

## SECONDARY CAPITAL RAISING REVIEW DIGITISATION OF SHAREHOLDINGS

### INDUSTRY UPDATE

The recent review of secondary capital raising in the UK ('the Austin Report'), authored by Mark Austin, makes a number of important recommendations to continue progress in modernising UK capital markets, as communicated to clients on 9 August. This paper now focuses on the Report's recommendations regarding digitisation of shareholdings, intended to better facilitate retail investors' participation in secondary capital raising and to enhance the effectiveness of interactions between issuers and their investors. Significantly, this involves action to achieve full dematerialisation of paper share certificates, as well as steps to enhance issuer communications with all intermediated investors.

The Austin Report's recommendations were swiftly endorsed in full by the Chancellor, including with respect to formation of a Digitisation Taskforce, to be chaired by Sir Douglas Flint (current Chair of the board of abrdn plc). The Taskforce is mandated to provide draft recommendations for the implementation of digitisation of shareholdings by Q2 2023, with final recommendations to be tabled Q2 2024. We can therefore anticipate very rapid action to further define the detailed requirements to implement the government's digitisation policy. This is positioned to be a once-in-a-generation transformation in the structure and administration of the relationship between all UK issuers and their investors.

The Report highlights that the 'drive to digitisation' should:

- achieve the full eradication of paper share certificates;
- ensure that the rights attached to shares flow to end investors quickly and clearly, and that investors are able to exercise those rights effectively; and
- remove all paper-based processes in the securities settlement infrastructure.

The Report therefore sees digitisation encompassing all these elements – dematerialisation, improvements to the enfranchisement of intermediated investors, and removal of paper processes.

Several high-level recommendations are made to achieve this, that we examine below, and which are intended to be subject to more detailed definition by the Digitisation Taskforce. It will be important to break out the specific elements, consider the impact, and appropriate path for each individually, as well as within an over-arching digitisation strategy.

### ■ ERADICATION OF PAPER CERTIFICATES

As the Report highlights, shareholdings can already be dematerialised via deposit into accounts in the CREST settlement system, and indeed a sizeable proportion of shares are already held in this dematerialised form. However, despite dematerialised holdings in CREST being available since 1996, a sizeable number of investors in UK issuers have elected to hold outside of the CREST system, directly registered in their own name and

thus currently hold share certificates. The major UK share registrars have estimated that there are approximately 8.5 million directly registered certificated holdings across UK registers, a number which has remained steady for at least the past 7 years.

The full removal of these share certificates is a key plank in the government's digitisation strategy, and indeed has been discussed within the market for many years. Computershare has been a longstanding supporter of efficient and effective dematerialisation of UK shareholdings. However, it is important to recognise that removal of paper certificates for these 8.5 million shareholdings will be a significant undertaking, and careful consideration of the most effective model to dematerialise these positions, and the associated impact on the shareholders and their investee companies, will be critical for the UK market to achieve the efficiency benefits of dematerialisation whilst protecting investor and issuer rights.

### A little history:

- Dematerialisation has been part of market discussions and planning for decades.
- European Central Securities Depository Regulation would have seen dematerialisation introduced by 2023-2025.
- The Brexit transition of CSDR removed these key dates from the UK iteration of the regulation.

### What is the best approach to eradicating certificates for UK?

Simply put, dematerialisation means recording the ownership of securities in a digital form, rather than using paper share certificates to represent ownership. It is worth appreciating that all UK shareholdings are already recorded in digital form – share registers themselves are of course not paper-based. However, only shares held in CREST are considered fully dematerialised. Shareholdings held outside CREST and directly registered in the investor's name on the share register are required under UK law to have their holding represented by a paper share certificate, which is prima facie evidence of legal title although the register itself is fully digital. Furthermore, an increasing proportion of interactions, such as voting and other communications, between issuers and their certificated shareholders are also already undertaken digitally.

So, the key question is how to remove those paper share certificates, and all the remaining associated paper-based processes. The Report does not recommend a specific future model for a fully dematerialised UK shareholding system. It does however canvass some aims for dematerialised systems, which are broader than the removal of share certificates and segue into the digitised administration of all shareholdings, including intermediated investors holding via nominees in CREST. These aims include:

1. **Analysis:** Enable issuers, investors, and intermediaries to undertake detailed analysis of a company's investor base
2. **Equality:** Strive to enable equality of participation in corporate actions, irrespective of company or investor profile
3. **Communication:** Enable efficient two-way communication between the company and its entire investor base
4. **Simplification:** Reduce cost and complexity for issuers, investors and intermediaries

To these aims, we would recommend that the Taskforce give due consideration to the critical issue of investor choice in how they hold their shares and whether the holding is intermediated. The Report already recognises investor choice as a central principle in the formation and operation of CREST, so that CREST is an optional way for shares to be held. At present, approximately 8.5 million shareholdings in UK companies are directly recorded on issuers' registers and not held via an intermediary. It is our view that a model which continues to allow investor choice is the most suitable for the UK market.

