



Shareholder ID: The Resounding Silence of Non-Disclosure

A Commentary from PR Newswire's Disclosure Advisory Board

Shareholder ID: The resounding silence of *non-disclosure*

In an era of unprecedented corporate disclosure requirements for public corporations, investors with hidden identities—and sometimes hidden agendas—are keeping silent about their participation in the US capital markets. Trading beyond the reach of regulations, these investors may conceal their identities from other market participants as well as from corporate issuers.

Whether significant shifts in stock price or volume by unidentified shareholdings are deliberate or unintentional, the reverberations created by non-disclosure can profoundly affect the capital markets and all participants.

Non-disclosure on the part of investors is not just an “issue” for issuers. It creates a disorderly market for everyone. As long as disclosure remains a one-way transparency street, all involved participate at their own peril. Furthermore, capital markets characterized by shareholder anonymity can emit reverberations that deter both investors and public offerings.

Consequently, we believe it’s time for undisclosed significant US investors/traders to be required to break their resounding silence and announce who they are in a timely manner. We’re calling for shareholder identity transparency to make disclosure a two-way street—and our capital markets more attractive to investors.

Let’s consider how the thundering silence of non-disclosed shareholders is affecting investors, public companies, investor relations professionals, boards of directors—and the capital markets themselves.

Vibrant equity markets around the world depend on the active participation of investors. However, certain practices in the US send mixed signals and put many investors here at a disadvantage. For example, while we extol the virtues of long-term stock ownership, we expect investors to trade and remain in the market even with incomplete knowledge about who holds the other shares. When large blocks of stock of uncertain ownership move for undisclosed reasons, and often with large percentage changes in share prices, we provide no forum for investors to raise objections. Their only alternative is to make uninformed decision calls that may profoundly affect their portfolios. And IROs and executives who have met with investors on days when these block trades cross, and cause share price movement, can later have this fact used as an indication that material non-public information must have caused the price movement

“In an era of ‘right to know’ advocacy, US public companies should have the right to know who their shareholders are.”

At the same time, we expect public companies to offer their shares and to make elaborate disclosure to a sizable, undisclosed market of investors. In an era of “right to know” advocacy, US public companies **should** have the right to know who their shareholders are and who created major transactions in their stocks

This lack of knowledge—as well as legal or regulatory recourse—places public companies at considerable risk. They expose their shares to potential price manipulation from unknown holders with unknown intentions; they face increased exposure and vulnerability to takeovers and proxy fights without the ability to engage in the kind of dialogue that a well-intentioned activist should welcome. Further, they become susceptible to the agenda of short-term holders who may induce company actions not favorable to longer-term business objectives.

“We believe it’s time for undisclosed significant US Investors/traders to be required to break their resounding silence.”

For example, we've witnessed short term investors maneuver to extract quick dividends from cash rich companies before moving on to their next target. We've also seen how undisclosed investors holding short positions employ tactics designed to lower a company's stock price. Especially if they are being paid in stock.

While the rules remain ineffective in giving companies the right to know their shareholders' identity, regulators and others have become increasingly vocal about the detailed responsibilities of companies to communicate with investors. Widespread clamor for simultaneous investor communication spawned Regulation Fair Disclosure in 2002. Since then we have charged investor relations professionals to promote corporate transparency and to deliver messages—faster and more comprehensively—to a partially unknown audience of corporate shareholders. Failure to do so can result in serious penalties for their companies and their management, as well as public outcry. Yet, no one is raising a din about the irrationality and impossibility of developing good communications for an unknown shareholder audience.

Even as shareholder activism mounts, market practices continue to inhibit disclosure professionals from communicating directly with certain investors. As shareholders cry out for majority voting or for a “say on pay,” embargoes on direct communications with investors is disadvantaging corporate boards of directors as well. Following the Enron /WorldCom eruptions, we've redefined corporate governance and demanded boards to be more accountable to shareholders. Nevertheless, we've left untouched the barriers that impede directors' conversation and engagement with certain beneficial owners. Furthermore, these barriers contribute to practices such as empty voting (discussed below) which, in addition to affecting the outcome of directors' elections, may also bestow unfair advantages on some investors who may even hold short positions.

“We have charged investor relations professionals to promote corporate transparency...nevertheless, we've left untouched the barriers that impede directors' conversation and engagement with certain beneficial owners.”

It doesn't take long for discouraging words to spread about capital markets which facilitate the prevalence of secret identities and create opportunities for surprise and potential stock manipulation. Eventually, both companies and investors will turn away.



