of protecting other shareholders from 'stealthy takeovers' which seek to avoid paying the full market value for the share purchases by concealing intent. Secondly, this argument also demonstrates the reality of the purported "benefits of reciprocity"[135], be it only one example of such benefits – i.e. that the whole process of transparency of agency and ownership does not just confer normative benefits to the market, but that to each individual shareholder there are clear, quantifiable and identifiable benefits – in this case that of protection from other shareholders' "potential transgressions"[136].

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[132] Anthony Collins, Appendix IV, Letter to the Financial Markets Commissioner, 4th September 2003
[133] cf. Re Bestwood [1989] BCLC 606, Re Lonrho [1988] BCLC 53, [1987] BCC 265
[134] There has on this been some academic comment, listed in the bibliography and in the introductory notes – it is however not relevant to the point at hand. What constitutes a "reasonable time" is not a point of substantive importance here.
[135] Anonymous fund manager, quoted in a presentation at a seminar entitled "Transparency of Ownership", attended by the author, London, January, 2004
[136] Andrew Collins, above

2.3.2 Transparency is essential to the operation of the market as a whole.

First, timely and efficient communication is essential to efficient markets, and this is recognised by most governments – hence the increasing legislative trend towards the strict regulation of market disclosure by companies. However, efficient communication with the markets is clearly impossible without an accurate and up to date knowledge of those markets. Whether or not one accepts the "Efficient Market Hypothesis"[137] in its entirety, it is impossible to argue that share prices could accurately reflect their net present values if based on incomplete or out of date information. However, whilst uniform and timely distribution of, and attention to, accurate information might be the ideal, the absolute requirement for efficient markets is for it to reach the most interested parties. The market therefore depends heavily on the ability of companies and their distribution networks to build up an accurate picture of the markets – and particularly of the parties most interested in any specific company, for the reasons already discussed above.

2.3.3 Transparency of ownership of equities impacts upon the valuation of equities – institutional investors would benefit from improved transparency with more stable and probably higher general levels of valuations.

2.3.3.1 The theory of equity valuation

It would be incomplete to cover the issue of the impact of poor levels of transparency on the market without understanding how the market values securities. We can classify valuation methods into three distinct groups: Discounted Cash Flow (and the dividend discount model),

[137] Covered supra.

Relative Ratio Analysis (common examples include the Price/Earnings and Enterprise Value /EBITDA) and other discounting based valuation models (most commonly a residual income model[138]). English concludes that whilst Discounted Cash Flow may be the least widely used (due to its complexity, time constraints and the requirement to build and maintain sophisticated multi-period financial models in order to predict future cash flows as well as the sensitivity in the valuation to terminal / perpetuity assumptions), discounted cash flow remains "the most familiar, and arguably, the most rigorous of equity valuation techniques"[139]. It is therefore logical to focus primarily upon an analysis of the discounted cash flow valuation technique.

2.3.3.1.1 Discounted cash flow (DCF) valuation.

As already stated, discounted cash flow is the most theoretically rigorous method of equity valuation. It is based upon the notion that the value of any given security is the present value of all future cash flows accruing to it. Calculating "Present Value" involved discounting future cash flows at a risk-adjusted opportunity cost of ownership[140]. It can be expressed mathematically:

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[138] See "Applied Equity Analysis", James English, McGraw-Hill, 2000, Esp. Ch. 14, from 389. As a model, probably originally set out in "Annual Survey of Economic Theory: The Theory of Depreciation", Econometrica, July 1938, 219-241. Very similar in effect to the EVA model, originally published in "The Quest for Value", Harper Business, 1991, Chapter 8. See "The Analysis and Use of Financial Statements", White, Sondhi & Fried, 3rd Edition, 2003, at 705-714 for a critical comparison and analysis. Valuation based on Discounted Economic Profits is also commonly used and should produce identical results (see Appendices for valuation examples), see Copeland et. Al, supra. at 149. The whole principle of economic profits & discounted earnings can be traced all the way back to Alfred Marshall in 1890, see: "Principles of Economics", Vol. 1, MacMillan & Co., 1890 at 142.

[139] Ibid, at 289

[140] See Robert F. Reilly and Robert P. Schweihs, The Handbook of Business Valutations, Mc-Graw Hill, New York, 2000, esp. p. 331 onwards. Also see Palepu, Bernard & Healy, Introduction to Business Analysis & Valuation, South Western College Publishing, Ohio, 1996, Ch. 6

$$\text{Value of equity} = \sum_{1}^{i} \frac{(\text{Cash flow to equity})_i}{(1+k)^i}$$

Where $k$ is the risk-adjusted opportunity cost of equity (or the "risk adjusted discount rate"[141]). The most usual form for setting $k$ is under the Capital Asset Pricing Model (CAPM) where the cost of equity can be expressed as:

$$\text{Cost of equity} = \text{risk - free rate} + (\beta * \text{equity market premium})$$

Where the beta (β) is the sensitivity of the individual stock relative to the market as a whole[142] thus:

$$\beta = \frac{\text{Covariance(Benchmark Returns, Selected stock returns)}}{\text{Variance(Benchmark Returns)}}$$

What these equations tell us is that the value of a security today depends at least in part on the historical fluctuations of that security relative to the market. So in the case of two securities, where both have the same levels of anticipated cash flows accruing to them, *if one's historical returns have varied more sharply from the market rate of return than the other, then it will be valued lower.* It has already been demonstrated that a failure to communicate with a company's shareholders results in wider fluctuations in market price than a company that is effectively communicating with its shareholders; We can now extend this conclusion by

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[141] Simon Benninga, Financial Modeling, 2nd Ed. The MIT Press, 2000 at p.31

[142] CAPM, and by extension, β, is one of the most frequently attacked cornerstones of theoretical equity valuation. For one, β, should be used prospectively not retrospectively, and analysis has suggested that there is only a 45% correlation between historic and prospective β's, see "The Association between market-determined and accounting-determined measures of systematic risk: some further evidence", W. Beaver and J. Manegold, Journal of Financial and Quantitive Analysis, June 1975, at 231-284. However, for the purposes of this text we will assume CAPM as it applies to approximating the risk / opportunity cost of equity capital to be theoretically sound, if only because of the fact that it continues to be so widely used despite the academic and professional (notably Warren Buffet) criticism it has received.

stating that poor transparency impacts negatively on individual share price valuations, raises a company's cost of capital, and will also hinder long term returns on equity by raising management's threshold for future investments where investment net present value analysis is used to evaluate capital projects.

#### 2.3.3.2 Market valuation

Continuing with the theme of the impact of transparency on the process of equity valuations, the next question that must be asked is how knowledge by one analyst / investor of who the other analysts / investors are impacts upon their individual assessment of a share price's future value. There is therefore a distinction – whereas in the previous section we were concerned with the impact of transparency on the fundamental value of a company (i.e. its absolute worth), now we are concerned with a future market valuation – or what individual market players estimate to be the price another individual in the market will be prepared to pay at some point in the future. It can be argued that knowing who the current owners of any given security are impacts upon the price that a market individual estimates that security to be worth, and affects the estimate that a current owner believes the security to be worth at some point in the future. The argument is somewhat nebulous, and other than by interviewing a significant number of market participants (a study that would be prohibitively time consuming given current limitations) the only way to address this would be by way of a number of hypothetical examples:

1) Company B, with acquisitive intent, holds a 0.5% stake in company A. There are clearly a number of ways in which this might impact upon the

investment valuation of any given firm – applying a takeover premium to the valuation as well as reduced liquidity in smaller capitalised companies.

2) Company B, an activist hedge fund intent on bullying management into releasing a significant amount of retained cash to shareholders or re-leveraging the firms balance sheet, holds a 0.5% stake in company A. What impact would this have? What about knowing that companies C, D, and E hold between them some 35% and are closely allied in aims to company B? In case of fact, what if the 3rd party investor, holding 0.5% of the London Stock Exchange knew TCI held a significant part of the Deutsche Bourse and knew its intent?[143] What impact would that have had on his estimate of the future value of the London Stock Exchange's shares?
3) Company B holds 25% of Company A and is a long term strategic investor. What impact does knowing Company B holds this stake have upon your future estimate of the value of company A – given that the liquidity of company A's shares is effectively reduced by 25%?
4) Company A's share price has dropped 25% in the past 6 months. 40% of the shares are now owned by hedge funds. What impact would it have on our 3rd party to know that company B, a long only pension fund with a strong value bias, who previously owned 0.25% of company A, has recently bought a 0.5% stake?

[143] See http://www.ftmandate.com/news/fullstory.php/aid/599/Temporary_cease-fire_in_battle_for_London_Stock_Exchange.html

These hypothetical questions do not conclusively prove, and can not conclusively prove, that transparency of ownership impacts upon equity valuations, but they do demonstrate that to one investor, knowing who another investor is, or is not, may impact upon an estimate of the future value of the company. Obviously, if one extrapolates the effect of changes to an individuals future estimates to the market as a whole, the impact of these effects could be quite considerable.

2.3.4 The arguments above do need to be qualified however. There is a financial cost of transparency that cannot be ignored and must be taken into account when considering the adequacy of existing regimes. This subject cannot be considered in isolation from following sections of this thesis – to understand fully why transparency has a financial cost, one must understand the complexity both of holding structures and also of the internal complications for each institution (i.e. the reality that different pots of money are managed by entirely separate managers, with different sets of short and long term objectives may at the same time be buying shares in one company at the same time as the other is selling them. The same institution, with different sets of objectives could conceivably vote in two opposing ways – as their differing objectives lead them to different conclusions.

The fund management community would be quick to assert that these costs are very real.[144] The administrative burden of calculating net holdings as percentages[145] of market values, including calculations aggregated over a complex network of management contracts, combined with the continuing need to respond to s.212 letters[146] is an essential concern[147].

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[144] C.f. comments by Gemma Kingsley, Fund Manager, Newton, presentation given, 2004, at the IIRF conference Zurich, available at www.iirf.org/conferences/2004zurich/presentations

[145] See sections on declarable stakes, below.

[146] Even registrars operating designated accounts still estimate receipt of some 50 s. 212 letters each day – Hugh Gibson, HSBC Global Investor Services, quoted in "Seminar on transparency of ownership", Jan 2004, attended by author.

[147] Though objections on the ground of technological developments may prevail or at least propitiate such arguments.

2.3.4.1 The cost of research and investment innovation.

There is a second major aspect of the cost of transparency; institutional investors invest a large amount of time and money into their investment decisions. In a similar way to companies' investments in research and development, institutions research investment decisions – and come up with original insights into the relative valuations of their potential investments. The second cost of transparency is therefore that institutions are not able to protect their 'intellectual property' from other investors. This argument must in turn be qualified in three ways.

2.3.4.1.1 The value added of conventional equity research is probably limited, given concerns expressed above as to the possibility of genuine market out-performance by institutions solely involved in active investing.

2.3.4.1.2 Given this, merely knowing the content of other institutions' portfolios does not destroy the vast portion of the value created by that institution in conducting their own research. There are two sides to this argument. On the one hand, no one fund management house has a perfect track record with every single investment. Merely knowing that a particular house has invested a certain amount in a certain company does not reveal the full value of their research. A time delay would also make a substantial impact on this aspect of the cost of transparency – it is not so much that the returns on investment are short term (i.e. there is only a benefit to be had in an investment institutions" research in the short term), but that the market, and the company itself, are fluid organisms – and the investment case will change substantially over, for example, a three month period.

2.3.4.1.3 Disclosure of holdings to the company itself would not incur this cost. As demonstrated in the earlier part of this section – some of the most urgent reasons for transparency relate to a

company being able to identify who its shareholders are. The author, in his proposed benchmark below, argues for differentiated disclosure, whereby the public as a whole would be able to receive different sets of information from the company, negating a large part of this cost to the institutions involved.

### 2.3.5 Accountability to the market

The final justification is that there is a requirement that institutions exercise of their duties both as owners of public corporations and as managers of another person's funds.

2.3.5.1 If public companies exert significant influence over society as a whole, and we believe that the owners of public companies play a vital role in the process of governing these companies and holding them to account, as set out in section A, then the public as a whole has a justifiable interest in knowing how the duties of the persons nominated, largely by society as a whole through the allocation of investment funds, exercise this duty. It is only logical that to hold these owners to account society needs to be able to identify which companies they have invested in, and how they have exercised the rights attaching to ownership of parts of these firms. Opacity of ownership renders the accountability mechanisms between beneficiary and fiduciary inoperable and presents a significant barrier to market participant accountability, negating the benefits set out under section A, above.

## 2.4 The holders of other securities

So far in this thesis the author has chosen to focus on the holders of equity instruments, primarily institutional investors. There are two other classes of instrument that need to be

considered before proceeding further. The first of these groups is derivative instruments, which are derived from either equity or debt instruments otherwise traded in the market (other forms of derivates, be they currency, commodity, shipping, etc. are obviously not relevant). The author believes that consideration of these instruments should lie outside of the scope of this thesis – whilst they are most commonly used by the least accountable of market participants – hedge funds – they rarely carry voting rights and are very frequently traded, making their identification very difficult and their impact and relevance in the context of governance very limited. Furthermore, they are an extremely complex and technical category of instruments, and their explanation would occupy significant time and space, particularly given the impersonal nature of many "split" derivatives, where different characteristics of the same instrument are separated and then sold on to different owners. The second category of instrument not yet considered is debt instruments, and the author believes these to be far more relevant.

### 2.4.1 Debt instruments & creditors

#### 2.4.1.1 What are they?

In this section we are concerned with two distinct categories of debt. The first is financing through bank loans, or other forms of direct, illiquid and personal financing. This varies in complexity from straight forward overdraft facilities to complex syndicated loans and interest-swap facilities. The central issue here is the essentially stable nature of the creditor's identity (the debt is generally not bought and sold with any regularity, thus is held by one or more lenders for a relatively long period of time).

The second category is tradable debt instruments. In this category the author includes commercial paper and bonds (including convertible bonds). Also in this category the author considers preferred shares (as fixed interest and generally non-voting instruments even though technically an equity instrument) and hybrid securities (debt/equity hybrids treated as debt by governments for tax purposes and equity by rating agencies for the purpose of calculating credit ratings – strictly speaking preferred shares fall within this category).

