The Chartered Governance Institute UK & Ireland

Saffron House
6-10 Kirby Street
London EC1N 8TS

+44 (0)20 7580 4741
info@cgi.org.uk
cgi.org.uk

Sir Douglas Flint
Digitisation Task Force
HM Treasury
1 Horse Guards Road
Westminster
LONDON. SW1A 2HQ

By email: digitisationtaskforce@hmtreasury.gov.uk

25th September 2023

Dear Sir Douglas,

Digitisation Taskforce – interim report

We welcome the opportunity to comment on the interim report of your digitisation taskforce.

The Chartered Governance Institute UK & Ireland is the professional body for governance and the qualifying and membership body for governance professionals across all sectors. Its purpose under Royal Charter is to lead effective governance and efficient administration of commerce, industry and public affairs, working with regulators and policymakers to champion high standards of governance and providing qualifications, training, and guidance. As a lifelong learning partner, the Institute helps governance professionals achieve their professional goals.

One of nine divisions of the global Chartered Governance Institute, which was established 130 years ago, the Chartered Governance Institute UK & Ireland represents members working and studying in the UK and Ireland and many other countries and regions including the Caribbean, parts of Africa and the Middle East.

As the professional body that qualifies Chartered Secretaries and Chartered Governance Professionals, our members have a uniquely privileged role in shaping and administering companies' governance arrangements and are, in most cases, primarily responsible for liaison between the issuer and its shareholders. They are well placed to understand the issues raised by your interim report. In preparing our response we have consulted, amongst others, with our members. However, the views expressed in this response are not necessarily those of any individual members, nor of the companies they represent.

This response from the Institute is, we should make clear, unconnected with that of the CGI Registrars Group, which is an industry body for that specific constituency.

Our views on the questions asked in your consultation paper are set out below.

General comments

The idea that share certificates should be dematerialised is not new. Indeed, several of the members on our working group can recall discussion of dematerialisation as far back as the Stock Exchange's TAURUS project back in the late 1980s and up to its cancellation in 1993. We supported this change then and we continue to support it now.

But getting rid of share certificates, although a laudable aim in itself, is unambitious; what is needed is a rethink of the structure of the UK market – of what works and what doesn't and of how we can most effectively take advantage of the opportunities created by modern technology to make our market fit for the future. This is long overdue.

We were pleased to see the interim report addresses a number of these issues, and the Institute will be happy to engage with the taskforce as it continues its work. On that point, we were slightly surprised that the taskforce did not contact the Institute as part of its engagement process. We have a large number of members within listed companies, for whom a significant part of their role is managing the register of shareholders, particularly retail shareholders.

Getting rid of share certificates is also far more complex than many believe. The millions of certificated shareholders in the UK are a significant community and their interests need to be kept in mind. Although in overall terms they are a small community, with the overwhelming majority of shares held through variations of the nominee model, there are still several million of them – the latest estimates we have seen being 8-10 million.

Re-imagining the market to deal with the issue of dematerialisation requires the recognition of a host of often conflicting interests and priorities. This is one of the reasons why it has not happened before now. You will see from our answers to your questions below that we do not believe that your proposed solution – Model 3 – works as it stands. Nor to a greater or lesser extent do the other models in the interim report. We would hope that, had the Institute been consulted as part of your engagement process, we might have helped to avoid some of these pitfalls.

As you will see from our comments below, particularly in our response to question 5, we have reservations about the taskforce's preferred Model 3. As proposed, we believe that this is, quite simply, unfair to the millions of certificated shareholders and, consequently, unlikely to attract government support. We see Model 1 as far from an ideal solution, but as one which shares the impact of change more equitably across the market. Our preference would be for an enhanced Model 3, which retains the many benefits of this model, but also ensures that certificated shareholders retain their shareholder rights.

We will be happy to engage with the taskforce to discuss these issues as you progress your work.

