

HOW WELL DO YOU KNOW YOUR SHAREHOLDER BASE?

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The Best Case Scenario

If you are a director on a top 200 board it is likely that your board pack will include an analysis of the company's share register, with recent movements of major shareholders, on at least a quarterly, maybe even a monthly, cycle. If the company is large enough to support an in-house investor relations manager or team, this analysis might be accompanied by a report summarizing particular trends that may be emerging in the composition of the register. Increased shareholdings or a new entrant to the register following a recent roadshow, or an extensive period of dedicated targeting, might also be highlighted as evidence of the effectiveness of the company's investor relations strategy. But this is the best case scenario.

We are often surprised at how many experienced directors refer to the names of nominee or custodian companies when asked if they can identify their major shareholders. This suggests that the default position for many board packs is a copy of the top registered holders provided by the registry, with a summary of major movements to indicate who has recently bought or sold. Apart from some small or micro cap companies, largely owned by private investors whose names are clearly identifiable as the registered holders, there would be few listed companies whose directors could say they are fully informed about their shareholder base if this is what they are relying upon.

The difference between registered and beneficial owners

Listed companies that are large enough to capture the interest of fund managers who invest on behalf of institutional investors such as superannuation funds, hedge funds and sovereign wealth funds,

amongst others, will be familiar with the presence of nominee companies on their register – entities whose sole purpose is to hold and administer securities as a custodian (or registered owner) on behalf of the actual or beneficial owner of the securities. But it is not only fund managers who operate this way. Corporate investors, financial planners, brokers and prime brokers also use the services of nominee companies.

Nominee companies have become an integral part of the financial markets as they enable professional investors to comply with regulations and legislation. They effectively outsource the more administrative and time consuming aspects of managing portfolios of shares, typically on behalf of multiple clients or accounts located in multiple locations around the world. Most often, each nominee will act for multiple beneficial holders and in many cases a second layer of nominee companies.

So if a director is looking at five large nominee companies in its list of top twenty major shareholders, it is safe to assume that he/she actually has no idea who owns those shares or who is responsible for making the buy/sell decisions. It is not even possible to infer from the presence of an offshore custodian/nominee on the register, for example State Street Nominees, that the underlying investors are all offshore fund managers.

How to identify your beneficial owners (and why it matters)

The process associated with tracing and identifying who sits behind nominee companies is complex and time consuming. It is commonplace now for listed companies to engage a specialist register analytics firm to undertake this exercise on their behalf with

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many boards expecting to see a beneficial ownership analysis report included in their board packs on a regular basis. The work is highly specialized with only three firms in Australia with a track record of more than a decade able to offer this service. Experience does count as this work requires:

- a working knowledge of the Australian Corporations Act,
- connections with nominees in the domestic market,
- contacts with nominees located in all the major financial markets offshore,
- expertise to decipher the information received from these nominee companies,
- a database and software that is capable of processing large quantities of information received in a variety of formats,
- specialist knowledge to analyse this information and present it in a format that conveys relevant information in an easily accessible report.

There are a number of reasons why directors should take an active interest in identifying who the beneficial owners of their company are, including those responsible for the investment decisions associated with trading shares in the company. The most important one is that building strong relationships with investors based on open communication around a regular programme of briefings and meetings is fundamental to modern day investor relations. This is particularly relevant prior to AGMs when an open and productive conversation with major shareholders can make the difference between certain resolutions being supported or rejected. Secondly, for some companies it may also be important to monitor the movement of activist shareholders or a third party who is potentially acquiring their shares with a view to launching a takeover.

What might be going on behind the scenes

The complexities of financial markets and the ingenuity of participants to gain exposure to a company's securities without their presence being revealed, does mean that often investors will go to great lengths to remain anonymous. In this regard the wording of the Corporations Act that requires parties to disclose the beneficial owners on whose behalf they hold stock, is deficient when it comes to derivatives, stock lending, or nominee companies under the protection of local Banking Secrecy Acts

such as those in Switzerland. Nevertheless the shareholder identification process, in the hands of an experienced analyst, does limit the number of places or ways in which an investor can hide.

In our view, a beneficial ownership report should never be viewed as a box ticking exercise or as a place marker in a board pack. If the provider of this information is not occasionally asked to explain the output or confirm a particular holding, there is no incentive for them to go the extra mile in chasing down the difficult nominees. In the case of Stock Lenders and investors behind nominees protected by local regulations, there are ways - albeit requiring extra effort - to get information on the underlying beneficiaries. But a provider first needs to know where to look and then be prepared to invest the additional time to do so. To this end directors owe it to themselves and the shareholders they represent to know how to read these reports and to ask questions where something doesn't look right or understand why a large nominee holding could not be traced to its source.

A good example of when alarm bells might start ringing is an increased presence on the register of Prime Broker accounts. Institutional or Corporate investors can make use of special services offered by Prime Brokerages to their clients which allow the investor to significantly increase their purchasing power overnight. Monitoring and identifying the beneficial holders behind such accounts can often be the first line of defense for a company in danger of shareholder activism or a takeover bid.

Who owns your shares, may or may not vote your shares

We have left till last perhaps the most important reason why boards need to know who their actual shareholders are. It is one that has been the subject of much discussion and scrutiny ever since the introduction of the Two Strike Rule in 2011 which shone the light on one particular problem encountered by companies seeking to engage more effectively with their institutional investors. Namely the lack of transparency associated with when and how institutional owners will actively choose to exercise their votes versus delegate to their fund manager(s). It is not uncommon, for example, to encounter the presence of 'split voting' situations, where the voting entitlement of a fund manager is reduced, but not eliminated, as a consequence

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of some of their institutional clients retaining and directly exercising their votes. In other situations the institution will choose to reserve the right in certain situations to take back voting responsibility normally delegated to the fund manager. Into this mix needs to be added the influence of proxy advisers and the extent to which their recommendations are automatically followed or treated simply as input to a broader decision making process.

So the process of identifying who is responsible for the investment decisions, i.e. the fund manager or the beneficial owner, does not automatically provide the answer as to who is responsible for voting those shares. For that you actually need to take the analysis to another level by generating a Voting Entitlement Report, or its equivalent, in order to ensure that engagement efforts are correctly targeted. This is a complex exercise which requires direct confirmation of the voting protocols between a fund manager and the superfund as well as their reliance on proxy advisers. Not all providers are able to do such analysis and many companies leave it too late to make enquiries and then commission a report which can deliver reliable intelligence on who the company should meet with. All this should be done well before issuing the Notice of Meeting.

Conclusion

Effective and well targeted communication between a company's major shareholders and its management is regarded as the base line of modern shareholder relations. It assumes that both board and management know exactly who is responsible for the investment decisions attached to these holdings (beneficial owner or fund manager) and that when it comes to voting on resolutions at general meetings, a powerful fund manager by stock ownership may be less so when it comes to voting.

FIRST Advisers has been providing register analytics, governance, investor relations and strategic communications advice to its clients for over a decade. Contact Victoria Geddes or Amit Sanghvi on 02 8011 0350 for more information.