To some extent, this is already happening. The US capital market is the most threatened. Initial public offerings (IPOs) are listing on other exchanges and increasingly turning to Europe and Asia for their capital and liquidity needs. In 2006, according to PriceWaterhouseCoopers, there were 651 IPOs in Europe compared with only 224 in the U.S.. The Chinese capital markets attracted some of largest IPOs, raising 30 percent more capital than US IPOs) Then, there are a significant number of public companies that are going dark and turning to private equity for capital.

Earlier this year, US Senator Charles E. Schumer and New York City Mayor Michael E. Bloomberg issued a report predicting that New York is in danger of losing status as the global financial center. Stringent regulations and securities litigation are among the reasons cited. The press release announcing the report underscored that strong capital markets and financial services are crucial not only to New York but also to the US economy.

Others have disagreed with these reasons for declines. The arguments contra generally run along the lines that local markets are increasingly attractive in a global economy. Most reasonable commentators will, however, attribute at least some of the short fall to SOX and US litigation.

Are we willing to add shareholder identity problems to the growing list of reasons that are branding the US as a difficult, unattractive financial market?

Among major financial centers, the undisclosed shareholder syndrome is most prevalent in the US. In fact, there is a large gap, nearly a complete absence, of shareholder disclosure in the US compared to other sophisticated markets.

“Are we willing to add shareholder identity problems to the growing list of reasons that are branding the US as a difficult, unattractive financial market?”

Objecting beneficial owner (OBO) designations probably served as the initial culprit for creating large numbers of unidentified shareholders in the US. Through such classifications securities brokers, institutions and custodians shield investors from corporate issuers. When investors have OBO designations, the issuer – and hence the market - is not permitted to know their names or have direct communication with them. However, when investors have *non-objecting beneficial owner (NOBO)* designations, issuers receive their names and have the ability to communicate with them directly.

Arbitrary practices, which automatically funnel most retail investors into OBO classifications, are the real points of contention. Often investors are not given a choice to select

NOBO versus OBO status. Other investors are unaware that they are OBOs and that their identities and contact information are being withheld from the companies in which they invest. Still other investors, perhaps, are misled into thinking that a NOBO designation would result in their being besieged by mail or other communications from listed companies. Furthermore, most OBOs are unaware that they have lost the opportunity to cast their proxies and that someone else will vote on their behalf.

Newer financial products and practices not covered by long standing disclosure rules are further exacerbating the problem of shareholder identity. Prime examples are the growing popularity of cash-based derivatives and other products, which are attracting activity on both sides of the Atlantic. These products enable investors to aggregate shares without disclosure obligations to issuers or other market participants—even in potential takeover situations. The prevalence and magnitude of this activity—which has grown from the “*side action*” in the market to “*the action*” in the market—calls out for immediate change.

In the US, the growing practice of “borrowing” shares is enabling undisclosed investors without economic interest or with limited stakes to have an outsized say in elections that affect issuers and other investors. Borrowing shares also enables undisclosed investors to exert a far greater influence than their economic interest would otherwise permit. Institutions and brokers make money by lending these shares. Issuers, on the other hand, can be adversely affected by actions of these borrowers, but may gain no benefits from the loans.

“Newer financial products and practices not covered by long standing disclosure rules are further exacerbating the problem of shareholder identity.”

Many (most) long investors are completely ignorant of these vote-buying practices which give rise to “empty voting” and of whether they participate in the revenues these loans generate. Nor are investors aware of how their shares are being voted by undisclosed investors whose agendas are not necessarily linked to the long-term, best interests of other investors or of the company itself.

With details hidden, it is difficult indeed to gauge the magnitude of this activity. However, many investor relations officers believe that up to 30% of their equity is “lent” in one form or another. As proxy seasons become more hotly contested, there is a pressing need for companies to be able to reach out to shareholders currently classified as OBOs. These unidentified shareholders could represent a potential “swing vote” at annual meetings. Their votes might help to garner additional support for director elections and management resolutions and/or defeat resolutions proposed by shareholder activists. From the shareholder perspective, regaining the franchise will enable investors to have a voice and the opportunity to “speak out” by casting votes according to their own preference and in their interest.

“However, many investor relations officers believe that up to 30% of their equity is lent.”

In the UK, the *contract for difference (CFD)*, a highly-leveraged, tax-advantaged product currently falls outside shareholder disclosure regulations. This popular investment vehicle enables investors to benefit from share price changes and even to build positions for potential takeovers while operating undisclosed to other market participants. (Its equivalent in the US—an equity swap—has similar impact.) Relief from this practice soon may be in sight. The Financial Services Authority, the UK regulator, is investigating the situation and will pronounce shortly.