2.4.1.2 What control or influence do they exert over companies?

Creditors, whether specific direct creditors or the market in general, through the ownership of bonds or other tradable debt instruments can exert as much influence over companies' management. This is particularly true of individual large creditors, such as banks, who have a significant interest in seeing returns on their investments. A large part of their power derives from control rights that attach to "covenants" attaching to the debt in question.[148] Covenants generally require the borrower to adhere to certain conditions, for example the maintenance of certain proportions of assets. If the borrower breaches these conditions, then the lender gains rights to take certain actions for example seizing certain assets. Furthermore, both financial lending institutions and the debt markets exert significant control over companies because of a continuing need to refinance, "As a result of having a whole range of controls, large creditors combine substantial cash flow rights with the ability to interfere in the major decisions of the

[148] See Smith, Clifford and Warner, 1979, "On financial contracting: An analysis of bond covenants", Journal of Financial Economics, 7, 117-161

firm".[149] This control can have serious negative impacts on long term returns to shareholders – existing covenants may prevent future investment[150] and the negotiated power of major creditors may force inefficient liquidation, particularly when much of the value of the firm lies in future growth[151]. Whilst there has been some academic discussion on the theoretical role that creditors have to play in corporate governance[152], there is only limited empirical evidence. However, it has been noted that in Japan, firms with a "principal banking relationship" have significantly higher levels of board turnover whilst underperforming than those who do not[153]. Furthermore, in Germany there is some evidence that financing banks (also holding equity) are significantly more effective at improving management performance than other blockholders[154]. Individual cases have been documented of the role specific fixed income investors have played in corporate governance[155]. In all cases, however, the impact that creditors have on corporate governance is limited by the legal measures in place in each country and is

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[149] Andrei Shleifer and Robert W. Vishny, "A survey of Corporate Governance", The Journal of Finance, LII No. 2, June 1997

[150] See Hart and Moore, 1995, "A theory of debt based on the inaliability of human capital", Quarterly Journal of Economics, 109, 841-879.

[151] See Diamond, 1991, "Debt maturity structure and liquidity risk", Quarterly Journal of Economics Studies, 106, 1027-1054.

[152] C.f. Grossman-Hart, 1986, "The costs and benefits of ownership: A theory of vertical and lateral integration", The Economics of Information and Uncertainty (University of Chicago Press, Chicago). Townsend, 1978, "Optimal contracts and competitive markets with costly state verification", Journal of Economic Theory, 21, 265-293.Hellwig, 1985, "Banking and finance at the end of the twentieth century", Wirtschaftswissenschaftliches Zentrum discussion paper No. 9426, University of Basel.

[153] See Kaplan and Minton, 1994, "Appointment of outsiders to Japanese boards: Determinants and implications for management", Journal of Financial Economics, 36, 225-257 and Kan and Shivdasani, 1995, "Firm performance, corporate governance and top executive turnover in Japan", Journal of Financial Economics, 38, 29-58.

[154] Gorton and Schmid, 1996, "Universal banking and the performance of German firms, Working Paper 5453, National Bureau of Economic Research, Cambridge MA, USA.

[155] See Gilson and Stuart, 1990, "Bankruptcy, boards, banks and block holders, Journal of Financial Economics, 27, 355-387 and Gilson, Stuart, Kose John and Larry Lang, 1990, "Troubled debt restructurings: an empirical study of private reorganisation of firms in default", Journal of Financial Economics, 27, 315-355

dependent on cultural issues[156]. In general, the legal protection offered to creditors exceeds that of shareholders (debt being more "senior" in corporate finance terms than equity). In addition, creditors have individual rights of action against a company for payment in ways that shareholders do not – making them even more important to identify as individuals.

In conclusion, creditors can exert significant influence, both directly and indirectly over a company's management. It is essential that we are able to identify who a company's creditors are, both in terms of tradable debt instruments and direct creditors. Additionally, the problems that commonly occur when companies need to renegotiate debt held by a large number of dispersed creditors (i.e. where there are a large number of small creditors it is harder to renegotiate in the face of bankruptcy or default than where there are a small number of large creditors[157]) may be more easily overcome when the creditors can be easily identified and communicated with – so the interests of shareholders may be protected in the long run by a company's ability to identify and communicate with holders of traded debt to prevent liquidation at times of cash flow or funding crises. Their holders' accountability and identification is therefore as critical as the holders of equity instruments.

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[156] For example, in Germany and Japan large banks exert significant influence because of both block holdings and board positions. For a discussion on the legal regime in Italy and its impact on creditors role in corporate governance see Fabrizo Barca, 1995, "On corporate governance in Italy : Issues, facts and agency", manuscript available from the Bank of Italy, Rome, quoted in Shleifer and Vishny, above.

[157] See Gertner and Scharfstein, 1991, "A theory of workouts and the effects of reoganisation law", Journal of Finance 46, 1189 - 1222 and Bolton and Scharfstein, 1996, "A theory of predication based on agency problems in financial contracting", American Economic Review, 80, 94-106.

### 2.4.2 Hybrid securities

The distinction between equity and debt instruments is becoming further blurred by the (re) emergence of blended equity and debt instruments that are often referred to as "hybrid" securities (also called "Dequity"). These instruments are rising in popularity primarily because of their capacity to be treated as debt by tax authorities (thus making coupon payments to security holders tax deductible) but allowing rating agencies to treat the securities as equity (with the corresponding effect on credit ratings). They have significance to this thesis however, primarily because of the holders' capacity to exert, potentially, far greater impact on the company than either debt or equity holders individually :

With dequity, however, the investors can provide safeguards to protect their interests. With dequity, an investor has more than a vote at the annual meeting as a means of directly influencing management action.

> With [hybrids], however, the investors can provide safeguards to protect their interests. With dequity, an investor has more than a vote at the annual meeting as a means of directly influencing management action...Investors can use dequity creatively when they want to impose restrictions on management discretion but at the same time want to specify conditions under which the constraints are automatically lifted or provide themselves with the means to make such choices under prespecified [sic] conditions. Therefore, the creation of dequity in all its varieties can involve a great deal more than merely creating a tax dodge, although it sometimes is just that. Dequity can also be more than a means for solving case-specific problems, although it is also sometimes just that, as well. In the broader sense, dequity can be the mechanism for defining new forms of business organization that are very different from the traditional corporation.[158]

[158] Andrew H. Chen, and John W. Kensinger, Innovations in Dequity Financing (New York: Quorum Books, 1991) 6

The process of identifying such instruments is generally equivalent to that used to identify debt holders, as the two shall be treated together for the remainder of this thesis.

# 3 Section C – transparency in context: structural concerns

Sections A and B, above, highlight some of the reasons why transparency of securities ownership is an important concern, specifically as part of the governance framework. This section sets out four structural and practical observations that impact on the ongoing discussion.

## 3.1 A statistical regression analysis of institutional ownership of the S&P 500[159]

The first and second of these observations can only be proved by reference to real world data on institutional ownership patterns. Other than the most general observations about ownership levels[160], it is very difficult to obtain good quality ownership data that can be rigorously analysed, because of the lack of a comprehensive top-down transparency regime in many countries, including the UK. However, the US 13-F system does allow this sort of analysis for US institutions' holdings in US companies, for reasons that will be discussed in detail below. The author recognises that this thesis is focused on the UK and that the inclusion of foreign ownership data only provides limited analytical support. However, in other ways the structure of institutional ownership in the UK and the US can be characterised as similar in a superficial sense, and there is a high chance that analytical insight from a US focus can be applied to the UK market in a limited way.

In order, therefore, to analyse institutional ownership patterns as they apply to transparency of ownership, a regression analysis of EDGAR (i.e. 13-F obtained) holding

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[159] Data provided by Reuters, correct as of 13th February 2007

[160] Such as those set out in the DTI study referred to above

data has been performed by the author, using EDGAR data sourced from Reuters, which has revealed two key findings[161].

3.1.1 The US market is categorised by a high level of institutional ownership in general, and individual institutional stakes are generally small relative to declarable stake levels in jurisdictions that have them[162]

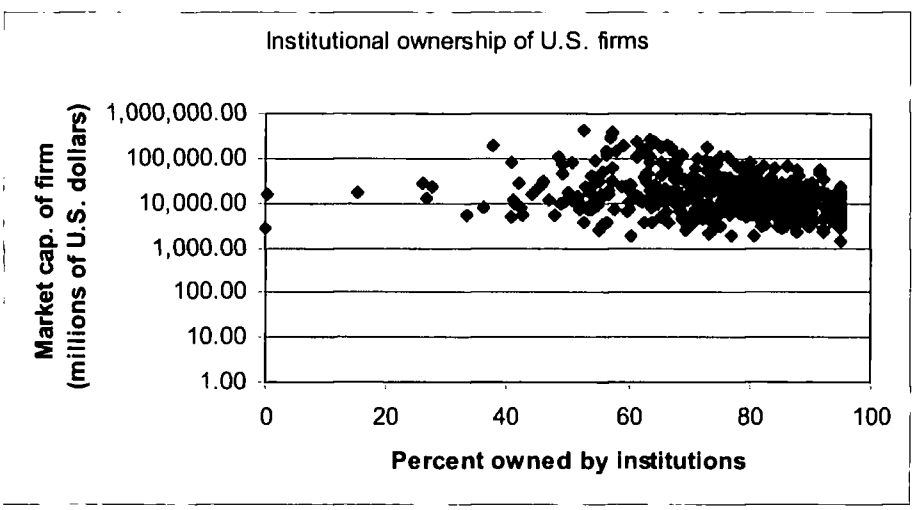


Figure 3.1.1.A

3.1.2 Figure 3.1.1.A, above, shows the top down institutional ownership levels for the S&P 500, broken up by market cap. A statistical regression on the same data gives an $R^2$ [163] of 0.06 which indicates that within the S&P 500 ownership levels are not related to

[161] All graphs and regression conclusions are therefore the sole work of the author based on his own analysis. Data is correct as of 13th February 2007.

[162] The concept of "declararable stakes", which is a key one when discussing transparency of ownership, is discussed in detail below. For the purposes of this analysis, they can be summarised as regulatory devices that trigger mandatory disclosure of a person's holding when it reaches a certain size relative to the size of the company invested in (generally at a level between 1 and 5 percent).

[163] R squared is a measure of "fit" of a proposed linear statistical model. It is more formally referred to as the "coefficient of determination". For further details see http://en.wikipedia.org/wiki/Coefficient_of_determination , where the formal definition is given as "the proportion of variability in a data set that is accounted for by a statistical model".

market capitalisation. The average ownership level for the S&P 500 is approximately 75%, with the majority of firms being between 60% and 80% owned by 13-F compliant institutions. Institutions, therefore, predictably represent extremely important "players" in the transparency debate – far greater than so-called "retail" owners (i.e. private individuals). These same institutions generally take what could be classified as objectively large, but relatively small, stakes in the firms they invest in :

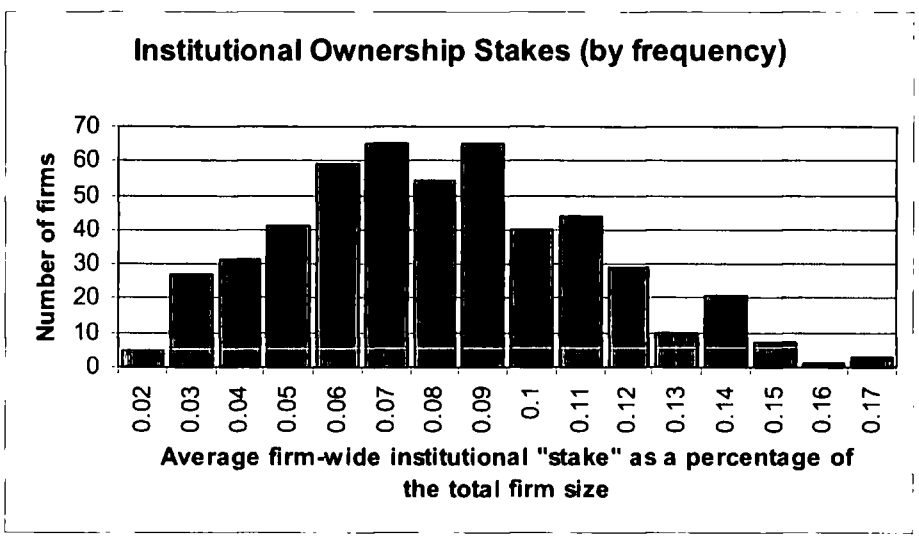


Figure 3.1.3.A

Average approximate institutional holding sizes (calculated by taking the total institutional ownership figure and dividing by the number of institutional holders) are approximately normally distributed, around the median of 0.075%. The lowest declarable stake level, as shown in section 4 below, is 1%, with many countries having minimum levels at 3% or even 5%. At the 1% level, transparency would only disclose positions more than 10 times the size of the average, and would disclose only those positions significantly more than two

standard deviations away from our sample sizes' mean[164]. It therefore follows that there is a very strong logarithmic correlation between market cap and average institutional position:

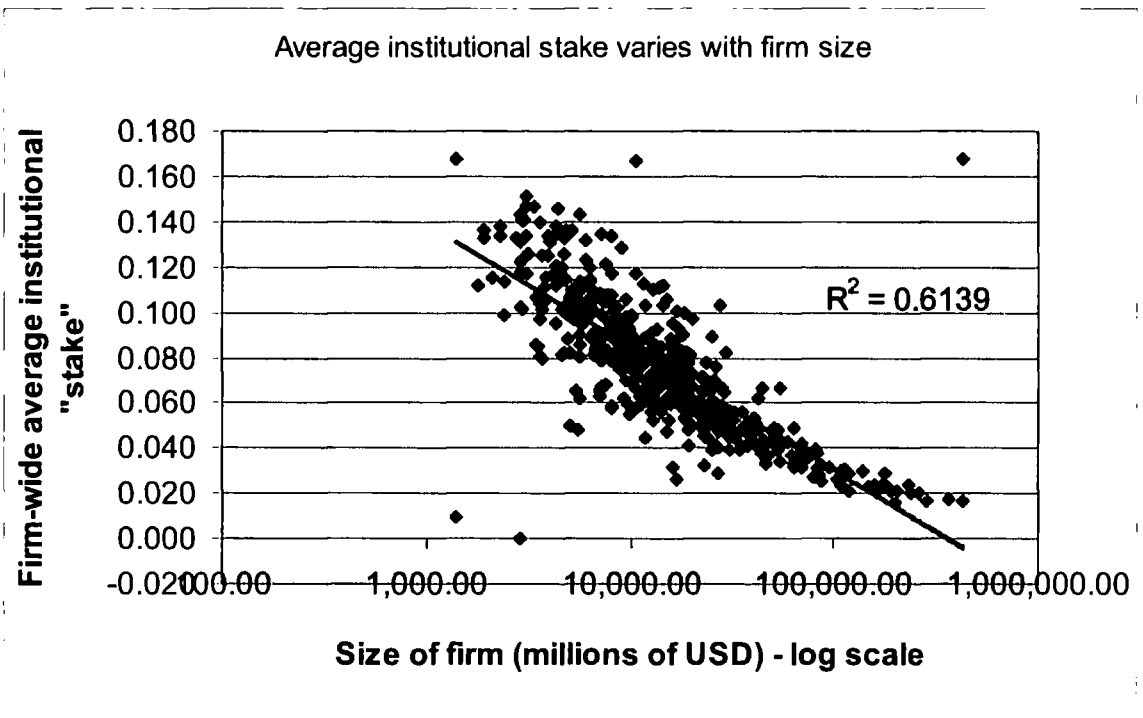


Figure 3.1.3.C

An $R^2$ of over 0.6 shows a very strong correlation. As one would expect, as the size of a firm decreases, an institution makes a correspondingly larger position, relative to the firm. The logical implication from this is that in absolute terms, institutions tend to take similarly sized positions. It therefore follows that, given the wide range of market capitalisation of leading stocks (in our sample set running from $427 billion to $1.2 billion), our analysis shows that a significant holding varies in direct proportion to size.

