manifest

the proxy voting agency

Safe Custody & Shareholder Rights

The Impact of Pooled Accounts

A Manifest Discussion Paper

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1 Introduction

The selection of a global custodian can be a long and fraught process for many investors. Only rarely will the needs of the proxy voting team be an integral part of the due diligence process. One of the key fundamentals for consideration will be the decision to have securities managed in either the custodian's omnibus account or one or more designated accounts. Despite the impact this decision can have on the smooth operation of a voting programme, it is one that is routinely missed, misunderstood or considered to be a non-issue. Frequently Institutions appoint a custodian only to discover that the companies in which they invest no longer know that they are a shareholder, or that they can not readily ascertain how many shares they own and how many are on loan. Why? Quite simply because the transition to the custodian's omnibus account has rendered them all but invisible to the companies they own.

In this paper we aim to demonstration that ownership through individual designation of assets offers beneficial owners transparency of ownership and a clear and certain legal title as far as companies are concerned, without detriment to either cost of efficiency.

Due to the complexity of company law and custody operations some level of necessary simplification has been applied to the scenarios described in this article.

2 Differences between omnibus & designated accounts

To answer this we must firstly understand how funds can be held in custody; in general an Institution (fund manager, pension fund etc.) will appoint one or more custodians to take legal ownership of their assets and to perform certain related administrative functions. The Institution remains the beneficial owner of the shares, but the custodian, or more exactly a nominee operated by the custodian is now the legal owner of these assets.

From a fund manager's point of view, the custodian will normally open one account in their Custody system for each Fund, such as an index tracking fund, or a smaller companies' fund, that is to be held at the custodian. In the case of Pension Schemes they will normally open one account for each fund manager who is managing assets for the pension fund, or for each sub-Fund of the Pension.

So far so good; it's at the next level of detail that the differences become clear. This is where we start to look at how these accounts will be represented on a "Register of Members" of a Company or similar; this is how shareholders are normally identified to the market, the registrars and the Issuing companies themselves. This registered name comes from the Nominee which holds the assets. These are legal entities in their own right and will normally feature at least part of the name of the custodian Bank which owns, or is the parent of, the Nominee, such a Chase Nominees Limited, HSBC Global Custody Nominees Ltd or Bank of New York Nominees Ltd in their identity. If the nominee name is in this form it is referred to as 'un-designated'. It is these undesignated accounts that the market refers to as 'omnibus accounts' or 'pooled accounts'.

However if the nominee name is more detailed - along the lines of Chase Nominees Ltd A/C XYZ or Nortrust Nominees Ltd A/C 123 - then this is a designated position; it is the "A/C XYZ" or "A/C 123" that is referred to as the designation and this can be any combination of letters or numbers. The actual designation is a matter of choice for the custodian and their client to agree upon and can be as descriptive (or not) of the underlying beneficial owner as they would like it to be.

It is worth noting that it is possible to have several custodial accounts present under one designated nominee name, so-called 'hyper-designations'. Therefore, a specific pension fund or fund manager could have all of their custodian accounts in a single designated nominee name, giving them one name on the 'Register of Members' of the companies in which they invest. In practice custodians rarely share nominee names between themselves, so the appointment of more than one custodian by an Institution would necessitate the use of one or more nominee names for each custodian although, theoretically, the designations on these Nominees names could be the same at both custodians.

In an increasingly sophisticated market where shorting and stock-lending have become the norm, issuers are required to have the most up to date intelligence possible. In the case of designated accounts it is quite a simple matter for issuing companies and registrars to contact specific shareholders. It's also a lot easier for companies to give their *bone fide* details to issuers in order to engage with them.

If we compare this situation to the omnibus nominee position matters become less transparent. The assets of any number of Institutions could be present in an omnibus nominee – from outside the Custody system there's no way of telling how many of the Nominees' shareholding belongs to each underlying shareholder, how many underlying shareholders there are and who they might be.

3 Finding out who holds what

Shareholders are not, in fact, guaranteed anonymity within an omnibus position. In the UK, issuers have the authority under section 793 (previously section 212) of the companies Act 2006 to require disclosure of the interests of beneficial shareholders, including those in omnibus positions. Similar legislation exists in other markets.

Even so, it has been noted by certain market participants that custodian banks routinely fail to respond to these requests in relation to their omnibus positions, or indeed at all. This leads to a lack of transparency in share ownership, which can cause problems for both issuers and Investors when trying to engage in meaningful dialogue as the Issuer may not know that a given Investor is actually a member of the Company, or what level of ownership they have.

