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Example
UNCERTIFICATED SHARES: A COMPARATIVE LOOK AT THE VOTING RIGHTS OF SHAREHOLDERS

By

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In order to promote sound corporate conduct, it is essential that shareholders actively participate in the governance of the company. The primary mechanism to achieve this lies in the shareholder’s right to vote at meetings. However, an analysis of the nature of shares, and the history surrounding the introduction and development of uncertificated shares in particular, reveals a structure that often interposes multiple nominees between the issuing company and the underlying investor. Such a structure has the potential to dispossess the underlying investor of his rights, which may have concomitant negative effects on the corporate governance of the company. A comparative study of the legal framework for uncertificated shares in the United States, the United Kingdom and South Africa reveals varying degrees of protection for the underlying investor. Unfortunately, none of these countries has resolved the problem completely, and it is suggested that a move to a direct, transparent holding model, where the underlying investor, rather than an intermediary, is recorded in a company’s share register, is a better solution.
# TABLE OF CONTENTS

**INTRODUCTION** ................................................................................................................... 4  

**CHAPTER 1: SECURITIES AND SHARES** ........................................................................ 7  

1.1 Securities ..................................................................................................................... 7  
1.2 The nature of a share ................................................................................................. 10  
1.3 Certificated and uncertificated shares ....................................................................... 16  

**CHAPTER 2: FROM PAPER TO ELECTRONIC SHARES** .............................................. 21  

2.1 The ‘Paper Crunch’ ................................................................................................... 21  
2.2 The structure of electronic markets ........................................................................... 23  
   2.2.1 Immobilisation and dematerialisation ..................................................................... 23  
   2.2.2 Direct and indirect holdings .................................................................................... 24  
   2.2.3 Centralised or fragmented holdings ......................................................................... 27  
2.3 The South African electronic share environment ...................................................... 27  
   2.3.1 The creation of Strate .............................................................................................. 27  
   2.3.2 The legal framework ............................................................................................... 29  
      2.3.2.1 The Companies Act, 1973 ................................................................................. 29  
      2.3.2.2 The Securities Services Act, 2004 .................................................................... 31  
      2.3.2.3 The Companies Act, 2008 ................................................................................. 32  
   2.3.3 The current structure in South Africa ...................................................................... 34  

**CHAPTER 3: SHAREHOLDER VOTING** ........................................................................ 37  

3.1 The importance of shareholder voting ...................................................................... 37  
3.2 The problem with intermediation ............................................................................. 39  
3.3 The specific experiences of the United States, United Kingdom and South Africa .40  
   3.3.1 The United States of America ................................................................................. 40  
   3.3.2 The United Kingdom ............................................................................................... 46  
   3.3.3 South Africa ............................................................................................................. 52  

**CONCLUSION** ...................................................................................................................... 62  

**BIBLIOGRAPHY** .................................................................................................................. 65
INTRODUCTION

One of the most prominent features of the last decade or so in economics has been the high number of corporate scandals that have taken place. Many of these involve large, publicly traded companies with diverse shareholdings, and their failures cause repercussions beyond those unfortunate enough to be immediately involved.

The cause of most of these scandals and failures can often be traced back to a lack of sound governance at the companies concerned. The fact that there have been so many indicates that the standard of corporate governance internationally is regrettably low. In theory, it is the board of directors that is responsible for the governance of a company. However, shareholders, through their power to appoint and remove directors, have an important influence on how the board ultimately behaves. In order to improve these standards, it is essential that shareholders take an active role in the governance of the company. They can contribute by attending meetings and voicing their opinions, or by voting on resolutions even if they are not present. Shareholders should be insistent in holding the board responsible for maintaining ethical values such as accountability, fairness and transparency. It is in this manner that the overall level of corporate governance will be improved and, hopefully, the number and impact of such scandals will be reduced.