[164] Standard deviation = 0.03, mean = 0.075, median = 0.076. n.b. 2 standard deviations either side of a sample set's mean is considered statistically significant, and should be only 5% of a sample size – i.e. a declarable stake level of 0.6% would only "catch", statistically, 5% of institutional positions.

Observation 1 therefore suggests that there is a strong case for either a variability of granularity of transparency according to size, set to a level sufficiently fine to identify statistically significant stakes, or for a universally fine degree of transparency to cover both ends of the spectrum. A universal level, even as small as 1%, is therefore inadequate.

### 3.1.3 Observation 2: Whilst calculating "turnover" of institutional positions is difficult, superficial analysis suggests that turnover may be as high as 10% of a firm per month.

Calculating how frequently the average institution "turns over"[165] is very difficult to do accurately. There are two possible approaches, both of which are flawed in different ways. The first approach is to look at monthly share turnover figures sourced from the relevant stock exchanges. The problem with these figures is that they include all trading in an individual firm's shares – not just the trading in institutions' positions[166]. A histogram (frequency) showing the variance in monthly net share turnover as a percentage of a firm's market capitalisation is shown below. The results are very approximately normally distributed around a median of approximately 15% of share capital, see figure A below.

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[165] i.e. changes an individual holding

[166] This problem will be particularly accentuated for market-made (i.e. quote driven not order-matched stocks), where one or more market-makers are involved in trading small blocks of shares at high frequency to provide liquidity to other market participants.

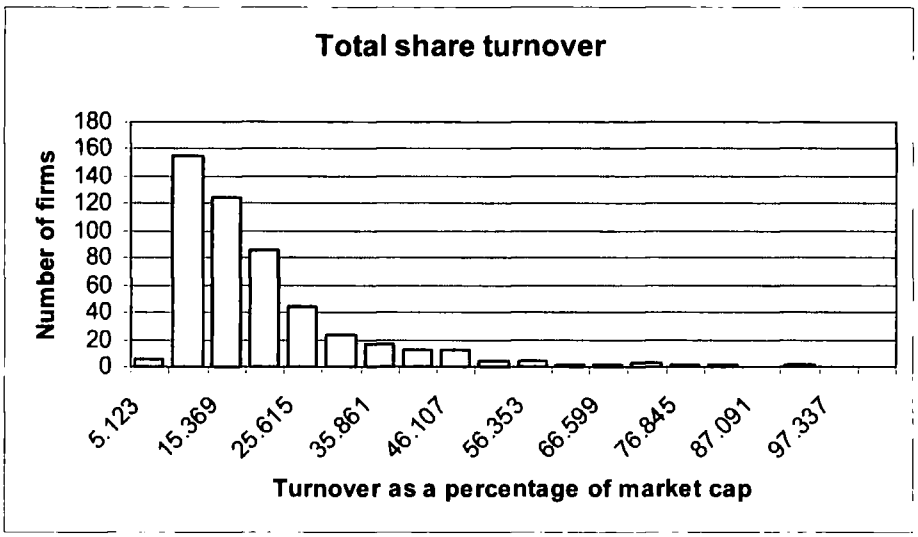


Figure 3.1.4.A

The second possible method is to use 13-F filing data, by comparing institutional positions at the beginning and end of each reporting period. This has two problems. Firstly, reporting is periodic – and so by measuring turnover across periods, one misses out on inter-period changes in positions. The data itself is also conceptually difficult to analyse – with gross changes in institutional ownership the more intuitive analytically.

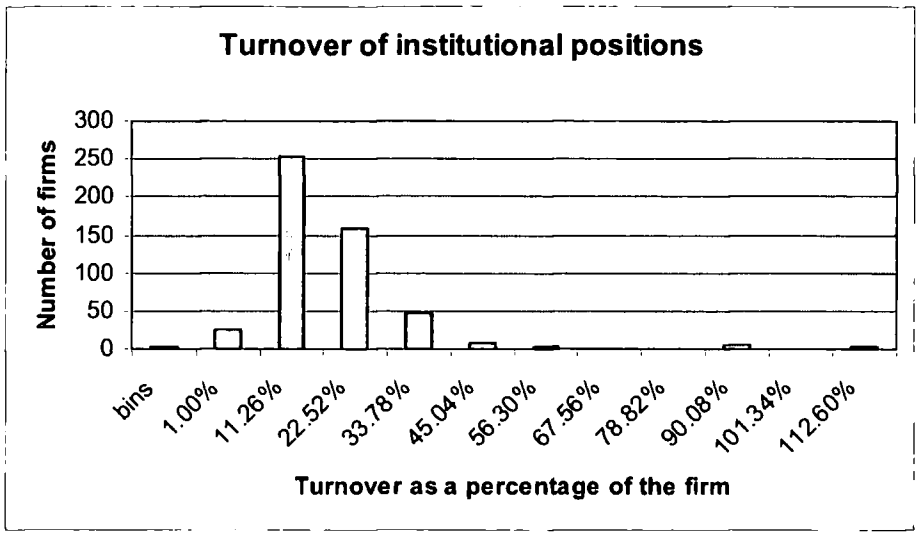


Figure 3.1.4.B

Figure B shows that institutional turnover is normally distributed around approximately 20%.

These data cannot be taken too seriously, for all of the reasons already given. It also over-emphasises the importance of shorter-term institutions, which have an arguably lesser importance in the context of the transparency debate. However, the general point that transparency is time sensitive is reinforced by these data. It is difficult to quantify the requirement for timeliness, but one could tentatively suggest that the data justify sensitivity at the 2 weeks – 1 month level.

## 3.2 Observation three: Institutional holdings make extensive use of trust structures, and transparency needs to be able to penetrate through many "layers" of nominee accounts[167]

The obvious question, from an educated layman or observer, would be "Why, in an era of dematerialised share registers, is there a problem with transparency at all?"[168] The logic behind this question is obvious – with the advent of the CREST system in the UK, and similar systems elsewhere, any interested party can simply request access to the shareholder register and look up the names of the registered shareholders directly. The problem with this is that it ignores the impact of nominee accounts and beneficial share ownership (except under certain limited jurisdictions, such as Scandinavia, which have their own distinct problems, discussed below in section D). There are essentially two problems with nominee share ownership. Firstly, shares are registered not in the name of the underlying owner, but instead in the name of a nominee account. The nominee account may be a direct 1 – 1 account – such that with the right information it is possible to line up the account with the underlying owner – or a pooled nominee account, where many underlying shareholders use the same account in which to hold their shares. Some hypothetical examples are set out below[169]

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[167] The following examples and explanation draw heavily on Ryder & Register, "Investor Relations", and the following additional sources :

R. Minns, Pension Funds and British Capitalism, (London: Heinemann, 1980) 41
Committee of Inquiry into UK Vote Execution (London: National Association of Pension Funds, 1999)
The Law of Pension Fund Investment (London: Butterworths, 1990) Ch. 4
Institutional Shareholder and Corporate Governance (Above)
Linklaters & Paines, Unit Trusts: The Law and Practice (London:Longman, 1989)

[168] In fact, the 2003 IIRF survey, above, found that this was, in fact, one of the most common comments from industry professionals when surveyed. See http://www.iirf.org/transparency

[169] The examples and diagrams that follow are based on this author's industry knowledge and informal interviews with industry participants (particularly with Richard Jenkinson of Junction RDS). Supporting data can be found in the DTI Nationwide shareholder data (above).

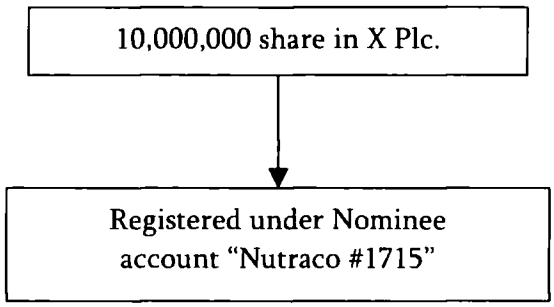


Figure 1

Such a holding would, in fact, be partially transparent, as the Nutraco nominee account is a one-to-one designated nominee account for Merrill Lynch Asset Management. However, this would not reveal the controlling interests or even the beneficial owner, since the funds may be under management on behalf of a pension trust, or may have voting rights vested elsewhere. Thus, given that "equities owned beneficially by institutional investors...are managed by fund management firms. ... In the case of some firms...the vast majority of assets under management are those of external clients"[170], we know that the structure employed may (and almost inevitably will) be more complex than the above example. Therefore varying figure one, we may hypothesise the following example –

[170] ibid. at 5

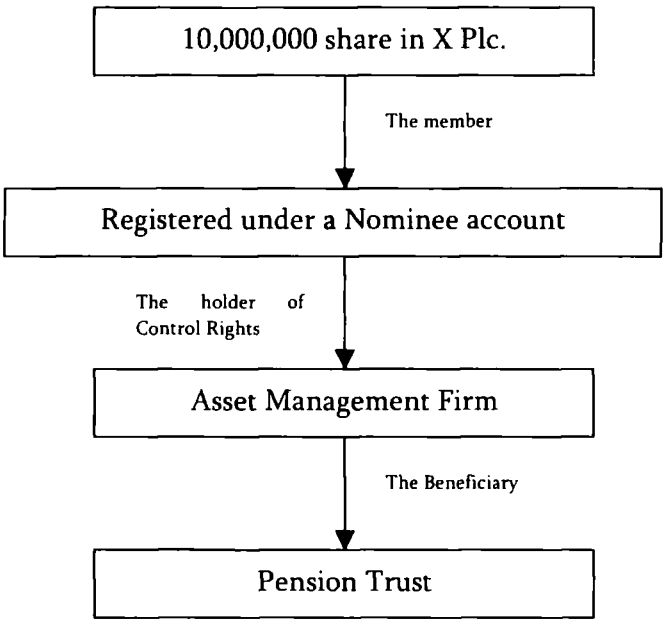


Figure 2

Control rights tend to encompass voting rights and information rights, and normally also carry a discretionary right to trade the shares in question.[171] They may, and often will, be divested across many sets of fund managers, with voting rights attaching to corporate governance agents, transfer rights vested in the fund manager, and information rights still vested elsewhere[172]. It is therefore apparent that the process of shareholder identification is much more complex than it may initially appear. For various reasons, it may be essential to identify both the beneficiary and the agent holding controlling interests (hereafter 'the agent'). By amalgamating all the above information one can compose a hypothetical bottom-up model.

[171] See G.P.Stapledon, Institutional Shareholders and Corporate Governance (Oxford: Clarendon Press, 1996) 89.
[172] See Pensions Act, 1995, s34.