Our views on your recommendations are as follows:

Recommendation	CGI viewpoint
1. Legislation should be brought forward, and company articles of association changed, as soon as practicable to stop the issuance of new paper share certificates.	Disagreed. This should not be done before the future solution is agreed and structures in place.
2. The government should bring forward legislation to require dematerialisation of all share certificates at a future date, to be determined as soon as possible.	Agreed, but subject to and dependent upon the agreement of a future solution. See our response to question 5 below. We do not agree with your preferred solution as it stands.
3. The government should consult with issuer and investor representatives on the preferred approach to 'residual' paper share interests and whether a time limit should be imposed for the identification of untraced Ultimate Beneficial Owners (UBOs).	Agreed. But see our response to question 2 below.
4. Intermediaries should have an obligation, as a condition of participation in the clearing and settlement system, to put in place common technology that enables them to respond to UBO requests from issuers within a very short timeframe.	Agreed.
5. Intermediaries offering shareholder services should be fully transparent about whether and the extent to which clients can access their rights as shareholders, as well as any charges imposed for that service.	Agreed.
6. Where intermediaries offer access to shareholder rights, the baseline service should facilitate the ability to vote, with confirmation that the vote has been recorded, and provide an efficient and reliable two-way communication and messaging channel, through intermediaries, between the issuer and the UBOs.	Agreed.
7. Following digitisation of certificated shareholdings the industry should move, with legislative support, to discontinue cheque payments and mandate direct payment to the UBO's nominated bank account.	Agreed.

Specific consultation questions

Question 1 – what would be an appropriate timeline to require all share certificates to be dematerialised to ensure that the communication arrangements necessary to allow previously certificated shareholders to have access to their rights are in place?

As noted in our general comments above, it is our view that this question risks putting the cart before the horse and assuming that the dematerialisation of existing paper share certificates is the target to be attained. In reality, it is only one of many issues that must be addressed if the UK market is to be modernised – and not even the most pressing one at that.

We believe that it would be inappropriate to require dematerialisation of all existing share certificates or to stop issuance of new certificates until we have an agreed future model for the market which will ensure the efficiency of the market and an equitable solution for all parties concerned. None of the proposed solutions currently does this and it is therefore too early to start thinking about timelines.

As the report points out (page 10) " Many of the past reviews cited above have examined, in detail, … the practical and legal issues that would need to be overcome to … [remove paper share certificates and processes from the UK's trading and settlement framework]." Given the millions of investors holding share certificates, the potential for many of them to be less sophisticated or experienced share owners, our view is that a communication programme for at least two to three years would be required if the market were not to descend into chaos.

Anything less than this will create confusion and complexity for existing registered shareholders; potential disadvantage with participation in new issuances for their investee companies; cost and complexity for the issuer; and overall complexity for the market of running dual systems and processes pending the full removal of certificates.

Question 2 – What approach should be taken to the disposition of 'residual paper shares, and should a time limit be imposed for identifying untraced UBOs?

This question seems to us to assume a higher incidence of untraced UBOs than we believe to be the case. While there is always a percentage of 'gone away' shareholders on a register of members, experience indicates that this is typically less than 10%, predominantly amongst the smaller shareholdings.

We are concerned that there is a risk of passive investors, who hold their shares 'for a rainy day' and are not regular traders, to be inadvertently treated as forming part of this group. It may be that the extensive communications programme will, in the same way as the 'if you see Sid' campaign back in 1986 encouraged people to buy shares, encourage them to reconnect with their investments. Certainly, the efforts of companies to re-connect with shareholders using tracing agents have often found that the shareholder still lives at the registered address – they just haven't bothered to deal with some correspondence. This is their right, and it is important that such individuals are not disadvantaged.

We would also question the optics of this approach from a political perspective. At a time when the government is trying to encourage savings, action which disadvantages small investors seems, at best, misguided.

Question 3 – with regard to 'residual' certificated shareholdings attributable to uncontactable shareholders, do you support each issuer having the option to manage these residual interests themselves within the authority contained within their articles of association as well as having the option to transfer the proceeds of sale to the UK's Dormant Assets Scheme?

Yes. Each issuer will have its own view of its relationship with retail shareholders; some regard them as potential customers and actively manage them, others do not.

Question 4 – is the ability to have digitised shareholdings held on a register outside the CSD important to issuers or UBOs?

With respect, we would suggest that this is very much a secondary issue compared with that of the choice of digitised share model dealt with below. We doubt whether the majority of certificated shareholders are aware that the way in which the market operates is that their shares are currently held on a register outside the CSD, nor would they care. However, what many of them are very much aware of is that they have ownership rights and a direct relationship with the issuer in which they own shares.

Question 5 – do you agree with the taskforce recommendation that the optimal architecture is for all digitised shareholdings to be recorded in the CSD and managed and administered through nominees?

No, we do not.