The most important tool that a shareholder has to influence the behaviour of a company is the power to vote. Any country that seeks to enhance corporate governance should ensure that the processes around shareholder voting are as straightforward as possible in order to encourage such behaviour. After all, shareholder passivity in large public companies is a well-documented phenomenon. If a shareholder has negative perceptions on the value of his vote, or is discouraged by the complexity of the process, this will only increase his inclination not to take part. In the same way that shareholder activism promotes good corporate governance, shareholder passivity can undermine it.

One of the concerns faced by countries with advanced economies is that shares in large public companies have been converted from paper certificates, directly held by the shareholder, to electronic ones maintained in the books of various institutions. This change was necessitated by the ‘Paper Crunch’ that first struck in the late 1960s, when trade volumes on stock exchanges reached such a high level that it became practically impossible to process
the huge amount of paper documents that were generated. The electronic conversion brought
great efficiencies to the trading and settlement of transactions on the stock exchanges, but it
created a problem for shareholders and their ability to exercise their rights. By their very
nature, electronic shares cannot be held by shareholders themselves. Instead, they are held as
records in the systems of various intermediaries that make up a large web, at the centre of
which sits the central securities depository, which is ultimately responsible for the orderly
custody, transfer and settlement of all the shares and their transactions. The structure of the
holding systems, however, means that the investor is usually not recorded as the shareholder
of his shares. For the purpose of administrative efficiency, it is usually a nominee of one of
the intermediaries that is recorded as the shareholder in the company’s share register.
Legally, then, it is this nominee that has all the rights attached to the shares, and the actual
investor has none. This includes the right to vote.

In order to resolve this problem, countries such as the United States of America, the United
Kingdom and South Africa have developed legal and structural frameworks that allow the
investor to exercise his rights. In the United States, these mechanisms involve a system
through which the rights of the shareholder are passed from one intermediary to the other
down all the levels of the holding chain until they reach the investor, and then passing his
voting instructions all the way back up the chain until they reach the issuing company. In the
United Kingdom, this system is also used in some ways, but the legislation has been tweaked
to provide the possibility for the indirect investor to have a direct relationship with the issuing
company, thus bypassing the intermediary if the intermediary so chooses. In South Africa, the
legislation has gone one step further and granted direct voting rights to the indirect investor
by amending the definition of what a shareholder is. In addition, there is also an obligation on
the intermediary to disclose the identity of the indirect investor (or the holder of a beneficial
interest, as it is termed) to the issuing company. This creates a direct relationship between the
indirect investor and the company, something that is not present in the regimes of either the
United States or the United Kingdom.

However, the solution in South Africa is not perfect. Complexities in the proxy voting
process mean that it is possible for votes to get lost or incorrectly assigned. The true way
forward to ensure that the rights of indirect investors are protected and entrenched is to move
to a centralised, direct custody system. This is a system where the name of the investor is
recorded as the shareholder in the books of the central securities depository, the topmost level
of the custody chain. In this way, the investor will have a direct relationship with the issuing company. Since he will also be recognised by the company as the shareholder, he will be able to exercise his rights, including the right to vote, directly, and without the intervention of any intermediaries. The South African legislators have shown good vision by enabling exactly such a system in the relevant sections of the Companies Act, 2008, and Strate Limited, the central securities depository, has introduced some account structures that have begun to take advantage of these changes. It is suggested, however, that the South African market should embrace the move to such a system, and to implement it as a matter of priority.

In discussing this topic I shall take a comparative look at the legal and structural frameworks surrounding uncertificated shares in the United States of America, the United Kingdom and South Africa, with a particular emphasis on the position in South Africa.

No discussion on the voting rights of shareholders can be undertaken without first examining the nature of a share and from where those rights are derived. I shall begin by differentiating the concept of a security from that of a share (a differentiation which is sometimes overlooked by both authors and legislators). I shall then examine the manner in which the nature of a share has been defined through various cases, before determining whether the nature of a share is affected depending on whether it is certificated or uncertificated.

In order to understand the structure of the uncertificated market, I shall also give a brief history of the ‘Paper Crunch’ that engulfed the financial world from the late 1960s onwards. This context will allow for a better appreciation of the compromises that were introduced into the system, some of which persist to this day. I will also examine the various categories of uncertificated custody systems, and their differences, before focusing in some detail on the history of uncertificated shares in South Africa, the structure of the market, and the legal framework that underpins it all.