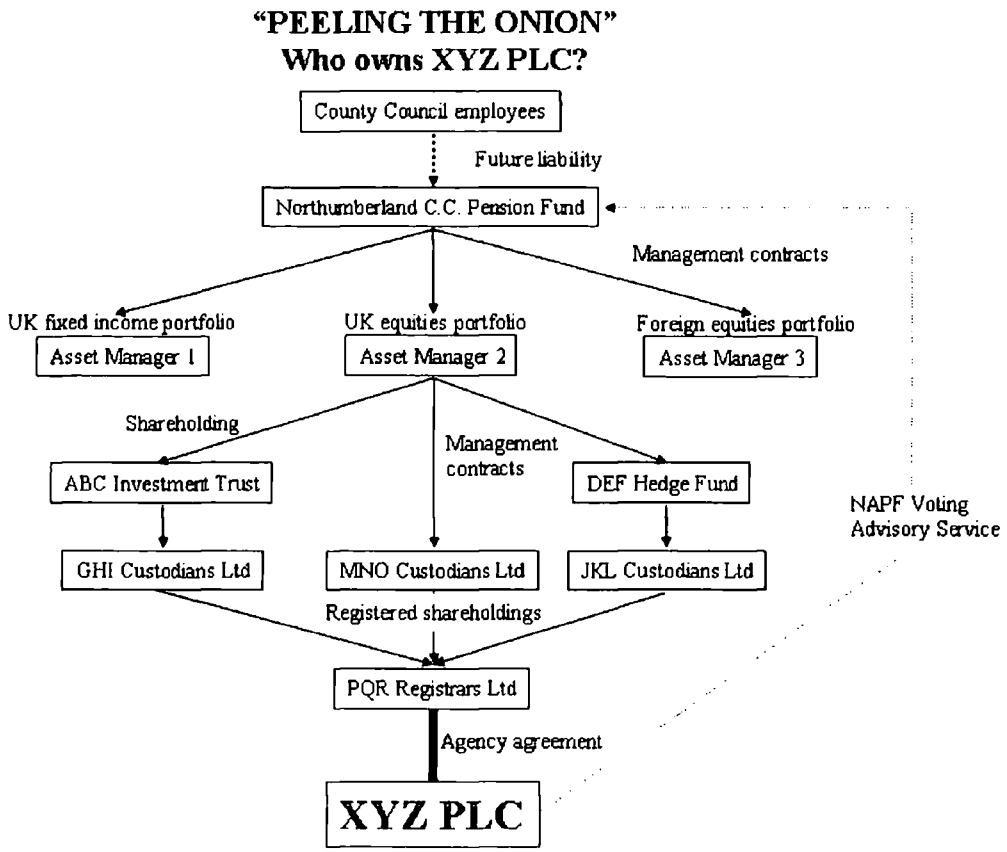


Figure 3[173]

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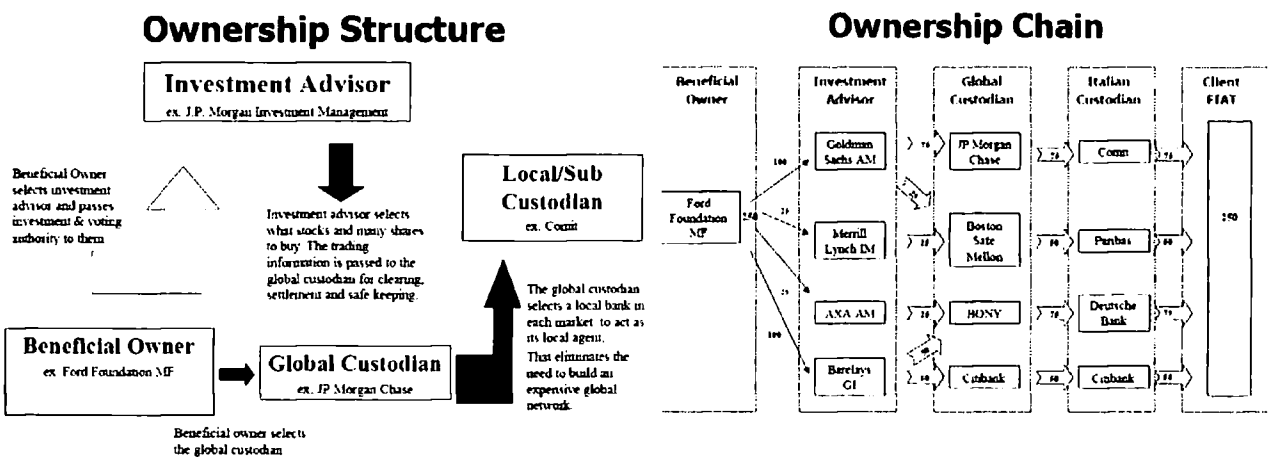
It would be too complex to map the holding structures of such funds even covering two or three of the companies in which they held shares. Figure 3, therefore, attempts to illustrate simply the complexity of the task at hand. It also illustrates that the process may not be as simple as identifying one beneficial holder or identifying one controlling agent, as there may

[173] Based on a similar illustration by Ryder & Register, above, at 72

be several[174]. Monte Titoli's legal department have also helpfully provided the following illustrations of ownership structures which they have encountered in their own work[175] :




### 3.2.1 Observation four: share ownership is becoming rapidly more of a global issue and transparency needs to be analysed within this context.

The increasingly global nature of capital markets is an oft-discussed issue, and there is little purpose in repeating the debate here. That cross-border ownership in the UK has increased in recent years is an undisputed fact :

> "The total "overseas" holding of UK equities increased from 7 per cent in 1963 to 13 per cent in 1992. It then accelerated to 24 per cent by 1998...the slight decline in the proportionate holding of local institutions between 1992 and 1998 has almost certainly been offset by an increase in the holding of overseas institutions.[176]"

[174] The additional complexities of where one fund holds a compound interest (i.e. one exercised through two or more fund managers operating independently of the other through separate management contracts, possibly managed in different countries) in the same stock is considered below

[175] See : "The Shareholder ownership chain" - Ennio Della Piane and Andre Perrone, legal department, Monte Titoli

[176] Share ownership and control in UK, above, at 4

The impact of this is obvious – if transparency regulations are only effective within a domestic context then they are already, and are increasingly even more, inadequate. It is vital that the analysis that follows is focused on effectiveness in the context of global capital markets.

# 4 Section D – a proposed transparency of ownership benchmark

As discussed in sections A, B, and C above, the goals of transparency of ownership and accountability vary according to the parties concerned. Table 4.1 below sets out the major concerns discussed in the above sections, broken down by party concerned.

| Parties | Objectives / Justifications | Qualifications / Problems |
|---|---|---|
| Market Participants : General Public<br>Market Participant : Regulators / Government | • Accountability on governance, voting, and decision making. Enable beneficiaries to assess performance of managing agents. Create an environment where general public and governments are able to assess "wrong doing" by participants and regulate effectively.<br>• Providing incentive structures to improve performance of both participants - through encouraging active ownership and well as active management - and that of company management from resulting increased monitoring and feedback.<br>• Highlight and discourage "conflicts of interest" and encourage the development of adequate structures / systems to manage those which are unavoidable. | • Costs of full transparency to institutions which would be ultimately borne by general public.<br>• Free-rider costs to individual fund managers' research investments. If transparency is too effective then incentives to engage in research and active ownership are decreased as others are able to "freeload" onto others' investments by replicating manager behaviour.<br>• The overall picture is very complex. It needs to be easy to identify who holds voting discretion and investment discretion over individual holdings, as well as being able to trace holdings back "up the tree" to beneficiaries. |
| Participant : Company | • Reduced volatility through improved communication processes<br>• Effective and equitable allocation of management time (requires a long term "picture" of the shareholder base)<br>• Cost savings in the communication process.<br>• Auditing and monitoring the voting process<br>• Reduce role of highly conflicted financial intermediaries in the communication process. | • Timeliness essential for effective management of communication process. Need to carefully manage free rider problem (as above).<br>• Fine detail required – not adequate to identify holders at (for example) the 1% level, because of the significant absolute size of smaller stakes. |
| Participant : Shareholder | • Protection from wrong-doing in the takeover context.<br>• Improve the efficiency of the capital allocation process and to allow firms to understand the objectives and characteristics to fellow or potential fellow shareholders.<br>• Enable co-operative governance and overcoming some of the externalities (i.e. the free rider problem) that act to discourage investments in corporate governance by enabling shareholders to co-operate in the process of applying pressure. | • Especially important in this context that other security holders are also identified, particularly equity derivatives where these carry voting rights, but also credit instruments. In the context of companies facing financial difficulties, credit instrument holders may assert more power than equity holders.<br>• Conflict exists on the issue of timeliness. For one, it is important that a prospective shareholder knows that a short-term activist hedge fund has just taken a large stake, but it is also important that the hedge funds' research investment is protected. |

Table 5.1

In the light of the above table, it is clearly obvious that assessing the current legal regimes in place depends on formulating a clear set of standards that take into account the above concerns and complications. The issue is not at this stage how either law or commercial practice should enable these requirements to be achieved, but by what standard existing systems should be assessed. The author proposes the following seven point test.

1) A test of comprehensiveness

Transparency should not be limited to equity instruments, but should cover equities, credit instruments and all derivative instruments which carry voting rights or which can be used directly to influence management, for example debt covenants, or can convert to instruments carrying such rights.

2) A test of personage

Transparency should not be limited to institutions, but where possible holdings should be connected to individuals of influence in exercising either investment discretion or voting discretion, such that those persons can be clearly identified, communicated with and where appropriate held accountable, just as the managers of public companies are. In other words, transparency should target the genuine decision makers/fund managers themselves - ie. the individuals who in fact exercise investment discretion. And firms should not be able to shield those genuine decision makers behind nominated individuals (such as 'corporate governance officers') who in fact do not take significant decisions.

3) A test of timeliness

Transparency should be as close to real-time as technology and practicality allows, subject to the qualifications under tests 6 and 7.

4) A test of proportionality

Transparency should be implemented in such a way as to scale in the detail of coverage proportionate to the size of the underlying firm[177]. The level of transparency should be proportionate to the size of the position this represents, and be sufficiently detailed so as to enable all of the functions of transparency to be effectively fulfilled.

5) A test of global effectiveness and universality

Transparency regimes should function effectively. Any rules and regulations should be applied equally and should be equally effective, so that individual classes of participants or nationalities of participants are not unfairly able to avoid having to disclose holdings. A regime of transparency should be functionally and practically effective, particularly in a global and cross-border context.

6) A test of competitiveness, cost and efficiency

Transparency regimes should not impose any significant cost burdens on any parties. The system(s) should not threaten the competitiveness of any one or more major financial centres through overly burdensome regulation or the creation of competitive advantages through non-compliance. Transparency measures should be efficient in their operation, not prone to errors nor time consuming to implement.

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[177] A ½ % holding in the largest firm in the S&P 500 would equate to approximately $2 Billion (larger than a 100% holding in the smallest!) whereas for the smallest firm this would amount to only $ 6.2 Million (figures correct as of 29/12/2006, see http://www2.standardandpoors.com/spf/pdf/index/500factsheet.pdf).

Any rules or regulations should be clear, easy to understand, unambiguous and simple and not burdensome to comply with.

7) A test of differentiation

Regardless of how transparency data is collected, it should be distributed or made available differentially to different parties. In particular, there should be a delay in the timeliness of the information that should vary dependent on the cost of dissemination to that party borne by the provider or the participant whose holding is being disclosed (i.e. the value of research investment destroyed by the disclosure concerned).

# 5 Section E – benchmarking the existing structures, systems and regulations[178]

## 5.1 The major systems of transparency in place across the major countries researched.

Whilst the provisions and laws in place across the countries surveyed are set out in detail under section 5.2 below, the author has attempted to categorise the major systems in place in table 5.1.1 :

| Type | Description | Failings |
|---|---|---|
| Declarable stakes ("Triggered" Disclosure) | Participants are obliged to disclose holdings where such a holding is above a given threshold. Disclosure made to either the company, to a regulator or to a central register. | Requires continual checking by participant and auditing by regulator. Difficult to enforce. Insufficiently detailed. Imprecise. Impersonal. |
| Disclosure "on demand" | Participants are obliged to disclose either holdings or underlying beneficial interests at the demand of a regulator, intermediary or company. | Expensive, inefficient, impossible to verify, difficult to enforce. |
| Disclosure by registration | Registers, updated either periodically or shortly after transactions. Includes simple nominee registers (such as a UK register), and full beneficial interest registers. | Depends on the quality and accuracy of registered data. Questions must be raised over whether practically workable in a global context. Mere nominee registration effectively useless. |

## 5.2 The UK model

A public company may by notice in writing require [disclosure from] a person whom the company knows or has reasonable cause to believe to be or, at any time during the 3 years immediately

[178] The following sections, aside from the materials covering the UK, draws heavily upon "Disclosure of share ownership in listed companies: an international legal survey", Charles Mayo, Simmons & Simmons, 2004. The author acted as the UK based liaison and co-ordinator for this study.

preceding the date on which the notice is issued, to have been interested in shares comprised in the company's relevant share capital[179]

### 5.2.1 The shareholder register[180]

In the UK shares in public quoted companies are generally not issued as bearer shares, but are registered (or "dematerialised"). The company is required to keep a register of shareholders ("members"), under section 133 of the Companies Act 2006 (s. 352 of the Companies Act (1985)). The register must include names and addresses[181] and the number of shares held[182]. There are penalties for failing to keep a register accurately[183]. Whilst the Act implies that the register should generally be kept at a companies office[184], the Act allows for a register to be maintained by a 3rd party, and for the register to be kept at their office[185]. A register is generally to be kept in an easily accessible manner with an appropriate index[186] and there is a comprehensive and general right to access to the register by the public[187]. For the purposes of this thesis however the key provision in the act is s. 126 which states that "No notice of any trust, express, implied or constructive, shall be entered on the register, or be receivable by the registrar...". Given the prevalence of nominee accounts for share registration this means that merely reviewing a shareholder register is not sufficient under the seven tests

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[179] Companies Act 1985, Chapter 6, s.212 (Eng.)
[180] It should be noted that the position in the UK has not been substantially impacted by the Companies Act 2006, which came into force in part from the beginning of 2007. References given are to the Companies Act 2006, with the corresponding section of the 1985 act where appropriate. The exception is s.212, where the author will continue to refer to s.212 notices because of the wide extent of their common usage in the context of shareholder identification amongst non-legal practitioners.
[181] s. 113 (2)
[182] s. 113 (3)
[183] S. 113 (7)
[184] S. 113 (1)
[185] S. 113 (1) (b)
[186] s. 115
[187] S.116

established above. Fortunately, there are two major classes of provisions which enhance the quality of available data in the UK.

### 5.2.2 Declarable Stakes

Under ss.792[188] any person, legal or natural, acquiring an interest in the relevant proportion, normally 3%, of "Relevant share capital" must disclose as such to the company within the prescribed period[189]. Under s792(2) it may even be interpreted as requiring disclosure at 3% of any class of shares, even if that holding is significantly lower than 3% of the total voting capital. Disclosure must occur within the prescribed period running from registration – which is most relevant in the context of share issues[190], but only when the holder becomes aware of the arising of his interest[191]. The definition of what comprises an interest is extremely wide[192] with a small number of exclusions including derivative options, but only where they do not have attached voting rights[193].

### 5.2.3 Concert Parties

Protection against the stealthy acquisition of holdings through what are known as "concert parties" is also offered by both the Act and the Code on Takeovers and Mergers. Under s.824 the definitions of a "concert party" and the precise rules applicable to them are quite complex – and setting them out here in some depth is unnecessary, save that to state that

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[188] CA 2006
[189] Note that this requirement places a greater obligation that required under relevant directives, above.
[190] National Westminster Bank Plc v. Inland Revenue Commissioners [1995] 1 A.C. 119 HL.
[191] S.792
[192] s.820
[193] s.820

under s.825 each member of the party is taken for the purposes of ss.792 to be interested in not only his own holdings but also the holdings of persons with whom he is acting in concert. As such, any notification that he makes must also list the names of such persons and their interests[194].