That said, we do not agree with any of the proposed models as they stand.

In our view, Model 4, whilst attractive in the sense that it represents a significant modernisation of our market, is based on technology that is, as the report states on page 15, at an early stage of development and adoption. This may be the way of the future, but it is not yet in a sufficiently developed state to be considered.

Model 2 might well be made to work, but would only be practical were the issuer required to arrange a sponsor to manage the investor account with CREST and we believe that the costs and lack of current infrastructure outweigh the benefits. As your report states (pages 14-15) "there are increasingly few direct members of CREST, and the platforms we consulted with advised they rarely see any interest to do so." This low take up suggests that it is not the solution for which the market should be looking.

This leaves Models 1 and 3 which we see as, in many ways, broadly similar although each presenting their own challenges.

Model 1 is, to a very considerable extent, based on the 'Industry proposed model' that was presented to government back in 2014. It has the merit that it largely reflects the current market system, but without paper share certificates, and therefore is least likely to create confusion or cost in the market. It also has the merit that, as there was, at that time, little will to make such a fundamental change, the interests of all participants are largely respected and there is little downside for any of them, other than some development costs for the main infrastructure providers.

Although we have seen no evidence of "consequential friction as shares move between the two registers" as the report suggests (page 14), (at least not to any material extent and that in relation more to other paper processes than the presence of paper share certificates), it should be possible to design a system where there is no such duplication.

However, Model 1's similarity to the current market structure is also a disadvantage. It would still require the shareholder to become more digital, but they would be effectively held within a service model or platform provided by the issuer or its registrar. Model 1 therefore runs the risk of further entrenching many of the challenges of our existing structure. The objective of such a fundamental change to the UK market structure should surely be to derive some advantages from this change and move to a 'best in class', structure, rather than merely replicating the status quo minus share certificates. See our suggestion below.

Model 3 represents a requirement that all shares be intermediated through a nominee model. This has the advantage that all shareholdings would be held directly in the CSD, removing the need for movement between sub-registers and the CSD and it is fair to say that some of our issuer members strongly prefer this model. Their argument is that this is the way of the future and that it is more equitable for all shareholders rather than allowing the market to be subject to a more costly solution for the benefit of a minority of certificated shareholders.

However, in our view Model 3 as currently proposed is fatally crippled by the disadvantages that it brings to both issuers and their certificated investors: the former lose their direct relationship with their shareholders – valued by some, although by no means all issuers; while the latter lose all their ownership rights and would have to establish a new relationship with a nominee provider and go through all the KYC procedures necessary for a nominee to hold and administer their dematerialised interests. As the report states (page 14) "We note that many certificated shareholdings are modest in value and so the UBOs of many certificated holdings may not be of much interest to the platforms they might seek to join."

Therefore, we believe that Model 3 as proposed fails the test of three of the principles set out in the taskforce's terms of reference – specifically:

- Principle 1, which states that "…Paper certificates should be eradicated with costs apportioned in a fair and balanced way. Specifically, digitisation should reduce costs within the system …";
- Principle 3 which states that "The removal of paper certificates should not result in the degradation of the rights of current holders of paper certificates to, for example, vote, receive information and participate in corporate actions."; and

- Principle 5 which states that "Any model must be predicated on a logical and measured transition plan that minimises disruption and costs for issuers, intermediaries, and investors."

On balance then, and for all its flaws, we believe that Model 1 is very marginally the best of the alternatives offered at present.

That said, it would be relatively simple for the drawbacks with Model 3 to be rectified, in which case it would clearly be the better solution. The report suggests (page 15) that the certificated shareholders could be intermediated by "in the first instance, a nominee arrangement facilitated by individual issuers or a centralised nominee." The government will need to amend the Companies Act 2006 and the Uncertificated Securities Regulations in order to abolish share certificates and make the other changes proposed in the report. It is entirely within their gift to create a dematerialised structure which offers full shareholder rights to those intermediated by it, without the need for KYC arrangements for existing shareholders. Generally, we see KYC requirements as an important safeguard for the UK market, but in this case – of existing shareholders in public companies whose holding mechanism is being changed – we see grounds for an exception. Of course, we would expect them to go through that process at the time of any future trade. This arrangement preserves choice, might be funded by the issuer, or centrally, and might be provided by any chosen service provider which might include the issuer's existing registrar.