Although our focus for this paper is the market havoc caused by non-disclosed investors, we observe that, on the flip side, non-disclosed investors may be doing themselves a disservice. Investor relations, corporate boards and senior management cannot reach or communicate with these investors. Nor can these investors always communicate with the companies in which they hold positions. Non-disclosed investors may not be able to gain management access, as companies are unable to prove their shareholding through the register. Investors may also be excluded from road shows, miss out on IPOs, and be unable to express their views in recapitalizations, and so on.

“Non-disclosed investors may be doing themselves a disservice.”

Fortunately, emerging global standards of disclosure of shareholder identity are becoming best practice and heralding change. Already in various markets, we see issuers gaining not only the right to know the identity of shareholders and the right to peremptorily challenge investors but also the right to withhold dividends from unidentified shareholders, to prevent share transfers, and ultimately to disenfranchise non-disclosed shareholders altogether. Regulations mandating the right to demand the identity of beneficial owners now exist in the UK, France, Australia and South Africa, among others.

In the UK for example, public companies have the right to demand the identity of their beneficial owners and to place restrictions on the shares in question if the owners do not respond. At the same time, issuers are obliged to fulfill their responsibility of keeping the market informed. Together the UK’s Companies Act 2006 and the FSA Disclosure and Transparency Rules establish an operating framework for shareholder identity. (Please see Appendix for more details.)

“ Global standards of disclosure of shareholder identity are becoming best practice.”

Earlier this year, Germany broadened its rules on shareholder disclosure for investors acquiring more than 3% of the voting rights of a public company. The rules establish various thresholds (between 3% and 75%) for the acquisition of voting rights. Each threshold triggers mandated public disclosure on the part of the investor whenever the investor reaches, exceeds or falls below the threshold.

In Holland, regulators recently proposed share ownership disclosures at the 1% level, a more stringent requirement than the currently required level of 5%. This proposal, yet to be enacted, does not include derivatives or the right to demand the identity of beneficial owners.

As shareholders in other parts of the world are becoming more transparent, US shareholders need to be required to reveal their identity as well. Too many glaring paradoxes exist between capital markets in the US and those abroad. For example, foreign issuers can find out more about their US investors than US issuers can find out about US investors. US issuers (because of local market regulations) can find out more about their international shareholders than their domestic US ones. Investors abroad know the identity of other investors in the markets; however, when these foreign investors invest in the US market, they give up this kind of insight.

“Foreign issuers can find out more about their US investors than US issuers can find out about US Investors.”

Left unsettled, these paradoxes could thrust US capital markets out of competition. Therefore, we call upon shareholders to disclose their identities and announce who they are. After years of ever increasing corporate transparency, it’s about time for a little *quid pro quo* on the part of shareholders.

Technology already exists to provide daily shareholder identity reports. More paperwork, or even requiring monthly instead of quarterly filings of Forms 13F and 13D, is probably not the best solution. Larger companies may have resources – or access to commercial providers of information - to sift through the additional paperwork; smaller companies may not.

We are encouraged that the outcry for greater shareholder transparency is being heard.

Committee work now underway at the NYSE may influence OBO/NOBO classifications. At various NYSE working groups, support is growing for the SEC’s review of rules to make it easier for issuers to communicate with investors. NYSE committee research indicates that given the choice and appropriate information, most investors would prefer NOBO designations. In fact, the NYSE is considering a proposal that would allow investors to make an informed choice on their status. If the majority of investors in NYSE listings become NOBOs, perhaps other US markets may follow.

“We call upon shareholders to disclose their identities and announce who they are.”

We entreat disclosure professionals to reach out to institutions and simply ask them to disclose their

“We urge disclosure professionals and company management to write to the SEC.”

holdings. By way of precedent, in the proxy advisory area a letter writing campaign to institutions helped improve shareholder identity disclosure. If practices in the UK or other markets sound appealing, we urge disclosure professionals and company management to write to the SEC and

suggest a similar approach be considered.

The resounding silence of the US shareholder identity problem calls for immediate action. The aftershocks are permeating our capital markets and making them less attractive than investment venues in other parts of the world. Overall, shareholder non-disclosure is affecting all participants and creating a disorderly market in the US.

Appendix

Rights to identify your shareholders: the UK approach

Issuers around the world enjoy a patchwork quilt of rules that allow them to know the identity of their holders of their equity. Countries such as the UK, France, Australia and South Africa have put into place very similar systems. For example, here's how it works in the UK.