### 5.2.4 Disclosure "on demand"

Provisions that relate to demand-led disclosure under what was s.212 of the Companies Act 1985, and now s.793 of the Companies Act 2006, allow a company to serve notice on a person whom it knows, or has reasonable cause to believe, has[195] an interest in voting shares in the company. The notice may essentially ask two things, firstly to give particulars of his own past or present interest[196] and any other interests known to him[197], and secondly, where that interest is a past interest, to give details of the current holder[198]. It also requires that that person also discloses details of other persons who have an interest in the same shares[199]. Response must be within a reasonable time[200], but no guidance is given on what a reasonable time may be – other than that only 2 days will probably be unreasonable[201]. Thus where a person is the beneficiary of a nominee holding, on behalf of a further beneficiary, he must confirm his own interest and give details of the person for whose benefit he holds such an interest. Under s.808

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[194] S.825
[195] or to have had in the past 3 years
[196] s.793 (3)
[197] s.793 (4)
[198] s.793 (4)
[199] s.793 (5)
[200] s.793 (7)
[201] Re Lonrho [1988] BCLC 53, [1987] BCC 265

/ s.810 (formerly s.211 and s.219) any such register composed must be made available to the public of disclosures made under both s.793 and the declarable stakes provisions.

### 5.2.5 The Transparency Directive[202]

The Transparency Directive updated and amended parts of the Consolidated Admissions and Reporting Directive and was implemented in the UK by regulations made under the Financial Services and Markets Act, 2000. The Directive recognised that :

> Efficient, transparent and integrated securities markets contribute to a genuine single market in the Community and foster growth and job creation by better allocation of capital and by reducing costs. The disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency.[203]

The directive was generally concerned with market transparency as a whole, with a particular emphasis on issuer transparency and the ongoing harmonisation of capital markets in line with the preamble objective quoted above. Article 9 however required member states to implement a regime of declarable stakes, with minimum declarable stakes starting at 5%[204]. This has had no impact on the position in the UK with declarable stake levels well below the required minimum[205].

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[202] 2004 /109/EC (full text at http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2004/l_390/l_39020041231en00380057.pdf )
[203] Transparency Directive (above) at p.1 (s.1)
[204] Article 9 (1)
[205] See http://www.fsa.gov.uk/pages/About/What/International/EU/fsap/td/index.shtml for further information

### 5.2.6 Remedies for breach

Failure to comply with such an order may, under s.794 (formerly s.216), subject such shares to restrictive measures preventing the voting, issuing or transfer of such shares. This is limited to what the person being asked actually knows and where the person in question can show that the requirement on him was "frivolous or vexatious"[206].

#### 5.2.6.1 The issue of "reasonable" time

It is worth noting that there is continuing confusion over the what constitutes a reasonable time period to respond to s.212 (s.793 – hereafter considered equivalent) notices – there has been some weight of comment on this issue, of particular note is "Section 212 Companies Act 1985; what is a reasonable time?"[207] and Re Lonrho (No. 2) cited below.

### 5.2.7 The case law

Given the scarcity of the case law on disclosure of interests in the UK, and the variety of points they detail, a number of them and their main findings are detailed below.

#### 5.2.7.1 Re F H Lloyd Holdings plc[208]

Lloyd Holdings restated the original purposes of the provisions under the 1981 act clearly:

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[206] s.795 (2)

[207] Freshfields, available at B.J.I.B. & F.L 1989, 4(3), 145-146 (Butterworth's Journal of International Banking & Finance Law). There is also some reasonable discussion of the relevant issues from a practical perspective in 'Patrolling your share register', P.L.C. 1990, 1(3) 18-19

[208] [1985] BCLC 293

"...the clear purpose of Part IV of the 1981 Act[209] is to give a public company, and ultimately the public at large, a prima facie unqualified right to know who are the real owners of its voting shares"[210]

This reading of the intentions behind this part of the act was echoed by the DTI in their 1995 consultation :

"[Firstly] The department considers that the original purpose of Part VI was to enable companies to know who might be in a position to influence their affairs...[and secondly] market transparency, since the information notified to listed companies...must be...made public"[211]

In the case law that followed Lloyd the courts were to echo this reading, and to give significant priority to a company's (and hence the publics) rights "to know" under s. 212.

5.2.7.2 Re Geers Gross plc[212]

Geers Gross highlights one of the key failings of the provisions under s.212 – which is that whilst in a purely domestic context it is highly effective, in a global and cross-border context it comes into strong conflict with other national laws[213]. The facts were summarised in the reported judgement:

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[209] Which became part XV of the 1985 act.
[210] Nourse LJ, at 293
[211] Company Law Reform, "Proposals for reform of part VI of the companies act, 1985", April 1995, DTI
[212] [1988] 1 All ER 224, (also : [1987] 1 WLR 1649, [1988] BCLC 140, [1987] BCC 528)
[213] Swiss banking secrecy laws, especially under Article 47 on the Swiss Law on Banks and Articles 43 & 44 of the Swiss Stock Exchange Law, strictly prohibit disclosing client data, such as which clients own which shares, under fear of very strict penalties. A Swiss banks' refusal to disclose holding data under these circumstances is understandable.

"E entered into an agreement with GG, a publicly quoted company, not to acquire more than 20% of its share capital. GG suspected that E might have breached the agreement by using nominee companies, and obtained an order...imposing restrictions...on the transfer of...shares (i.e. about 3% of GG's share capital)...held by a nominee company on behalf of a Swiss bank. The bank refused to disclose the names of its clients who had bought the shares."[214]

Not only this, but s.793 (old s.212) letters often falls foul of the sheer stubbornness or plain ignorance of international shareholders. During the course of their survey into the practical effect of transparency measures globally the IIRF and Citigate concluded that a typical response from U.S. institutions varied from "not understanding the 212 letter" or "not thinking it applied to them"[215] to an absolute refusal to recognise that foreign law binds their holdings[216]. The courts response in Geers Gross is important:

"Since a public company has a prima facie unqualified right to know who were the real owners of its voting shares the court could take into account...whether there had been a failure to disclose relevant facts about the shares. Since GG would be less able to determine the beneficial ownership of the shares and whether E had breached the agreement once the shares were sold, the applicants failure to disclose the identity

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[214] Ibid. at 224

[215] Non-attributable quoted in the 2003 IIRF survey, included in the appendices.

[216] Such as : "Where is your aircraft carrier then?", Nick Arbuthnott, Citigate, interview with author, 2004

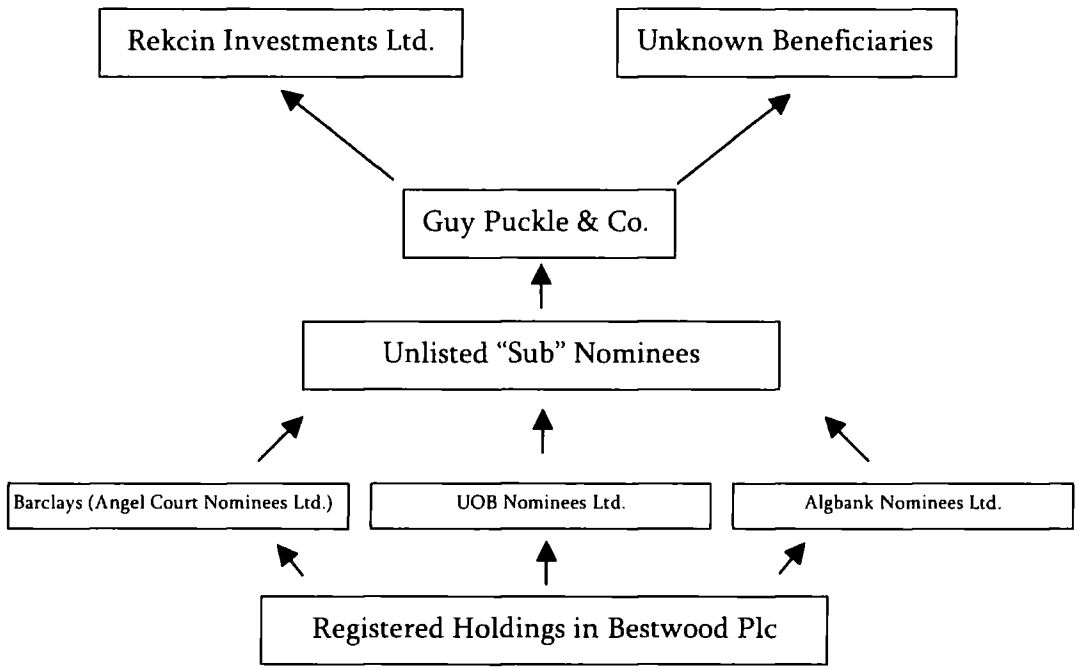
of the owners of the shares was sufficient reason for the court to refuse to give approval...notwithstanding that innocent purchasers of the shares might be deprived of the benefit of ownership for an indefinite period."[217]

The court clearly found that the right of a company to identify the holders of voting rights was effectively inviolate – over and above rights of effectively innocent third parties. More importantly, the court refused to find that a company's right in this respect could be limited in any way in terms of the accuracy or exactness of the information being sought. S. 212 / 6 does provide a truly effective method of identifying beneficial owners – but may require serious aggravation of the owners in question in order to achieve it which may not be practical or sensible for public companies in a broader context.

5.2.7.3 Re Bestwood plc[218]

Re Bestwood raised two points of significant note. The first is an illustration of the complexity of holding structures – in Bestwood the court had to consider thirteen separate respondents – and those were just the parties whose responses that the court found inadequate or were contested in some way. The structure, being somewhat complex as reported in the judgement, is illustrated below:

[217] Supra., at 224, authors emphasis
[218] [1989] BCLC 606 & [1989] BCC 620




The second point of note is that the court found all of the contested nominees liable for costs – taking the view that "paid commercial nominees are professionals. They know the ropes...if they act for overseas beneficiaries and find themselves in a position where, as a result of the default of their beneficiaries, they are made defendants to litigation, they take the risk that orders for costs may be made against them...a fortiori it should be the position of a mortgagee who is registered as the shareholder for his own interest and protection." [219]. However this is only the case where the nominee has "[not] provided full information within his power...or has contributed to the costs which have been incurred"[220]. Thus, the court effectively limited a nominee's duty to providing the best information available to him at the present time and to acting in a timely fashion.

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[219] Millett J at 3
[220] Ibid. at 4 [authors emphasis]

5.2.7.4 Re Ricardo Group plc[221]

Whilst the substance of Ricardo dealt with a detailed and complex dispute over the nature of interests transferred under contractual obligations. Of more interest, and relevance, was Millett J.'s concise judgement on the issue of costs, which requires no elaboration:

"in my judgement, these restriction order are not to be used as weapons to gain a temporary advantage over an opponent in a contested takeover bid. Their only legitimate purpose is to coerce a recalcitrant respondent into providing the requisite information. The company ought not to rush off to court without prior warning and see ex parte relief, unless it has reason to believe (a) that the respondent is deliberately withholding information, and (b) that if prior warning were given the respondent would dispose of his shares and thus evade the imposition of restrictions without which the information would be unlikely to be forthcoming".[222]

5.2.7.5 Re Lonrho (no. 1)[223]

Lonrho (transcript), was the first of a series of judgements relating to incomplete or inaccurate disclosures under the old s.212 – 216 during the hostile takeover of the Lonrho group. Browne Wilkinson's judgement demonstrates the comprehensiveness of the obligations that arise under s.212, especially in the international / cross-border context. He argued that:

"It is grossly negligent, in my view, for a corporation to go into the market and make hostile acquisitions of shares without ensuring that, whatever happens, it has the means to comply with the [relevant] statutory requirements...It is not possible to enter this type of sophisticated market properly and without gross negligence if you do not have in place the necessary organisation to ensure that the information required by that market is forthcoming and if given."[224]

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[221] [1989] BCLC 566, [1989] BCC 388
[222] Ibid. at 575
[223] Transcript: Chilton Vint, Chancery (Companies) July 1989, also see Re Lonrho Plc, [1988] BCLC 53
[224] Sir Nicholas Browne Wilkinson VC, at 19

In the reported judgement (as opposed to the judgement on facts, as detailed in the transcript), the issue before the court was whether House of Fraser Holdings Ltd. had answered a s.212 notice adequately. Vinelott J. summarised the position by stating that "in reply to a notice...he initially gave some unhelpful and facetious replies. These replies seem to me entirely out of place. A company is entitled to expect a prompt, full and frank reply to an enquiry under s.212...[This] and its related sections are an important part of the machinery afforded by the 1985 act to aid the proper supervision of the conduct of the stock market[225]"

5.2.7.6 Re Lonrho (No. 3)[226]

Re Lonrho (No. 3) introduces one important qualification to No. 1, allowing an exception for understandable human failure. In this case, the judgement was given by Hoffmann J : "the discretion s.216(2) gives the court...[is important in that] ...[the] subsection says that the order may be made. It does not say that it must be made. In...[this]...case there were reasonable grounds for supposing that the company had not...given full and accurate information...I accept that the policy of the Act is that there should be full disclosure , but allowance must also be made for human fallibility...".

5.2.7.7 Re Lonrho plc (No. 2)[227]

No. 2 was concerned with the issue of exactly how long is a "reasonable time" within the scope of the Act to respond to a s.212 notice. The effect of the judgement is to keep a "reasonable time" open ended. It must include an allowance for the parties to consult with

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[225] Re Lonrho Plc. [1987] BCC 265 at 268 (authors emphasis)
[226] [1989] BCLC 480
[227] [1989] BCLC 309



English & Welsh solicitors (especially in the context of an overseas organisation), but need not include an allowance for any holiday days where such holidays are not recognised as such in the UK. The remainder of the judgement was concerned with detailed matters are not relevant to the remainder of this discussion.

### 5.2.8 The adequacy of existing provisions

Seven tests were proposed, under section 3 above, against which to test the various systems analysed in this section of the paper. These tests were:

#### 5.2.8.1 Comprehensiveness

The UK system fails on the test of comprehensiveness. The law applies only to equity instruments (and probably derivatives, although as already mentioned there is no clear position regarding derivatives). Credit instruments are excluded from these provisions, as are credit derivatives.

