Shareholder identification

Amit Sanghvi explains why accurate, comprehensive identification of a company's registered shareholders is an essential component of an effective investor relations strategy.

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IT'S ENOUGH TO GIVE YOUR CEO NIGHTMARES. AN UNKNOWN shareholder has doubled their shareholding in your company overnight but they can't be identified because they are protected by privacy legislation in their offshore jurisdiction. Or suddenly, one day that unassuming one per cent shareholding held in a prime broker intermediary account disappears and is replaced by a beneficial owner of 10 per cent who votes against the remuneration report at the AGM - enough for a first strike.

Unfortunately such situations are becoming more common as institutional investors take advantage of legal mechanisms to disguise their presence on a company's register or the true size of their holdings.

Current measures in place to identify the beneficial owner of shares, as opposed to the registered owner, have increasingly been found wanting when it comes to offshore investors. Not to mention the creative use of intermediary services to disguise ownership.

Section 672

Typically, a company wanting to find out its beneficial shareholders will issue its registered shareholders a notice under section 672 of the Corporations Act. Of these, the larger registered shareholders are typically nominee companies which hold shares on behalf of sub-nominees, fund managers, high net worth individuals and other institutions.

The notice requires each nominee to reveal the entities on whose behalf they hold shares. In cases where this is a sub-nominee or some form of a pooled account, the company must then follow the chain, issuing more 672 notices, until eventually arriving at the ultimate beneficial shareholders.

This method, in theory, should override foreign privacy and secrecy legislation. However, faced with the choice of breaking local or Australian laws, offshore recipients of the 672 notice will understandably choose to follow their local directive.

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The only way this is going to change is if the Australian Securities and Investments Commission (ASIC) engages the relevant offshore authorities to include a section 672 exception within their legislation.

It's not just jurisdictional hurdles that can prevent a company from following the chain and identifying its beneficial shareholders. The very structure of an investment made by a shareholder can itself be an obstacle in the identification process. Share swap and step-collar arrangements, stock lending, shorting and collateral management are just some of the derivative strategies used by investors that can dramatically complicate the correct identification of shareholders.

In reality, once a shareholder decides they want to trade stock anonymously the notice and disclosure regime can easily be rendered useless. Retailer David Jones discovered this last year when it was unable to confirm its suspicions that Premier Investments' Solomon Lew was the ultimate beneficiary of the 5.5 per cent stock held by registered shareholder Deutsche Bank.

The use of derivatives by activist investors can substantially increase their purchasing and voting power overnight, and when used to short a stock they can have a devastating impact on a company's share price. Boards need better transparency when it comes to such creative investment structures.

Bypassing privacy laws

An offshore retail broker, using Citibank North America, was recently found to be rapidly acquiring shares in an ASX-listed company.

Previous attempts to identify the beneficial shareholders behind the broker had been thwarted because the beneficiaries were Canadian residents and, as such, protected by local privacy laws.

The investigation into the broker holding bypassed the retail broker to speak directly with its parent company instead.

After much deliberation the parent took the view that as the beneficial shareholder information would only be shared with the company it could, and would, respond to a section 672 notice on behalf of the retail broker.

The 672 notice can still be a powerful tool if used intelligently and it is still the basic tool for shareholder identification. However, while it's easy enough to launch a fleet of 672 notices, if you are not sending them to the right entity, asking the right questions, or sending them to the right people within an entity, they may return no useful information.

Beyond the 672 notice there is a degree of investigative nous required which can and does yield results when used to uncover beneficial shareholders in offshore jurisdictions or hiding behind derivative arrangements.

There is, however, no piece of legislation or off-the-shelf product that companies can use to work at this deeper level, where having good contacts within institutions and extensive financial markets experience become critical. The examples accompanying this article give a sense of how these investigations can play out.

Target market

There are clearly sound defensive reasons for a company to correctly identify its beneficial shareholders. But perhaps the most under-appreciated and financially beneficial reason for doing so is targeting new investors and additional shareholder funds, such as in a non-deal roadshow or capital raising.

The blueprint for any effective raising strategy must include identification of those existing shareholders who have deeper pockets and an appetite for more shares.

With the advent of accelerated capital raisings, with exotic acronyms like AREOs, PAITREOs and JUMBOs, it is even more vital to know with as much certainty as possible the identities of all beneficial shareholders.

Under such equity raising structures, investment banks will bypass registered shareholders and accelerate the process by going directly to the underlying beneficial institutional investors to present the offer to them.

If there are any unidentified institutional shareholders at the time of the offer, then there is very little time left to uncover them at this stage. Any underlying institutional investor left unidentified because they are hidden by an offshore privacy policy or because their investment structure was "too complicated" to unravel, will miss out on the offer. It's as simple as that.

By equal measure, an opportunity to raise capital through these investors will have been squandered and the beneficial investor may well be left disgruntled.

Similarly, a book-build of potential new investors is more successful when a company uses the knowledge of its existing shareholders and the shareholders of its peers to narrow down which types of investors would most likely be interested.

Widening the investigation

Last year a company wanted to know why as many as 4 per cent of its shares were unaccounted for after attempting to identify its shareholders.

The initial investigation yielded the same result but then it was widened to include any investors that had recently been in contact with the company but had not been identified as a shareholder through the initial investigation of nominee holders.

This led to the discovery that one such investor was in fact involved in a step collar arrangement with a broker, the structure of which allowed both to deny any beneficial ownership of shares.

It can be a powerful argument to put before a potential investor that your company has the same investment attributes of another company in which they already have a significant shareholding, but offers better value.

Once it was deemed sufficient for a company to analyse its shareholder register once a year for the top 20 shareholder list in the annual report. Now, once a quarter is considered the minimum best practice and it is not uncommon to undertake monthly analysis. Those involved in M&A activity may analyse their register as often as weekly and the intensity of accelerated capital raisings necessitates daily updates.

Shareholders have become more elusive; sometimes through deliberate cunning, sometimes because a duty-bound nominee is unable to disclose its client's identity.

While it is clear that a section 672 notice has limited authority in these situations, companies cannot afford simply to give up the hunt. Accurate, comprehensive identification of a company's registered shareholders is not only a vital component of investor relations practice, it is one of the foundations of effective investor relations.