UK issuers listed on a UK stock market have two sets of investor information available to them. One is *reactive*, and the other *proactive*. These rights are given through two rules: the Companies Act 2006 and the FSA Disclosure and Transparency Rules.

First the reactive:

The FSA Handbook is the operating manual for financial services businesses and listed companies in the UK. A notification by the investor to the issuer is required when an investor has acquired an interest in more than 3% of the issued share capital, and then subsequently if it crossed further boundaries of 1% (absolute) of the share capital. These notifications must be made within two business days.

So if an investor acquires 3.6% it would make a notification to the company. If they acquired a further .5%, crossing the 4% threshold, they would make another notification.

If a Company receives information that an investor has a notifiable holding, the company then has an obligation—under the Disclosure and Transparency Rules—to inform the market and the stock exchange via a press release to a Regulatory Information Service within one day following the day on which they were informed. In this way, the market as a whole is aware of these transactions.

Next the proactive:

Since 1985, companies in the UK have had 'a prima facie unqualified right' to know who owns their shares. The relevant clause—"Section 212" has been so well used it has entered the IRO's lexicon. This right has recently been renewed under the new Companies Act 2006, although under a different name "Section 793".

This rule helps companies deal with a difficult problem. Increasing consolidation in the share custody industry, there were fewer nominee holders (street names) accounting for more stock. Typically, 50% of a company's stock could be held in 10 nominee accounts. With this decreasing transparency of shareholdings, companies have been able to use notices to the nominees to force disclosure of the identity of the beneficial owner.

The notices are issued—often by the company's registrar. There is no standard form for these notices, although a sample is available at <http://www.dti.gov.uk/files/file30060.pdf>. The notices can be retrospective—up to 3 years.

Once the notice has been received, the shareholder must respond with details of the beneficial ownership within a 'reasonable' time (normally two or three business days).

The company then has some obligations of its own. It must publish an index of the responses received, and make them open for public inspection.

This right applies to companies domiciled in the UK, and to their shareholders all over the world. In practice, investors may challenge the right—especially for example in Switzerland, where there are banking secrecy rules. Companies therefore have certain powers to force disclosure.

These include applying to a court to have restrictions imposed, such as disenfranchising the shares (so they can't be voted at an Extraordinary General Meeting, for example), not paying dividends on them, or not allowing them to be transferred. All or some of these can effectively render the shares worthless.

"Material interests"

Both reactive and proactive situations described above exclude 'non material' positions especially synthetics such as derivatives. Thus, the owner of a Contract for Difference (CFD) for example is NOT obliged to disclose their ownership—even if it passes 3%—or to respond to 793 notices.

Members of the PR Newswire Disclosure Advisory Board

PR Newswire's Disclosure Advisory Board is comprised of leaders in the corporate, regulatory, investor, reporting, and academic communities. The board debates current disclosure and governance issues and proposes "best practices" for improved financial and corporate reporting.

Members of the Disclosure Advisory Board are:

John Bierbusse, corporate director and retired equity research analyst at A.G. Edwards

Janet L. Fisher, partner, Cleary Gottlieb Steen & Hamilton LLP

Valerie C. Haertel, VP/director of investor relations, Medco Health Solutions, Inc.

Jerry Hostetter, VP/director of investor relations and corporate communications, Smithfield Foods Inc.

Mark Hynes, managing director investor relations services, PR Newswire

Deborah Kelly, partner, Genesis Inc.

John L. Kelly, co-head, industrial research team, Goldman Sachs

Mary Beth Kissane, president and founder, Corporate Perception Research

Sam Levenson, SVP investor relations, Sony Corporation of America

William A. Relyea, managing director, H.C.Wainright & Co., Inc.

Diane Salucci, SVP, Bear Wagner Specialists LLC

Martin Shea, EVP, investor relations, CBS Corporation

Kurt P. Stocker, member of the board of directors of NYSE Regulation, Inc. and chairman of the New York Stock Exchange Individual Investors Advisory Committee

Anna Sussman, director investor relations and corporate communications, Pharmion Corporation

Louis M. Thompson, Jr., partner, Genesis Inc. and managing director, Kalorama Partners, and former CEO, president and board member of the National Investor Relations Institute.

Views of the Disclosure Advisory Board do not necessarily represent the views of PR Newswire or its parent company, United Business Media.

We invite your comments and recommendations on the proactive measures disclosure professionals, public companies and investors can take to turn this situation around.

Please e-mail us: information@prnewswire.com

Or, post your comments our blog:
<http://www.transparencymatters.blogspot.com>.



PR Newswire

United Business Media