#### 5.2.8.2 Personage

The UK system fails on the test of personage. S.793 notices do not require disclosure of individual or individuals with "investment discretion" as proposed under this test.

#### 5.2.8.3 Timeliness

The UK system neither passes nor fails the test of timeliness. Whilst the UK allows relatively prompt discovery of share ownership, it requires s.793 letters to be sent

back and forth, often requiring several letters to "pierce" through complex webs of nominees and sub-nominees. This is not so much a problem with the provisions per se, rather it is a problem with the commercial and practical usage of s.793 notices.

5.2.8.4 Proportionality

The UK system does not specifically address the issue of proportionality. Declarable stakes obviously fail under this test, but s.793 effectively provides a company with the means to identify holders to whatever scale they deem appropriate. The system therefore effectively passes this test.

5.2.8.5 Global effectiveness and universality

The UK system partially passes this test. As seen above, s.793 is fully effective in a confrontational context at discovering stakes, or rendering the shares effectively useless until such disclosure is made. However, s.793 does suffer a large degree of practical ineffectiveness in the context of day to day use by corporations. There has been little research in this matter, other than the IIRF survey already mentioned. They found that the largest problem with s.793 was straightforward non-response. The worst culprits were found to be continental holders, followed by U.S. institutions[228]. In the case of continental institutions, the problem was often one of a failure of understanding – often because share ownership operates within an unregistered system, i.e. one of bearer rather than registered shares. Here the domestic banks and small institutions are

[228] IIRF, 2003, above

unfamiliar with UK provision and are unused to the whole notion of transparency at levels below that of declarable stakes. Alternatively some institutions are simply belligerent, especially in the US. The US system of disclosure works in a very different way, through a central reporting mechanism for institutions, so that failure to understand the nature of the 793 letter is hardly surprising. The large institutions are less often the culprits, "The truly international institution, a Fidelity or a Capital, understands the s. 212 letter...and obeys it"[229]. One response mentioned by a respondent in the survey was for an institution to question the applicability of UK law to a US based institution, asking "where your aircraft carrier is"[230] to enforce the UK provisions.

Alternatively, complying with s.793 requests brings some market participants into direct conflict with domestic law. For example, a Swiss bank could be caught between domestic criminal sanctions and the effective confiscation of capital, particularly as permanent non-compliance may leave the shares in question permanently frozen[231].

8) Competitiveness, cost and efficiency

The UK system fails this test. There is no data or research, that the author could find, that addresses or attempts to estimate the cost of sending and replying to s.793 notices, or for institutions to administer a system of monitoring all of it's holdings to trigger declarable stake declarations. Regardless, given the extent to which technology

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[229] Quoted in the CFI London presentation (above)
[230] IIRF Survey presentation – anonymous verbal comment.
[231] See Gower & Davies at p601, fn 70

has progressed, it seems truly inadequate to still be sending pieces of paper all over the country to determine something that could easily be handled electronically. If only in this aspect, s.793 and the associated provisions require reform.

5.2.8.6 Differentiation

The UK system also fails this test. There is no scope in the UK for discrimination between the various involved parties.

5.2.8.7 Conclusion

The existing case law demonstrates that in a confrontational, "one off", or hostile context, s.212 and the associated UK provisions function as an extremely effective method for investigating individual holdings and for policing and enforcing transparency on individual institutions. It will also become clear, as the systems in place in other countries are covered, that s.793 provides the best system for transparency currently available in any jurisdiction. In the context of the need for a continuous and on-going process of transparency, s.793 suffers from serious faults, only some of which are repairable by legislative modification without substantial conceptual redesigning. The most serious of these is the inherently confrontational nature of s.793 – repeatedly writing to your shareholders to demand that they disclose

## 5.3 Other commonwealth heritage systems, especially Australia

Whilst the author does not wish to cover Australian or other minor-commonwealth or commonwealth heritage systems in great detail, it is worth noting that in many areas they

operate very similarly to the UK. Australia is the most important of these, and Jonathan Beestall's, "Getting to know your shareholders, a comparison between the UK and Australia"[232] which covers this subject in much more detail, is most useful for further detail. The most significant difference between Australia and the UK is that the Australian Securities and Investments Commission (ASIC) also have the power to request an s.212 style disclosure be made directly to them[233].

## 5.4 Continental Europe – a comparative analysis of the legal provisions available in major continental European economies.

Continental Europe, including Switzerland, will be handled as one group by the author, because of the structural similarities between the various regulatory provisions. Rather than detail these individually, the basic provisions are set out in the table below[234].

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[232] [1991] ICCR 97

[233] See Beestall, Ibid. at 99, and the Corporations Act, 2001, s. 9, s. 608, s. 671 and s.672,

[234] Information consolidated from information provided by Simmons & Simmons

| Country | Relevant statute | Declarable stakes | Notes |
|---|---|---|---|
| Austria | Stock Exchange Act 1989, Articles 91 & 48 | 5%, and 5% increments to 50%, followed by 75% and 90% | |
| Belgium | Law of 2 March 1989,<br>Royal Decree of 10 May 1989<br>Articles 514 and following of the Company Code.<br>"Transparency Legislation Information Code", April 2004 | 5%, and all 5% increments there after | The company code provides for individual company by-laws to require disclosure at the 3% level |
| Denmark | Securities Trading Consolidated Act, section 29 | 5%, and 5% increments from 10% | |
| France | Code de Commerce, article L. 233-7 | 5%, 10%, 20%, 33.33%, 50%, 66.66%, | The code does not even acknowledge a distinction between legal and beneficial ownership. |
| Germany | The Securities Acquisition and Take-over Act, sections 21 and 22 | 5%, 10%, 25%, 50% and 75% | |
| Italy | Law No. 58 of 1998 (the Consolidated Law on Financial<br>Intermediation), and various regulations issued by CONSOB | 2%, 5%, 7.5%, 10% and further increments of 5% | |
| Netherlands | Disclosure of Major Holdings in Listed Companies Act 1996 | 5%, 10%, 25%, 50% and 66.66% | |
| Spain | Law 24/1988, Royal Decree 377/1991, Order of 23 April 1991 | 5% and all further 5% increments | |
| Switzerland | Federal Act on Stock Exchanges and Securities Trading 1999,<br>Articles 20 and 41; Ordinance of the Federal Banking<br>Commission on Stock Exchanges and Securities Trading | 5%, 10%, 20%, 33.33%, 50%, 66.66% | Disclosures must be broken down by fund as well as institution. Swiss Banking Secrecy laws explicitly prohibit the disclosure of beneficial interests by Swiss intermediaries. |

The continental system has been affected by the EU Transparency Directive, which has been implemented in various ways by member states. The substantive impact of the Directive, as is relevant to this thesis is to harmonise declarable stake levels across the various member countries (all increments of 5%). The below criticisms of declarable stakes are still valid, and

the authors position is that the 5% minimum stake level under the directive is woefully inadequate.

The continental system can therefore be categorised as one dependent on declarable stakes alone. The following seven test analysis focuses on that dependency.

5.4.1.1 Comprehensiveness

There is no provision for transparency of derivative instruments or credit instruments. Not even all equity holdings must be disclosed.

5.4.1.2 Personage

Declarable stakes make no allowances for disclosure of personage.

5.4.1.3 Timeliness

As far as it goes, declarable stakes must be disclosed in a short period of time, generally 7-14 days.

5.4.1.4 Proportionality

The test of proportionality was originally proposed with declarable stakes in mind. The key problem with requiring individual stakes to be disclosed at a fixed threshold is essentially that whilst a 5% holding in HSBC Holdings Plc. would be very large, for, say, an AIM listed company even a 5% stake might well represent an utterly insignificant portion of even a small institutional fund.

#### 5.4.1.5 Global effectiveness and universality

Declarable stakes are ineffective in a global context. With no means to police their existence declarable stakes rely on individuals to be knowledgeable about regional law.

#### 5.4.1.6 Competitiveness, cost and efficiency

Constant monitoring of individual stakes, particularly when this involves cross-referencing multiple funds to establish if any individual declarable stake level has been passed is required. There is no central registry for making such declarations and they require individual institutions to have their own procedures for formal notification in place.

#### 5.4.1.7 Differentiation

Differentiation is not addressed in any of the individual systems studied by the author. It could easily be addressed by the regional authorities by adding time bars to publication of the data in question, but due to the inadequacies of the underlying data there seems little point.

### 5.4.2 Conclusion

Declarable stakes are manifestly inadequate in the global capital market. They fail to deal with nearly all of the underlying issues surrounding transparency of ownership, except in the case of the takeover context, where they are only partially successful, failing to establish a means of policing the declarations received. There is an urgent need to reform them on an EU wide basis.

## 5.5 The US model – disclosure under the 13-F system

### 5.5.1 The US system

Whilst U.S. company law is generally examined on a state by state basis, in the context of shareholder transparency the analysis is simplified because the bulk of the relevant law is found under s.13 of the 1934 Securities Exchange Act. It has not been substantially changed since that time. The act provides for a similar regime of declarable stakes to the UK[235], albeit at the higher level of 5%, including protection from concert parties[236]. Such reports are filed with "each exchange where the security is traded, and filed with the [Securities & Exchange] Commission"[237]. There is a continuing obligation to report "material changes" at the 1% level[238].

Alongside this though, every institution with an "aggregate fair market value on the last trading day in any of the preceding twelve months of at least $100,000,000" must file a report with the commission detailing "the name of the issuer and the title, class, CUSIP number, number of shares...and aggregate fair market value" of each security "with which the...investment manager exercises investment discretion"[239].

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[235] Section 13-D of the Securities Exchange Act 1934 – see http://www.law.uc.edu/CCL/sldtoc.html for further information.
[236] S.13-D(3)
[237] S.13-D(1)
[238] S.13-D(3)
[239] S.13-F(1)

### 5.5.2 Analysis using the 7 test methodology

#### 5.5.2.1 Comprehensiveness

Section 13 fails the first test of comprehensiveness. There is no provision for transparency of derivative instruments or credit instruments.

#### 5.5.2.2 Personage

Section 13 also fails the test of personage. Whilst focusing on the issue of "Investment discretion" which the author applauds, there is no way of identifying specific individuals, as generally with all of the regimes analysed in this thesis.

#### 5.5.2.3 Timeliness

Timeliness is one specific area on which the U.S. system fails notably. Three months is a woefully inadequate time period if the analysis on institutional position turnover discussed in Section 3, above, is correct.

#### 5.5.2.4 Proportionality

The U.S. system passes this test by default. Institutions have to report all positions, however large or small they are, so the issue of proportionality becomes irrelevant.

#### 5.5.2.5 Global effectiveness and universality

The U.S. system is primarily regional in nature, although it allows non-US companies to identify its US based institutional owners. However, section 13 is not applicable to overseas institutions.

5.5.2.6 Competitiveness, cost and efficiency

The author has no view on the cost and competitiveness impact of section 13 versus alternatives, although there is little reason to believe it is overly burdensome. Reporting, using the EDGAR system appears to be automated and fully electronic. Using a central registry is highly efficient and the online database in the authors own tests worked effectively.

5.5.2.7 Differentiation

Again, section 13 makes no provisions for differentiation between individuals in distributing the data in question. Such a change to the law would be relatively minor, allowing for immediate distribution to the company of its own data, immediate disclosure to the regulator and a delay in disclosing the data to the general public and to other institutions.

5.5.3 Conclusion

The U.S. system appears to function well in practice. It is structurally inferior to the UK system of s.212 notices in many ways, but is more cost effective and efficient through the use of electronic reporting mechanisms. Its central failures are the exclusion of smaller institutions and the time delay in reporting and disclosing the relevant data.

## 5.6 The Nordic system – the fully domestically transparent system.

A second alternative is a fully transparent system in place in some Scandinavian countries, specifically Norway and Finland. Finland's model[240] is one of a central securities depository[241] at which every domestic beneficiary must register its interests, and in which the use of nominee accounts is illegal. In Norway, the Securities Trading Act, and the Securities Registration Act, both of 1997, provide that, in addition to declarable stake provisions, all registered shareholders must be in either individual accounts, or for foreign shareholders only in Nominee accounts corresponding to one or more underlying investors. In the case of Foreign investors, the Registration act provides for Kredittilsynet, the regulatory body, to authorise such nominee accounts and to require, on demand, disclosure of the underlying beneficial owners. In Finland, in order to vote, foreign holders must register temporarily[242]. Superficially this system seems an ideal solution to the problem of opaque share ownership and agency, forcing institutions to disclose fully their interest in every domestic share that they own. Finnish companies seem to think so – with only 27% of IRO's surveyed unsatisfied with the domestic system[243]. However one need only examine the Finnish equities market briefly to identify why this system looks so successful: 34.4% of Finnish securities are owned by foreigners but note that Nokia Oyj, by far the largest Finnish company, is 89.19% owned by

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[240] Legal data regarding the system in Finland has been difficult to locate. This information is based on sources of imprecise legal quality and would be improved greatly with detailed research that has been impossible within time frame available.

[241] CSD – established as "an option" by government bill in 1990. As of 30.11.2003 their book entry system had 188 companies registered, with 901 912 registered owners. Market Cap. was €163.40 Billion – "The Finnish Book Entry System", HEX, 2003 at 24

[242] op. cit. at 6

[243] IIRF Survey, details given below, at 6

foreign investors[244], it is impossible to calculate what proportion of foreign holders actually register their interests in order to vote but, given current voting trends coupled with a clear specific disincentive, one could assume it would not be very high[245]. Whilst this model would deal with the domestic context very effectively, it lacks any enforcement power to compel foreign investors to disclose their holdings, which, with the reservations to it that have been noted above, the UK system does have. Whilst this means, in the authors opinion, that the Finnish system is potently ineffective on its own – a fact which should become progressively apparent to the Finnish corporate community as ownership of their securities divests – it may be highlighted as a constituent part of what might be assembled as a uniform "ideal" system.

There is a further problem with this type of system, demonstrated aptly by the real-life example which is represented in the following figure.