Finally I shall take an in-depth look at the shareholder voting processes in the three jurisdictions under discussion.
CHAPTER 1
SECURITIES AND SHARES

1.1 Securities

Companies require funding in order to pursue their business activities. This can be done either through the issue of securities or by borrowing the necessary funds that they require.¹

It is important to note that the term ‘security’ is wider than the concept of ‘share’. In the Companies Act, 2008 (hereafter the “2008 Act”), the word ‘securities’ is defined as meaning “any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company.”²

The Securities Services Act, 2004 (the “Securities Services Act”) provides an even more comprehensive definition of ‘securities’ that includes:

“(i) shares, stocks and depository receipts in public companies and other equivalent equities, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980);
(ii) notes;
(iii) derivative instruments;
(iv) bonds;
(v) debentures;
(vi) participatory interests in a collective investment scheme as defined in the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investment Schemes in terms of section 65 of that Act;
(vii) units or any other form of participation in a collective investment scheme licensed or registered in a foreign country;
(viii) instruments based on an index;
(ix) the securities contemplated in subparagraphs (i) to (viii) that are listed on an external exchange; and
(x) an instrument similar to one or more of the securities contemplated in subparagraphs (i) to (ix) declared by the registrar by notice in the Gazette to be a security for the purposes of this Act;

² See s 1 of the 2008 Act.
In South African law, therefore, the concept of ‘securities’ includes the concept of ‘shares’ as well as other instruments, such as debt instruments.

In the UK, the Companies Act, 2006 (hereafter the “UK Companies Act”) takes a different approach to definitions. Instead of a single definition for the whole act, each chapter defines terms for that chapter only. For this reason there are a number of definitions for ‘securities’, although on the whole their meanings are consistent. For example, sections 400(6) and 401(6) define ‘securities’ to include:

“a) shares and stock,
b) debentures, including debenture stock, loan stock, bonds, certificates of deposit and other instruments creating or acknowledging indebtedness,
c) warrants or other instruments entitling the holder to subscribe for securities falling within paragraph (a) or (b), and
d) certificates or other instruments that confer—
i) property rights in respect of a security falling within paragraph (a), (b) or (c),
ii) any right to acquire, dispose of, underwrite or convert a security, being a right to which the holder would be entitled if he held any such security to which the certificate or other instrument relates, or
iii) a contractual right (other than an option) to acquire any such security otherwise than by subscription.”

By contrast, sections 755(5) and 953(9) define ‘securities’ as only meaning “shares or debentures”, while section 783 again uses a very wide definition that means “shares, debentures, debenture stock, loan stock, bonds, units of a collective investment scheme within the meaning of the Financial Services and Markets Act 2000 (c. 8) and other securities of any description”. Section 1273 simply states that the definition of ‘securities’ is as per the definition in the Financial Services and Markets Act, 2000 (hereafter the “UK Financial Services Act”).

Unfortunately, the UK Financial Services Act follows the same structure as the UK Companies Act and does not provide a single, easily referenced definition. For example,

\(^3\) See s 1 of the Securities Services Act. The definition goes on to exclude money market instruments (except for the purpose of Chapter IV of the Act), and any security contemplated in paragraph (a) which is specified by the registrar in a Gazette notice.
section 102A, whose definition is only applicable to Part 6 (“Official Listing”), says that ‘securities’ means “anything which has been, or may be, admitted to the official list.” However, the “official list” is maintained by a “competent authority” and is not actually part of this piece of legislation. By contrast again, Part 2 of Schedule 2 of the UK Financial Services Act does contain a list of securities which includes shares, debentures, bonds, warrants, units in collective investment schemes and options, amongst others.

It is submitted that the drafting approach adopted by the United Kingdom is not the most accessible method of addressing the issue of definitions. Nevertheless, from this exercise it is possible to conclude that, like in South Africa, the UK legislation recognises that shares and securities are different instruments, with ‘shares’ being only a subset of the wider class of ‘securities’.