The problems with this situation become crystallised when issuers are trying to garner support for significant resolutions, such as Mergers, Takeovers or Share Schemes as a significant proportion of their issues shares could be held in omnibus positions, thus preventing the Issuer from being able to effectively trace who they should be talking to about these important issues.

However, this sword cuts both ways; activist shareholders in omnibus accounts may find themselves facing issues when trying to requisition a shareholder meeting as the Issuer could well not be able to trace if they hold a sufficient number of shares to be able to call a meeting.

- Lack of transparency prevents meaningful engagement and dialogue.
- Lack of surety of legal title could prevent exercise of shareholder rights.

4 Proxy voting

Although many investors assume that the "the custodian is responsible for voting" this has not always been the case and indeed the majority of Global custodians have outsourced their proxy voting service delivery to either ISS or Broadridge (ADP recently spun out its broker and investor services division as a new legal entity), some commentators have suggested that this wholesale outsourcing demonstrates a relatively low commitment to proxy voting by the global custody community and it is somewhat ironic that an 'outsourced service provider' has outsourced a so-called 'core service'.

Shareholders are, however, entirely free to chose how their assets are managed and controlled in their best interests. In the securities markets this will generally be under some for of contract, for example with securities dealing. With regards to the exercise of shareholder votes, a shareholder can empower another legal entity to be able to exercise their rights on their behalf through a Power of Attorney (PoA). PoA documents come in a wide array of formats, ranging from those with unlimited scope and duration to those with a specific scope of granted powers and/or duration, often depending upon either the jurisdiction of a company or their Articles of Association, or in the case of a custodian, personal preferences.

Looking at the UK market model of proxy voting, Manifest is able to appoint proxies to cast votes at meetings under a PoA in respect of designated positions as there is a definitive limit to our authority which is recognisable by both sides, i.e. the investor and the issuer as only one "owner" is represented by these positions. Therefore we are able to send proxy voting instructions to the registrars, signed under PoA.

However, it is not feasible to grant a PoA over a portion of an omnibus position. This is quite understandable as it would effectively give the holder of the PoA authority over the entire holdings of all the underlying shareholders in the omnibus account. In this situation Manifest will have no choice but to submit clients' voting instructions to the custodian's chosen outsourced voting service provider.

The precise routing of those instructions is not always clear and will vary from custodian to custodian. What is safe to say is that the additional steps in the voting process add risk and uncertainty as every hop in the vote's journey from fund manager to the registrar is an opportunity for error. Where a fund manager is dealing with multiple custodian accounts on behalf of numerous clients, the problems are magnified all the more.

The principle issue with proxy voting and omnibus accounts comes at the point of vote execution; unless every underlying shareholder in the omnibus account votes in exactly the same way on a given event it will be necessary to state what proportion of shares are being voted For, what proportion Against, what proportion Abstain and what proportion with Discretion on every resolution. This situation is known as ‘Split Voting’ and accurate reconciliation of holdings can be almost impossible, particularly if one or more of the underlying beneficial owners buys or sell shares after submitting their votes.

Although UK law stipulates that the voting deadline will be 48 hours before the meeting, and that the shares officially on the register 48 hours before the meeting will be entitled to vote, custodian’s voting service providers will have deadlines of between 7-10 days prior to the meeting to enable them to re-route their instructions back to the custodian for execution by whatever means.

- If a client buys shares in the period between the VSP voting deadline and record date this will either result in the need for a re-issuance of the voting instruction (if there is sufficient time remaining before votes must be received by the registrar) or this will result in a portion of their shareholding effectively going un-voted.
- If a client sells shares in the same period this will either result in the need for a re-issuance of the voting instruction (if there is sufficient time remaining before votes must be received by the registrar) or this will result in an ‘over-vote’ i.e. the receipt by the registrars for a voting instruction which represents more shares than are held by the Name on Register. In such cases the registrars are entirely within their rights to reject the entire batch of votes as there will not be sufficient legal certainty as to the intent of the shareholders. Companies would be placing the entire vote in legal jeopardy if they were to attempt to reallocate votes on behalf of shareholders. The entire position will therefore go un-voted. Given that an omnibus account could represent in excess of 10% of shares on register this is a significant problem for all concerned.