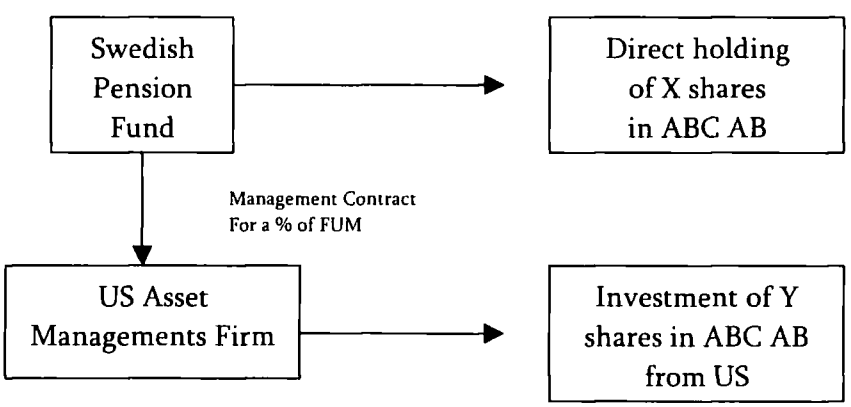


Figure 4

[244] op. cit. at 24 - A more representative figure is difficult to calculate.

[245] Given appropriate time and research resources this could be verified, but is impractical given the context at the time of writing.

In this example, taken from an non-attributable source[246] - a Swedish pension fund[247], registered an interest of only X shares, when in fact its US fund manager had reinvested a portion of the management contract back into the same company in Sweden because of currency price movements and it should have declared X+Y. The result was a much higher stake held than was actually registered – and this was only uncovered by a shareholder analysis firm working on their behalf. Where the fund itself doesn't know its holding[248] a system of compulsory disclosure ceases to work effectively –only a 212 type system enables companies to 'drill down' into complex holding structures, albeit only through time-consuming procedures. The Finnish and Norwegian systems therefore function effectively, in a trans-national context, as little more than regimes of purely declarable stakes, and therefore the 7 test analysis is superfluous, given the comments above.

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[246] The pension fund in question was in fact one of the largest Swedish pension funds and whilst this example was cited to the Author it has been done so on a strictly confidential basis.

[247] Note that the Swedish system of disclosure is very similar in the way it functions in practice to the Finnish system – with complete and compulsory disclosure of beneficial holdings.

[248] "Often the fund doesn't know what holdings its got" – R. Craighead, above

# 6 Section F – conclusions: towards a market driven global framework?

## 6.1 Pulling the strands together

Section E compared and analysed the various systems of transparency in several major capital markets and economies around the world focusing primarily on the UK system of demand-driven disclosure. It was clear that whilst the UK system surpasses alternative systems, it still fails in four key areas exposed using the 7 test methodology.

1) It is a costly and inefficient method of obtaining ownership data, laying a costly burden on financial institutions to respond to individual paper-based requests. The nature of the process of operation prevents collection of top down data, preventing the sort of analysis used in section C, which would be of use for regulators for monitoring purposes.
2) It fails to expose the crucial element of personage of ownership, which negates much of the potential benefits from disclosure of such ownership data.
3) It fails to cover all classes of financial instrument, focusing primarily on equity securities.
4) It fails to distinguish between the different parties to transparency, most notably between management, regulators and the general public.

On an international comparison the demand driven system does compare favourably to other alternatives. The major flaws in the U.S. 13-F system are timeliness,

with an effective 3 months delay, comprehensiveness – as only qualifying institutions are obliged to disclose, and a failure to discriminate between the various parties so that holding data is publicly available. Systems relying on declarable stakes, such as Continental Europe, fail in a number of ways; most significantly they only account for a minority of positions, and lack a discovery mechanism to enable companies to "check up" on individual institutions that they believe may not be complying. The full disclosure model, used mainly in Scandinavian countries appears initially excellent, but suffers from failures in a global context, and acts as an effective "disincentive" to voting which negate a number of the benefits of the increased transparency their system is supposed to bring.

The earlier analysis also raised a number of issues related to the globalisation of capital markets, and the problems this raises with transparency mechanisms. Particularly, concern was raised with the problems that cross-border holdings raise in terms of compliance and enforcement as well as the need not to create cost competitiveness issues that disadvantage one or more regional economies at the expense of others.

It is also worth noting that transparency falls into part of a wider framework of securities legislation worldwide. The Giovannini Group concluded that "the pan-EU investor is required to access many national systems that practice and operate...within different tax and legal frameworks" [249], and the author submits that this state of legal

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[249] http://europa.eu.int/comm/economy_finance/publications/giovannini/clearing1101_en.pdf

disharmony is causing many of the problems of shareholder disclosure. The problem is in fact more specific and distinct:

> Barrier 13 is the absence of an EU-wide framework for the treatment of ownership of securities... [Nominee] accounts are treated commercially and economically as being the focus of ownership. However, legally, their status differs across the EU. There is a lack of clarity about who has what rights and of what kind when securities are held for investors...even with solutions [to the conflicts] clearly in view...there remains a need for something more – a modernisation of the substantive law.[250]

The problem of transparency is compounded by differences in the way securities ownership is treated, not just across Europe, but world wide.

## 6.2 How serious is the problem?

One of the key conclusions of this thesis is that there is a significant problem with transparency of ownership around the world, even in the UK. The IIRF survey, made a number of relevant findings. Approximately 86% of Investor Relations Officers were in favour of pressing for reform, with 41% responding that they needed data not more than 1 month old to function effectively[251]. When asked whether national shareholder disclosure regulations do enough to ensure efficient communication between companies and their shareholders, 57% of responses were negative[252]. Fund managers, when surveyed, agreed that knowing the ownership structure of "a corporate" was an important factor to be considered (89% considered it a minor, significant or major factor

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[250] Ibid., Barrier 13
[251] IIRF Survey Summary, available at ww.iirf.org, pp 3-5
[252] p.17, above.

in their decision process[253]). Furthermore, nearly 90% of those surveyed preferred data less than 3 months old. Nearly 80% of fund managers understood that they were subject to declarable stake disclosure, but only 10% understood that they were obliged to respond to company requests[254]. Whilst only 65% accepted that in response to the continuing pressure on companies to disclose data to investors it was necessary to improve transparency, nearly 80% "perceived a benefit in greater transparency".

We can draw three conclusions that are the most immediately relevant to this study.

Firstly, that fund managers are notably uninformed, but the point must be conceded however that this sort of request would generally be dealt with by a fund management firms' compliance officer. While there is a lack of quantitative evidence to support this, it raises questions over the whole issue of a truly global equities market – are fund managers world wide aware of the national law that resides over each security that they hold in each country? Are fund managers really aware of the differing rules regarding declarable stakes? Do fund managers understand the need to register their beneficial interests with central bodies, like the Finnish CSD in order to vote? Further research is needed to quantify these questions.

The second issue raised is that both fund managers and corporate representatives understand the benefits that have been discussed above to greater transparency. This is a great encouragement and support to any reform proposal.

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[253] p. 19 above.
[254] P.23 above.

Thirdly this research supports the hypothesis that companies require a timely disclosure of beneficial ownership and control so as to enable an efficient and effective process of market communication. If this proposition is supported by both legal analysis and practical opinion it must become much more persuasive.

## 6.3 The future: are there any convincing solutions available?

A number of possible reforms are immediately obvious as a way of improving the transparency process. These will be considered in turn

### 6.3.1 Lowering the declarable stake threshold

The first, and most obvious, system for reform is that of merely lowering the declarable stake threshold to either 1% or even 0.1%. Of Investor Relations Officers surveyed[255], 43% saw this as the minimum level at which they would like to see disclosure of holdings. The Author respectfully submits that this solution, whilst seeming popular with both the corporates and representative of the current legislative direction[256], is impractical, inflexible and does not deal with either the underlying legal or practical problems. Merely reducing the declarable stake would not solve the problem of non-response, both fraudulently and negligently by foreign nominees and institutions, in fact it would probably only serve to increase the incidence of non-compliance. The author, furthermore, agrees with Nick Arbuthnott who argues that a declarable stake of 0.1% would be utterly impractical, "it is very difficult to see what companies would do with all that data, how they would analyse it coherently – and

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[255] IIRF Survey, above

[256] The threshold has fallen in subsequent companies acts, and has been addressed twice by EC directives

furthermore...impossible to see how such a high administrative burden could be laid upon the institutions without their objecting extremely strongly"[257]. The fundamental arguments against declarable stakes in general have been set out in some detail above, and need not be repeated in full here. Clearly then, reducing the threshold for declarable stakes even further is not a viable method for reform, dealing neither with the underlying problems, nor being a practical and workable solution, being overly costly and difficult to administer, and with no mechanism for effective policing of responses.

### 6.3.2 A pan-European s.212 provision

The second obvious possibility is to introduce a pan-European s.212 provision, probably in the form of an EU directive. There were in fact private representations made by the UK based Quoted Companies Alliance at the time of the original consultation on the Transparency Directive[258]. This suggestion has a fair amount of merit. Firstly it removes, at least on a European level, a lot of the problems that exist with s.212's operation in the UK, specifically some of the problems with its operation in the cross-border context. Secondly, s.212 provides a useful "investigatory" mechanism that is particularly useful in the context of hostile takeovers. If it were combined with a market-driven settlement based approach as discussed below, a pan-European s.212 provision would be an excellent partial solution to the transparency problem. However, for all of the reasons given above, using the 7 test methodology, a pan-European s.212 would be insufficient.

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[257] London presentation - above

[258] Private correspondence between the Author and the Q.C.A.

## 6.4 Where should the focus for the future be?

It is possible to identify, from the above analysis, three key areas which need to be addressed by any proposed reforms.

6.4.1 Firstly, any changes to the law need to operate on as wide a geographic scale as possible. The analysis earlier, particularly of the s.212 and Scandinavian provisions, has highlighted the need for transparency to be addressed in a trans-national manner. Owing to the current lack of a single global economic institution able to effect securities reform on a global basis, the most sensible immediate focus for reform would be the EU, particularly given the current focus on capital markets regulations across the EU.

6.4.2 The concept of attaching one or more individuals with the proposed "investment discretion" authority is currently missing entirely from all transparency regimes. It is easy to understand why, given the frequency with which fund managers change jobs, and the current administrative burden of constantly updating this information. But, this information is absolutely crucial for the governance processes the author has argued depend on transparency to function correctly. It is absolutely essential that companies, regulators and ultimately the general public are able to hold to account specific individuals making the underlying investment, and more importantly, governance decisions.

6.4.3 Finally, it is also apparent that transparency data needs to be collected in a systematic way, producing a minimal administrative burden, allowing for appropriate release to

the different parties in either a top down or a bottom up fashion. This implies the need for the involvement of a 3rd party institution of some sort to collect and administer this data as well as to control its dispensation as appropriate.

## 6.5 A market driven framework

### 6.5.1 A theoretical basis

One of the crucial questions in speculating about a possible solution to the problems discussed in this thesis is that of compulsion. If, as the author has argued, transparency has such great social utility, should all market participants be under a legal compulsion to fully disclose their holdings? The author believes not. For one, there are sections of the market who would be excluded from the market for reason of special legal consideration (such as Swiss institutions who would be unable to own any equities where they had to be fully transparent). More seriously, it would introduce a disincentive to owning equities in general. This would have the effect of raising the cost of equity capital – in the author's opinion unnecessarily. The author believes the market would more efficiently price equity capital if the market is allowed to allocate its own price to transparency.

Then, whilst being a fundamentally legal process, left to its own devices, the market should in theory be capable of efficiently pricing stakeholder transparency without outside influence, this approach suffers from a fundamental conceptual problem, as well as the effect of price externalities (specifically the problem of "free loading") as already discussed:

> Analogously, we hypothesise with respect to equity in publicly traded firms that organised capital markets will determine the optimal extent of shareholder identification and participation in corporate governance and that through an evolutionary process the standard corporate contract will acquire those optimal characteristics without government prodding...[but] to the Court, ... the state must be the "overseer..."...because "the very commodity that is traded in the 'market for corporate control' – the corporation – is one that owes its existence and attributes to state law[259]

The point is a difficult one to argue with. Not only does the market, conceptually, "mis-price" transparency, but the "market" for transparency is also one that is itself rooted in national legal systems. However, it is likely that the market will ultimately allocate resources much more efficiently than a state regulatory system will. The debate over corporate governance and the use of voting rights is to a certain extent paradigmatic, and the same conclusions can be drawn here. It will therefore be most efficient, as well as effective, for legal intervention to be minimised whilst ensuring that to the best extent possible externalised pricing factors are "internalised" through the use of financial and non financial corrective incentives.

### 6.5.2 A proposed minimal legal framework and market institution

It has already been argued that a proposed new structure need address 3 key areas. It needs to operate on a pan-European basis at the very least, attach a degree of personal responsibility and identity to holdings and to establish a centralised system which should operate in a low cost and effective manner. In addition to these three requirements, it has already been argued that the system should be primarily market driven with the minimal legislative intervention.

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[259] - J. Gregory Sidak & Susan E. Woodward, "Corporate Takeovers, the commerce clause and the efficient anonymity of shareholders", 84 Nw. U.L. Rev. 1092

The author therefore proposes the following three actions by the European regulators, which are explained in more detail below.

1) Establish a central body for the registration of "institutional" investors and the (possibly voluntary) registration of their ownership of all or most kinds of traded securities.
2) Legislate to force European companies to withhold voting rights from the owners of unregistered securities, for a period of time, to allow a market to develop to accurately price a "privacy premium" into unregistered securities.
3) Introduce an E.U. s.212 provision.

The author has shown that individual institutional investors should be held accountable to society and to their underlying investors as to their actions because of the overall public benefits. Many countries recognise the importance of the role that individual institutional investors play and require them to register individually (for example the Financial Services Authority in the UK). One of the greatest practical difficulties with making individuals directly accountable has been the fact that they change jobs and roles frequently. Having a pan-European central registry of suitably qualified and authorised individuals would bring two benefits. Firstly, it would provide a means for attaching personage to ownership information and secondly it would increase the general level of accountability of individuals. Centralising the administration and qualification of authorised individuals would also bring great benefits to the process of integration of European capital markets.

This same institution could also use the various pan-European settlement and clearing houses to automatically register changes in ownership of all kinds of securities. This would

require some minor changes to the way that securities are traded and cleared, but could be funded by a very small additional charge on all transactions. Instead of placing deals with brokers, or directly on any market with instructions to settle the trade against an individual account as is generally the case, trades would have to be made by an authorised individual on a given account, and the identity of the authorised individual would need to be attached to the trade all the way through the settlement process. When the trade settled, the central registration of ownership would then be updated automatically (i.e. electronically), leaving an accurate register of not only the account in which the security is held, but also the name of the individual who authorised the trade.