It is a similar situation in the United States. The Uniform Commercial Code (hereafter called the “UCC”) is a code of laws proposed by the Uniform Law Commission, which has as its object the harmonisation of laws across the federal states that make up the United States of America. The UCC is not law itself, but it becomes law when it is enacted as such in each of these states. It appears that by 1970 the UCC had been adopted by every state in the USA, although some states introduced variations to accommodate local practices.

In Article 8 of the Uniform Commercial Code, section 102(15) defines a ‘security’ as:

“…an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:

(i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;

(ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and

(iii) which:

(A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or

(B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.

Meanwhile, section 103(a) of the UCC provides that “[a] share or similar equity interest issued by a corporation, business trust, joint stock company, or similar entity is a security.”

From the above it is apparent that, in all three jurisdictions, it is legally accepted that a security is a class of instruments of which a share is but one. In South Africa, the 2008 Act makes such a conclusion obvious through the definition of ‘debt instruments’ in s 43. It holds that a debt instrument “includes any securities other than the shares of a company, irrespective of whether or not issued in terms of a security document…” (own emphasis). It is submitted that an investigation into a number of other jurisdictions which feature prominently in global commercial affairs will reveal the same distinction. In this regard it is instructive to refer to the UNIDROIT Convention on Substantive Rules for Intermediated Securities, Geneva 2009 (“UNIDROIT Convention”). UNIDROIT, or the International Institute for the Unification of Private Law, is an inter-governmental organisation whose purpose is to harmonise and co-ordinate private law initiatives amongst its member states. The organisation has 63 member states from five continents, covering a range of economically developed countries. The UNIDROIT Convention defines ‘securities’ as “any shares, bonds, or other financial instruments or financial assets…which are capable of being credited to a securities account…”

An in-depth discussion on the rights associated with all possible securities would be too wide-ranging and too voluminous for the purposes of this study. The remainder of this paper will therefore focus on the rights associated with shares, and not on those of other instruments or securities.

1.2 The nature of a share

Bearing in mind the historical and legal ties between the United Kingdom and the United States, on the one hand, and the United Kingdom and South Africa on the other, it is not at all surprising that the company law of these three countries shares a common foundation. In more

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7 See article 1 of the UNIDROIT Convention.
8 In addition, Schedule 10 of the JSE Listings Requirements requires that a listed company’s Memorandum of Incorporation must prohibit the issue of debt instruments with the right to attend or vote at a general meeting. Such instruments are therefore not relevant for the purposes of this dissertation.
recent years, each has developed and adapted that foundational law to address the unique challenges that they face. On the whole, however, a thread of commonality continues to run between them.

In all the jurisdictions we are examining, the nature of a share has been determined over many decades by a combination of both legislation and the common law interpretation of the courts. None of these countries has succeeded in codifying the entirety of its company law, hence the need for elucidation by the courts.

Currently, section 540 of the UK Companies Act defines a share as meaning a “share in the company’s share capital.” The meaning of “share capital” is not defined, although there are definitions for subsets of share capital such as “issued share capital” and “equity share capital”. There is also no section defining the precise nature of a share, whether it is corporeal, incorporeal, movable or immovable. It is submitted that these gaps in the legislation are regrettable. Both terms are used extensively in the legislation and the lack of clarity on what is meant could lead to uncertainty as to what is expected and required of companies, directors and shareholders in the UK.

As far as the common law is concerned, the authoritative dictum by the English courts on the nature of a share was delivered by Farwell J in *Borland’s Trustee v Steel Brothers & Co Ltd.*

The court declared that:

“A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se* in accordance with s 16 of the Companies Act, 1862. The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money settled in the way suggested, but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.”

In the wake of this decision, it has been argued that the emphasis in the courts moved away from regarding a share as an interest in a company and started defining the nature of a share.