5 Voting ex-UK

The web becomes even more tangled outside the UK.

Global custodians appoint local banks to provide Custody services in local markets. This is known as the ‘sub-custody network’. In the vast majority of cases the global custodian will maintain one omnibus position at the sub-custodian holding all of their clients’ assets in one single account. This is normally the case regardless of whether or not a client has asked for their shares to be held in a designated account in their home market.

The impact this has on proxy voting is the same as it would be under the UK model, although we have been told that in some cases the Sub-custodian will create temporary “ghost” designations around the time of meetings in order to better facilitate proxy voting.

This does of course raise the question as to why these designations can’t be maintained year-round to provide transparency and certainty instead of going through possible stock transfers and similar paper work every time someone would like to vote, thereby creating unnecessary paper work and possibly associated transaction costs or charges.

Matters can become further complicated in some markets that do not allow Split Voting at the Nominee or local market level. This can result in the votes being rejected entirely in the local market unless specific designations and/or entire new Nominees are created in order to facilitate the lodgement of the particular votes of individual investors whose votes do not match those of other holders of shares in the local market omnibus pool.

The need for tallying up votes before sending in a consolidated voting instruction for the omnibus position, and the possible need to spontaneously create new nominee names for positions to be held in, can lead to a significant degree of “padding” being applied to local market voting deadlines. The material impact of this is primarily felt by those who need to make decisions on how votes should be cast as this time comes directly out of the degree of lead time present between the availability of meeting materials and when instructions need to be sent. Naturally this also reduces the time available for Shareholders and issuers to engage in meaningful dialogue ahead of the vote.

- Omnibus positions lead to unnecessary over-complication of the voting instructions that need to be lodged.
- Padding of local market voting deadlines leads to a loss of time for engagement and decision making.

- The need to specify the number of shares being voted in a specific manner for omnibus positions can lead to shares going un-voted, either due to late settlement of trades or due to over-voting of positions.
- Designation provides clarity over attendance rights at meetings.
- Issuers are able to see which of their shareholders voted, and how, if their shares are held in Designated positions.
- Beneficial owners are able to easily identify their positions on Registers of Members.

6 Other matters

Stock lending impact shareholders in omnibus positions insofar as it is far less transparent as to whose stock has been lent, and indeed, what proportion of their stock has been lent. This can lead to issues with the apportionment of stock lending fees as well as problems with correctly determining the allocation of voting rights.

There can also be issues with omnibus positions in markets such as Spain where companies sometimes pay an additional dividend to those shareholders that participate in meetings of the Company. Again, how should these fees be apportioned in cases where not all underlying shareholders have voted?

Another facet of the widespread use of tied voting service providers by custodians is that this effectively removes the choice of service provider from the beneficial owner of the shares. If the shares are held in the omnibus position then the issue of choice becomes moot; it is simply not safe to have more than one service provider voting on this position. Furthermore custodians regularly try to persuade beneficial owners that it is not possible for a voting service provider not chosen by the custodian to vote shares in designated positions for legal or technical reasons. It could be argued that they have lost sight of to whom these voting rights belong.

Several barriers to designation are often cited by custodians;

- The Cost of maintaining a roster of Nominees.
- Problems with Stock Lending programs.
- Problems with Trade Settlements.

At first glance these seem reasonable objections, or at least they might have been 10 years ago when the use of technology was at a much lower level. Although interestingly, designated accounts were the norm in the British custody banks and it has been the increased dominance of the US banks where they imposed their US-designed systems on clients that has brought about this change in ownership structure.

By way of brief background, it should be explained that the US system of registering share ownership is significantly different to the UK. In the US, most shares are effectively owned by one large nominee “CEDE & Co”, the nominee company of DTC, the US market’s clearing and settlement system. Brokers and banks are responsible for maintaining their own records of client ownership in “Street Name” on their own computer systems rather than on a share register maintained by the company as is the case in the UK. In order to mail proxies to shareholders, companies must ask the banks and brokers to identify shareholders. This is a long and involved process which is why the US operates such a long record date system of 35 days. This can create the unfortunate position whereby a 30% shareholder can still vote their proxies, even though their holding has been reduced to a mere 0.003% in the intervening period.

US custody systems and procedures largely reflect the bulk of transactions they are required to perform, i.e. North American. This is not helpful in the context of cross-border voting where one size truly does not fit all.