This would then leave the central register with a matrix of information which could be analysed in any number of ways. It could be broken down by institution (i.e. company), and get all holdings of European companies in which it invests. It could be used to feed data to companies, allowing them to get an instantaneous (possibly delayed by a short period of time, say 24 hours) view of their shareholder base, allowing for cheap and easy communication, as well as massively simplifying the voting process (all votes could then be cleared centrally through the register). The information could be made public after an appropriate period of time, allowing investors to assess the performance of the individuals who have been managing their investors, and to hold individual institutional investors to account for the way in which they carry out their responsibilities as owners. Such a central register need not, and should not, be limited to just equity investors. Debt instruments and derivatives could also be registered.

In terms of total cost, no study has been carried out, and the author lacks the time and resources to make serious estimates of the cost of setting up such a central registry. However,

the author estimates that there is considerable cost borne by institutions in complying with s.212 notices and in monitoring and complying with declarable stake requirements which would become unnecessary under the proposed system.

The author also proposes that, whilst the system would work effectively as a compulsory system, this would effectively force a portion of investors outside of the capital markets because of the high value that they place on their privacy. The ideal "solution" to the transparency problem would be, as already argued, market rather than regulatory driven, and so the author hypothesises that to achieve this, the above proposed solution would be more effective if voluntary, with the qualification that un-registered or un-transparent are treated differently by the underlying company.

If a market based pricing mechanism to create a "privacy premium", as hypothesized above is to function effectively, regulations need to be introduced to support the distinction between registered and unregistered securities. The author believes that what is necessary is to remove the voting right from unregistered shares, to remove rights of "influence" debt securities (i.e. remove the right of a debt holder to enforce covenants) and to remove voting rights from shares that change hands as the result of the completion of a derivative contract. These rights, furthermore, should remain withheld for a period of time after the sale of an unregistered security, even if that security is then registered, possibly six months to a year. This would have the effect of creating a "secondary" market for unregistered shares and other securities. In the case of a share, the hypothetical difference in price can be expressed algebraically:

$$(P_{Reg} - P_{UnReg}) / P_{Reg} = (\text{Probability of takeover} * [1 + \text{Expected Price Premium}]) + \gamma - \psi$$

Where $\psi$ is the current market price of privacy and $\gamma$ is the control rights premium

This equation demonstrates, in a simplified way, what form this secondary market might take, and why a market driven solution to the transparency problem has such merit. The equation implies that the price difference would depend on three factors. Firstly, and most obviously, if voting rights are withheld then an unregistered share would not command the same premium as a registered share in the event of a takeover. Thus, the first part of the difference in price would be the product of the premium gained from a takeover and the expected chance of that takeover, all expressed as a percentage. The second proposed variable is the value of control rights to an equity holder, beyond that of a takeover. The right to influence management in the near term does have a value to an equity holder, and would be obviously absent from an unregistered share. Thirdly, the market price of privacy would also impact the difference in value, and would be different depending on the company in question. A number of observations should be made.

6.5.2.1 The market price of privacy would vary from the value an individual institution places on privacy, creating a potentially perfect market for transparency

The most crucial term in the proposed equation is that of the value of privacy. This obviously will vary depending not only on the company in question (the difference between registered and unregistered shares in Huntingdon Life Sciences would presumably be far greater than in Cadbury Schweppes) but also on the institution (Swiss Private banks would be the

obvious primary buyers of unregistered shares). Not only this, but arbitrage opportunities would also become available, with there being an incentive to "un-register" shares when the price discount becomes small enough, or when an individual felt that unregistered shares were trading at an unwarranted premium to registered shares. The same would apply to "registering" shares – where the discount between an unregistered share and a registered share grew too large, then there would be a financial incentive to "register" the shares and hold them for the time period specified to offset the price difference.

6.5.2.2 The price differential would be fluid, allowing the market to create an excellent inherent incentive to exercise control rights

One of the key advantages of the market driven system would be that, where the rights in question were important to an institution it would value them sufficiently to pay for registered shares, and where not important it would not need to pay for the premium. Not only this, but as time changed so the differential in price would change, so that where an important vote was to be held (say in the case of a proposed introduction of a poison pill, or a dispute between two groups of investors) the market would be able to efficiently price control rights. It is logical to assume that where control rights were being priced and valued by an institution, so there is then an incentive to actually use them.

6.5.2.3 Whilst debt securities fit the framework well, derivatives are problematic

As derivative rights crystallise into claims over actual equities, the system breaks down. It would, hypothetically, be possible to gain an interest through options in a security, and not have to register it for a number of months until the option actually crystallised. The author

proposes therefore that whilst securities changing hands because of options contracts should be treated in the same way, the options contract must itself be a registered security in order for the underlying security to not become immediately "un-registered" on change of ownership. Policing this might become complex in the case of someone intent on avoiding registration, and necessitates the third and final suggested reform proposal.

In order to allow the regulator the capacity to investigate ownership claims and to police the registration system, as well as allowing companies the ability to drill down into ownership of unregistered securities under special circumstances, the author believes that this thesis has demonstrated the value and effectiveness of the limited use of s.212 powers. The author therefore, for all of the reasons given under the analysis of s.212, support its introduction on an EU wide basis through a directive. Even in absence of reform proposals 1 and 2, this would improve transparency on an E.U. wide basis significantly.

## 6.6 Final thoughts

Whilst a reform process as sweeping as the author has suggested above is unlikely, because of the limited consideration of the importance of the issue of transparency, the author believes it would be an extremely powerful and effective solution to the transparency problem. It would also reduce the role that market intermediaries, such as corporate brokers and investment banks, play in the capital markets, which given the lobbying power and influence that they hold, such a set of reforms are very unlikely to gather the necessary popularity that they would need to be adopted. The issue of transparency fits within the wider context of conflicts of interest in capital markets, the governance "problem", agency costs and the long running debate on voting rights. This thesis has, in many ways, only scratched the surface of understanding and

analysing the ways in which these various factors and issues inter-react. Much academic and professional ink has been spent on discussing these complex subjects and there is little reason to see a single unifying solution to these issues presenting itself in the near term. What is apparent, however, is that the role that capital markets play in global economic growth is vital, and that in a rapidly globalising world characterised by rising inequality and public disenfranchisement, that there is little room for complacency among market participants. The markets becoming more open and accountable is only one small part of a much wider and broader debate, the consequences of which are going to be extremely serious for everyone. Amongst this confusion the issue of the accountability of market participants is sometimes lost, and it is time that its importance and centrality was recognised fully. A good place to start might be the transparency of exactly who it is who are electing to empower and setting the objectives of those same "managers [who] now have more power than most sovereign governments to determine where people will live, what work they will do, if any; what they will eat, drink and wear; what sorts of knowledge, schools and universities they will encourage; and what kind of society their children will inherit." [260]

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[260] Richard J Barnet & Ronald Mueller, above at p.3

# 7 Appendices

## 7.1 Appendix A – the history of s.212 in the UK

Reproduced with permission from "A brief history of Part VI CA (1985)" by Nick Patton, DTI,

[261]

1. Obligations to make disclosure of interests in shares were first introduced by CA 1967, s 33, though they had been recommended by the Cohen Committee in 1945[262]. CA 1948 had included Board of Trade powers – where there was "good reason" – for appointing inspectors to investigate ownership of a company (s 172), for requiring information on ownership and for imposing restrictions on shares and debentures. However, it imposed no automatic obligation on owners to disclose their interest at certain thresholds.

2. The Cohen Committee had recommended an obligation to notify beneficial interests of 1% or more in the issued capital of any company within 10 business days of becoming beneficial owner. The Jenkins Committee resurrected the idea in 1962, recommending a 10% threshold and a 7-day notification period. The 1967 act gave statutory effect to the idea. It set the threshold at 10% of shares carrying unrestricted voting rights and the notification period at 14 days. It applied the rules only to companies quoted on a recognised stock exchange. This was subsequently amended and extended by CA 1967, ss. 26 and 27, which reduced the

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[261] The above report was made available to the author privately, and is reproduced with permission here. It is not available publicly, to the author's knowledge and is reproduced here for background purposes.

[262] Report of the Committee on Company Law Amendment, (1945) Cmd. 6659, page 44, (f). Pages 77-45 dealt with the subject of Nominee Shareholdings, on which the Committee made a number of recommendations (a) to (n). Not all these found their way in the CA 1948, including recommendation (f) which required notification within 10 days by beneficial owners becoming interested in more than 1% or more of share capital not registered in their name

threshold to 5% and the notification period to 5 business days. S 27 introduced a power for a company to require disclosure of beneficial interest in its voting shares.

3. These sections were replaced by more comprehensive provisions in Part IV of the CA 1981, following a DTI Consultative Document in 1980 which came out of the DTI inspection and Stock Exchange report on dealings in the shares of Consolidated Gold Fields. These provisions extended the obligation to notify to all public companies (redefined by the 1980 Act to implement the Second Company Law directive). In the light of Consolidated Gold Fields, they also introduced rules to catch group interests of persons acting together, or "concert parties". They also introduced rules allowing an investigation and report by the company, to be requisitions by members holding not less than 10% of the voting rights carried by the company's paid up capital.

4. The CA 1981 provisions have been consolidated by CA 1985 (Part VI) and amended by the CA 1989 and various statutory instruments. Following a DTI Consultation Document in 1988 and an earlier review of the operations of the Panel on Take-overs and Mergers, the CA 1989 reduced the threshold to 3% and the notification period to 2 days. Following a further DTI consultation document in 1991, the 1993 regulations were made to bring domestic legislation into compliance with EC Directive 88/267 (The "Major Shareholdings Directive") on the information to be published when a major shareholding in a listed company is acquired or disposed of. Company law, supplemented by relevant parts of the Listing Rules, currently goes further in some areas that the Directive requires.

5. DTI considered proposals for reform of Part VI CA 1985 in a Consultation Document in 1995, but failed to gain Parliamentary time to implement them. The results of the 1995 DTI

consultation were considered again and largely endorsed by the Company Law Review in 2001. They are currently being considered as part of wider plans to reform company law in the light of the Review's work. However they will need to reflect changes to EU law that will take effect once the Transparency Obligations Directive, currently in the late stages of negotiation, has been approved.

Key Dates and documents

| Year | Event/Document | Subject/Significance |
|---|---|---|
| 1945 | Report of the Committee on Company Law Amendment ("The Cohen Report") | Recommended: disclosure to all companies of beneficial holdings of 1% or more of its issued capital, to be notified within 10 days and recoded on a company register. Not enacted |
| 1962 | Report...("The Jenkins Report") | Recommended: disclosure to quoted companies of beneficial holdings of 10% or more of its voting equity, to be notified within 7 days and recorded on a company register within 3 days of notification |
| 1967 | Companies Act, 1967 | |
| 1968 | Panel on Takeovers and Mergers established – *City Code on Takeovers and Mergers issued* | SARs and Code include disclosure rules in context of potential takeovers |
| 1976 | CA 1976 | |
| 1980 | DTI Consultative Document: Disclosure of interests in shares | |
| 1981 | CA 1981 | |
| 1985 | CA 1985 Part VI | |
| 1988 | DTI Consultative Document: Disclosure of Interests in Shares | European standards imposed to ensure minimum levels of market transparency |
| 1988 | EC Directive 88/267 (the "Major Shareholdings Directive") | |
| 1989 | CA 1989 | s.134 substituted 3% for 5% and |

| | | |
|---|---|---|
| | | 2 days for 5 days |
| 1991 | DTI Consultative Document: Disclosure of Interests in Shares: The EC Major Shareholdings Directive | |
| 1995 | DTI Consultative Document: Proposals for Reform of Part VI of the CA 1985 URN 96/633 | |
| 2000 | FSA took over from LSE as UK listing authority | |
| 2000 | CLR: Developing the Framework (URN 00/656) Paras. 4.178 – 4.181 http://www.dti.gov.uk/cld/modcolaw.htm | |
| 2001 | CLR: Final Report (URN 01/942) Para. 7.32 www.dti.gov.uk/cld/final_report/index.htm | |

## 7.2 A note on sources

The author, has, as already noted, received unpublished resources. They are marked as such in the bibliography below. The author has also conducted formal and informal interviews with a number of persons, as listed in the main body of the document. The author is notably indebted to John Pierce[263], Neil Ryder[264], Nick Arbuthnott[265] , Douglas Hornung[266], Tim Beyts[267], Itiola Durojaiye[268] and Richard Jenkinson[269], for their assistance, opinions, advice, quotations and the provision of unpublished materials, which, where relevant, has been fully attributed.

## 7.3 Abbreviations used

Nw. U.L. Rev – North-western University Law Review

ICCLR – International Company and Commercial Law Review

A.L.Q. – Arab Law Quarterly

LSGG – Law Society's Guardian Gazette

PLI – Practising Law Institute

B.O.F. – Back Office Focus

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[263] CEO, Quoted Companies Alliance

[264] Development director of the IIRF, Senior Partner, Sage Partners Ltd., and Formerly head of IR and executive committee member, BET

[265] Managing Director, Citigate Financial Intelligence

[266] Partner, Fontanet Jeandin & Hornung, Geneva

[267] Senior Director, Finit Systems

[268] Company Law Team, Department of Trade and Industry

[269] Managing Director, JunctionRDS and former head of IR services, Capita Registrars

Iowa J. Corp. L. – University of Iowa Journal of Corporate Law

Iowa L. Rev. – Iowa Law Review

B.J.I.B. & F.L. – Butterworth's Journal of International Banking and Finance Law

P.L.C. – Practical Law Companies

C.S.R. – Company Secretary's Review

Comp. Law – Company Lawyer

C.L.In – Company Law International

B.L.U. – Banking Law Update

N.L.J. – New Law Journal

Ariz. L. Rev – Arizona Law Review

NW.J.INT'L L.& BUS.–North-western school of law, Journal of International Law and Business

B.C. Int'l & Comp. L. Rev. –Boston College International & Comparative Law Review

Pace L. Rev – Pace Law Review

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