While at present dematerialisation in the UK requires shares to be deposited into CREST accounts, which are predominantly intermediated nominee accounts, this is not the only feasible approach. For example, there are long-established, proven international examples of secure, efficient dematerialised shareholding systems that continue to allow securities to be administered outside of the settlement system, such as those found in Australia or the USA. These markets embed the investor choice model – direct registration or holding via a nominee – that is currently central to the UK shareholding structure.

We would urge the Taskforce to consider international experience in effective delivery of digital solutions for shareholdings and will contribute our own deep experience in global markets to the discussion.

A model embedding this same principle had previously won broad support amongst UK stakeholders and government, in early discussions to effect full dematerialisation – an initiative which was deferred in the immediate aftermath of the Brexit referendum and has now been subsumed by this later government initiative. The Report's recommendation recognises the potential benefits that removal of share certificates will have on the UK market if done in an effective manner. It is our view that to be effective, the removal of share certificates must ensure the retention of shareholder choice, and the solution eventually adopted will need to prioritise the needs of both investors and issuers, in a way that works efficiently and is cost effective for all intermediaries as part of the wider market interaction.

The work of the Digitisation Taskforce will be key in ensuring that key stakeholder views are heard, and a suitably efficient and effective solution is introduced. We look forward to being able to contribute the views of our clients, and our knowledge and experience of similar debates in other markets, to the conversation and work of the taskforce.

## ■ ADDRESSING INTERMEDIATED SHAREHOLDINGS

Beyond removing paper share certificates, the Report recommends – and HM Treasury has endorsed – steps to connect issuers and their intermediated investors, and to allow intermediated investors to effectively exercise all shareholder rights. As noted above, this builds on the work of several prior reviews of the challenges of intermediated ownership, most recently with the 2020 Law Commission report (read more in our [November 2020 roundup](#)).

This Report recognises that while there are market benefits from intermediation, it has potentially come at some cost to corporate governance and transparency of ownership. As the market moves towards increased digitisation, it recommends that steps should be taken to remedy deficiencies in the existing structures by allowing beneficial holders to be able to access shareholder rights, whilst also allowing issuers greater transparency of their beneficial owners. Whereas those investors who hold directly on the register and hold a share certificate are able to exercise their rights, but face challenges over their ability to participate in corporate actions or changing market conditions in a timely manner; those investors who hold in an intermediated ownership chain are theoretically able to participate in a timelier manner but may face challenges with accessing and/or exercising rights. Therefore, the logical solution for the latter group will highly likely be different but complementary to the removal of share certificates, as the inefficiencies and legal gaps in the current broader system are progressively removed.

In our view, it is important to recognise that investors have varying reasons for choosing to be either intermediated or to hold their shares in a directly registered form, and this choice should remain as UK progressively digitises shareholdings and processes. We have supported the principle that all investors should be able to access their shareholder rights effectively and efficiently, and are longstanding proponents for enhancing issuers' transparency of all their investors. When previously such questions have been raised, the issue of who will pay for the provision and servicing of such rights has often stalled preliminary discussions. This will therefore be a critical element of the Taskforce's work to prevent this occurring.

The Report's recommendations regarding intermediated investors include consideration of:

- Amendments to s.793 of the Companies Act 2006 to enhance collection of electronic contact details of 'ultimate beneficial owners' and identification of 'decision makers' in respect of shares;
- Development of a system that maintains records and tracks changes in beneficial ownership of shares (in contrast to the current 'snapshot in time' approach to s.793 disclosures);
- Provision of a unique identifier to all beneficial owners to facilitate such tracking and allow visibility of aggregate holdings across methods of ownership, to be issued by a centrally recognised party; and
- Linking the 'decision maker' to the beneficial owner in respect of such tracked shares.

The Report posits that these mechanisms can be used to facilitate identification of investors to facilitate participation in various forms of capital raising (after all, the *raison d'être* of the Report), and digital communications between issuers and all investors. Additionally, it considers requiring intermediaries to pass through all communications regarding corporate actions in accordance with defined timetables, to facilitate rapid, effective investor participation. This latter would be an extension of the current UK implementation of the European Shareholder Rights Directive II<sup>1</sup>, consistent with EU efforts in this direction. To achieve all of this, consideration of various forms of new technology could be considered, in addition to existing mechanisms.

These various recommendations regarding intermediated holdings are all introduced as 'potential approaches'. This stands in contrast to the majority of the Report, which makes specific recommendations, including with respect to eradicating paper share certificates. This more tentative approach reflects the significantly higher degree of complexity inherent in these issues, which will require considerable expert industry analysis and discussion to determine more detailed recommendations. The key principles of market efficiency, investor choice, access, competition, who serves who, and who pays, will no doubt run through these more complex concepts.

Perhaps as a result, there is much ambiguity in the recommendations. It is, for example, not really clear who is the 'ultimate beneficial owner' - particularly in the case of funds - or a 'decision maker'. Issuer access rights and associated responsibilities are similarly not fully defined. Until these concepts - and others - are further considered it will be difficult to fully assess the potential impact. It is our hope and expectation therefore that the Digitisation Taskforce will conduct a more integrated analysis to clear up some confusion on these elements as they progress towards a full blueprint for the future. Computershare, including our team of beneficial owner analysis experts in Georgeson, will continue our engagement in this next level of discussion to represent our clients' perspective as the details are developed.