It could be argued that this is, in effect, a second register but, in reality, every nominee provider has a record of their UBOs and this is no different. The principal issues of certification and movement between the issuer and operator registers (although, as noted above, we do not believe this is as significant as the task force has been led to believe) are thereby resolved.

With that change, we would agree with the taskforce's recommendation of Model 3.

Question 6 – do you agree that the dematerialisation of current certificated holdings would be optimally pursued in a two-stage process, first to dematerialise to a single nominee (which could be sponsored by the issuer, an intermediary acting on its behalf or a collective industry nominee) and second to allow individual participants to move their beneficial interests to a nominee of their choice electronically?

No. We do not think this is necessary. Those who have chosen to hold certificated shares have chosen not to be intermediated by a nominee, so we see no merit in stage two of this process.

Question 7 – do you agree that facilitation of shareholder rights should be left to market forces, with full transparency as to whether access to such rights is available and where it is, clear communication around ease of access and charges allowing shareholders to choose between full service or lighter touch models?

Yes. We agree that facilitation of shareholder rights should be left to market forces. Given that we see such incredibly low number of holders exercising the rights that they have, it would be unfair to force all

nominee providers to provide these rights, when the cost of this would merely be passed on to the underlying holders who in an overwhelming majority of cases, see no value in them.

However, we would argue that, where the provider claims to offer shareholder rights, it would be helpful were there to be an accepted basic level of rights facilitation that should be available to all, free of charge, with complete price transparency over other services in line with Principle 3 of the workforce terms of reference. Currently, all services relating to the exercise of shareholder rights are free to certificated shareholders and this arrangement should be retained for the default model going forward.

Question 8 – What should the service level agreement be between issuers and the intermediation chain, with regard to the provision of UBO information? With regard to turnaround time and the frequency of request, what would constitute 'fair usage' of that process – essentially a 'baseline' obligation? Should aggregation be permitted such that individual UBOs below a minimum percentage ownership need only be communicated in aggregate; what should that percentage be?

We do not believe that any service level agreement is necessary. Issuers have considerable powers of enquiry under s793 Companies Act 2006, and intermediaries will have undertaken comprehensive KYC due diligence on their clients. Consequently, this should be available through the intermediation chain and it should be a requirement that the information requested is made available to the issuer within 24 hours of the request. As in your recommendation 4, this should be a condition of participation in the clearing and settlement system.

Question 9 – do you agree that only issuers should have the ability to access information below the level of what is recorded on the company's share register? Should there be restrictions on how issuers can use that information, including sharing the information?

Yes, but issuers should remain subject to the provisions of Part 22 Companies Act 2006, in particular s808 et seq. and provide UBO information to third parties where they are satisfied of a proper purpose. It would be helpful were Part 22 to be amended to include some de minimis threshold to curtail the mandatory disclosure by issuers of retail investors personal details.

There should be no restriction on how issuers themselves can use the information.

Facilitating access to shareholder rights

There is no specific question on this section of the report, which we see as one of its most important aspects. We could not agree more with the statement on page 20 of the report that "There should be no distinction in access to rights between shareholders who are directly registered and those who hold their shares through intermediaries." We also support your suggestion (pages 20-21) that the 'deemed consent' provisions of the Companies Act be brought up to date and that dividend and other distributions should be made by electronic payment rather than cheque. Of course, it is already open to issuers to make a change to this effect in their articles of association and, indeed, some have done so.

Legislative changes required

You asked for feedback on this section of the interim report. In our view the principal challenge is that we do not believe that your preferred solution, Model 3 above, does strike the "fair balance between the legitimate aims of digitisation and the impact on the rights of holders of currently certificated shares …[or] … comply with Article 1 of Protocol 1 to the European Convention on Human Rights as incorporated into domestic law through the Human Rights Act 1998" as you mention on pages 23-24 would be required.

We also do not think that implementation of your recommendations 4, 5 and 6 though amendments to the FCA handbook provides sufficient certainty of compliance. Formal regulation would be preferred.

There are, of course, a number of other minor changes that the Companies Act 2006 needs to bring it up to date and the Institute will be happy to engage with the Department of Business and Trade to discuss those as the legislation is drafted.

If you would like to discuss any of the above comments in further detail, please do feel free to contact me.

Yours sincerely,

Peter Swabey FCG
Policy & Research Director
The Chartered Governance Institute UK & Ireland

020 7612 7014
pswabey@cgi.org.uk