The increased sophistication of systems and technology in the last decade has significantly reduced the amount of cost-intensive manual processing. The cost of maintaining a CREST designation is a mere £150 a year, other local market equivalent costs are similarly low. SWIFT charges have declined by 70% in this period. Furthermore, custodians attract significant volume rebates so their direct processing costs associated with designation would seem both fair and reasonable to ensure surety of legal ownership and apportionment of financial and legal dues?

There is also the question of the quality of systems and procedures used by an institution if the act of segregating one client's assets from another will cause problems with either stock lending or the settlement of trades. The additional costs of Designation (if indeed, there are actually additional costs attributable to this) would more than likely be offset by increased efficiencies in a number of areas such as;

- Allocation of Dividends.
- Accurate stock lending
- Corporate Action Processing
- Withholding Tax Receipt Processing
- Share Position Reconciliation

Regardless of their commercial stance on designation however it is worth remembering that a number of custodians' legacy clients or more recently enlightened clients will be having their securities properly serviced, so it's clear that the arguments are possibly more to do with custodian convenience than customer choice.

7 Summary

Manifest and others believe that designated accounts offer investors significant operation, legal and governance advantages.

- Designated accounts enable assets to be held for a specific Institution alone;
- Designation allows easier identification of beneficial owners while still allowing a degree of anonymity behind the chosen nominee name;
- Designation allows the identification of Stock Lending transactions in line with the Bank of England SLRC Guidance;
- Reduced opportunities for 'Stock Poaching' and 'Vote Poaching';
- Increased efficiency and clarity for exception management at the custodian;
- Cleaner, clearer and safer process for proxy voting, removing the risks of under or over-voting and wholesale rejection of votes due to late trades;
- Improved deadline dates: designation can return several days to Beneficial Owners or their Managers to engage with issuers and make voting decisions;
- Designation need not impact on Stock Lending programs, trading or settlement, as assets should be correctly allocated to individual accounts;
- Designation can ease the process of allocating income from dividends, stock lending and exceptional payments for participation in shareholder events;
- Designation does not bring onerous additional costs – custodians do not necessarily charge more for designated accounts instead of omnibus;
- Omnibus account structures effectively disenfranchise shareholders by removing their identity from the view of the Market and issuers creating a barrier to the exercise of Shareholder rights;
- Omnibus accounts will hold assets for multiple Institutions that become co-mingled making legal certainty as to ownership less certain; and
- Omnibus accounts make it more difficult for the investor to monitor the efficiency of the custodian as mistakes are effectively "lost in the pool".

A recent EU Consultation on a possible Recommendation in the sphere of shareholder rights contains a proposal that could allow shareholders to be represented on the register of members of a company in their own right. This means that financial intermediaries (i.e. custodians) would need to be able offer their clients the choice of designated accounts and not to have their assets held in an omnibus pool. The Commission reserves the right to re-visit such Recommendations and convert them into Directives should they feel that the recommendations have not been followed or would be of greater benefit if they were Directives; perhaps market participants should start thinking ahead in order to develop a market-driven response to these issues, rather than wait for regulation?

In our own experience dealing with pension funds and investors that wish to maintain their own designations, the competitive market pressures on custodians have generally won the day and omnibus designations have been avoided. For smaller clients this is not always the case, as policy will have been dictated from Boston or New York. We question how appropriate it is for a service provider to be putting their own interests before the needs of their clients for legal certainty and operational efficiency.

Issuers depend on the AGM and EGM process to be able to conduct corporate affairs promptly and cost-effectively. All too often we are hearing stories of shareholder meetings not being *quorate* necessitating multiple announcements, securities accounts being suddenly "emptied" due to stock lending issues, on-boarding of new clients being unnecessarily complicated and so forth.

Ultimately client pressure brought to bear will change the status quo. Fund managers and pension funds face increasing scrutiny of their corporate governance policies and voting transactions. All too often their good intentions are being frustrated by inefficiency and lack of co-operation between market counterparties. In the 21st century it seems remarkable that relatively simple instructions should be so difficult to execute.

As matter of policy, Manifest does not offer services to custodian banks. Our reasons are simple. Solving the proxy voting problem of one custodian does not solve the problems of the fund manger that has to deal with multiple custodians. We believe that our model of straight through vote processing offers significant legal and operational benefits to our clients and we believe that the on-going debate at National and European level has borne out our long-held view that efficient proxy voting and pooled nominees are incompatible.

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