<sup>1</sup> This directive is already in force within the UK market but many of the intermediary obligations are not relevant due to the current UK definition of shareholder. The report recommends that, in order to consider extending shareholder rights further through the chain of ownership, the focus needs to be on automated and standardised approaches to identifying investors that work with UK regulation and the principles of SRD II. This has to be done in a way that strengthens obligations on intermediaries to transmit information through the chain of ownership, allowing end investors to exercise rights while ensuring that issuers can be assured of the timeliness and accuracy of the information.

## On another note:

We should highlight that the Report makes a number of incorrect references to the Australian securities settlement and shareholding systems, particularly to support its recommendations regarding allocation of unique beneficial owner identifiers to track ownership.

The Australian settlement system only identifies and reports legal ownership of directly registered investors, it does not show beneficial ownership or aggregate ownership across various accounts for one investor. In this regard it is very similar to the existing CREST system, with the key difference that retail investors can use a form of account that is equivalent to a CREST sponsored account.

In Australia, an investor can have direct legal title through CHESS via their broker or by being directly registered outside the CSD on a record administered by or for the issuer, which is known as Issuer Sponsored. This operates in a similar manner to the investor choice model discussed earlier in this document.

Investors can also hold beneficially via a nominee in the same manner as they can in the UK today, and there is no central identifier that aggregates the investor's holdings.

Both the development of a system to track beneficial ownership and the related proposal to issue unique identifiers to each owner will require substantive analysis and likely involve major development and financial investment by the stakeholders engaged in all levels of ownership recordkeeping and administration, including potentially multiple levels of custodial recordkeeping.

The report and the work of the Law Commission is right to highlight the challenges with s.793 provisions in that they only provide a snapshot of ownership as at a specific point in time, that issuers aren't provided with beneficial owner contact information to do any follow up on responses, and that the powers of enforcement are only available to members and often are the action of last resort.

## ■ GENERAL DIGITISATION – REMOVAL OF PAPER PROCESSES

As mentioned, the Report calls broadly for an encompassing digitisation strategy including the introduction of digital solutions to speed up existing processes, allow greater participation and transparency. The Report contemplates opportunities in multiple areas e.g. the use of platforms for processing rights issue or pre-emption offer acceptances, communication channels allowing information on events to be disseminated quicker or, as discussed above, better beneficial holder identification.

We support the calls for removal of remaining paper processes. It is worth noting that the UK already operates many digital solutions to support issuer and investor engagement, and registrars have successfully driven increasing digitisation in shareholder communications for directly registered shareholders, despite the law requiring their ownership to still be represented by paper certificates.

Shareholders have been able to elect to receive electronic issuer communications since the early 2000s and can provide instructions with respect of their shareholdings in many areas under existing law, including:

- Receipt of shareholder meeting materials;
- Proxy appointments and voting;
- Participation in shareholder meetings, where permitted; and
- Receipt of dividend information, including tax vouchers.

While take-up of digital solutions will vary dependent on the issuer, we have provided a few statistics below based on FTSE 100 registers administered by Computershare:

- 75% have consented to receive web-based communications for investor engagement under the 'deemed consent' provisions in UK Company Law;
- 17% of investors have positively signed up to receive direct electronic communications from issuers;
- Only 8% have specifically requested to continue to receive traditional physical communications.

The UK market already has well established digital voting and proxy instruction arrangements, and innovative new solutions, such as **Proximity**, are providing mechanisms to support intermediated investors in exercising their shareholder rights. We have seen a year-on-year increase in proxy appointments being submitted through online platforms, with our own proprietary proxy appointment system receiving in excess of 30,000 instructions so far this year.

However, there is clearly still room for improvement, and any additional measures that the Digitisation Taskforce can identify to encourage or progress towards defaulting to the use of digital communications would be welcomed.

Any digital solutions obviously need to ensure that those retail investors who may be digitally excluded are still able to communicate, participate and engage with issuers in an effective, efficient manner. We look forward to collaborating with the Taskforce and stakeholders to identify and progress removal of remaining paper processes as the digitisation strategy is progressed.

## ■ WHAT'S NEXT

We will continue to monitor the outcomes from the Secondary Capital Raising Review and look forward to engaging with the Digitisation Taskforce as it considers how best to deliver on its aims in the coming months.

The Taskforce will in our view need to ensure representation from a broad spectrum of issuers and their agents to ensure a balanced review of the needs of the capital markets.

In the meantime, we welcome any thoughts you may have on the recommendations, and any opinions, especially in the following areas:

- Whether retaining investor choice for direct registration is important to you and your shareholders?
- What challenges have you faced with a lack of transparency on beneficial holders, and how would you like it addressed?
- What do you currently do to allow digital engagement (e.g., utilise all forms of proxy appointment, offer payments via digital channels) with investors?

If you have any questions on the report, the contents of this document or even wish to help inform our positions on anything you've read in this paper please contact John Britton or your dedicated Client Manager.

Look out for our next paper where we'll be look at the technical elements of those recommendations focused on secondary capital raising.

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