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9 Gower “Some contrasts between British and American corporation law” 1956 *Harvard Law Review* 1369 1370, who makes the claim for the US and UK. It is submitted that the same applies to South Africa.
10 1901 1 Ch 279 288.
exclusively in terms of the rights attached to that share, for example the right to vote, the right to a dividend and the right to a return on capital upon the winding-up of the company.\textsuperscript{11}

In the case of \textit{In re Sir William Thomas Paulin; In re Percy Crossman}\textsuperscript{12}, Romer LJ followed this approach and declared:

\begin{quote}
"It is impossible to treat a share as being an interest in the company's assets, or an alienquot share in the company's capital, and to regard the contract arising from and contained in the company's articles of association as a separate and independent thing. That contract and the rights and liabilities that flow from it are of the very essence of the share."\textsuperscript{13}
\end{quote}

This approach highlights one of the fundamental principles of company law, namely that a company is a separate legal person which is capable of owning assets. The share thus grants its holder a proprietary interest in the company and not a proprietary interest in the assets of the company.

An illustration of this principle in effect can be found in \textit{Short v Treasury Commissioners}\textsuperscript{14} where the whole of the share capital of the company was compulsorily acquired by the state. The court of appeal held that the shareholders were not entitled to compensation for the value of the company, but only for the value of the shares. It was the shares that were being expropriated, not the company. As Evershed LJ stated: "Shareholders are not, in the eye of the law, part owners of the undertaking. The undertaking is something different from the totality of the shareholdings."\textsuperscript{15}

These decisions serve to confirm not only the separate legal personality of the company, but also the principle that the essence of a share consists of a number of rights. These rights are primarily of a contractual nature and are delineated in the constitutional documents of the company, while others are conferred by statute.

In the case of the United States, The Model Business Corporation Act ("Model Act") provides a simple and straight-forward definition of a share as “the units into which the proprietary

\textsuperscript{12} 1935 1 KB 26.
\textsuperscript{13} Ibid 57.
\textsuperscript{14} 1948 1 KB 116.
\textsuperscript{15} Ibid 122.
interests in a corporation are divided.” The Model Act is a general corporation act compiled by the American Bar Association as a reference model for individual states to follow. It is not law itself, but becomes law when it is adopted by a state. The Model Act has been adopted into law, either wholly or partially, by 29 states in the USA. However, this act does not go further into the nature of a share.

As we have seen, Article 8 of the UCC, which governs investment securities, does not itself contain a straight-forward definition of a ‘share’. Rather the nature of a share can be deduced from section 102(15) and the definition of ‘security’. As noted above, section 102(15) states that a ‘security’ is “…a share, participation, or other interest in an issuer … or an enterprise of an issuer….” In this context an issuer would include a company that “issues” shares or other securities. It is submitted that the use of the word ‘or’ indicates that a share is regarded as a form of interest in an issuer or in an enterprise of that issuer. However, the UCC does not provide any further clues as to what it might regard the nature of that interest to be. Presumably, this is to allow for the issuer of the share to determine the specific rights that are attached to that share.

Thus we see in the UCC a similar situation to the prevailing view in the United Kingdom, that a share is some kind of contract between the company and the shareholder, where the rights and obligations are bound into the nature of the share itself. For further clarification, however, we need to turn to the courts. Gower reports that in Barrett v King the courts declared that “[s]tock in a corporation…creates a personal relation analogous otherwise than technically to a partnership.”

While this view was predominant in the UK, it was not the same in America, where the concept of a share as property, with rights that were independent of the articles of the company, held sway for the first half of the twentieth century. In 1954, however, the Massachusetts case of Lewis v H.P. Hood found that a clause in the articles of a company

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16 See s 1.40(22) of the Model Act.
18 See s 103(a) of the UCC.
19 Gower (n 9) 1378.
21 Gower (n 9) 1378.
that allowed the directors to unilaterally purchase, retire or cancel any issued shares was not contrary to that state’s law and was binding on the shareholder. By implication, this means that the rights and obligations that define a share are of a contractual nature, and that their contents are to be found in a combination of the constitutional documents of a company and relevant legislation.

As with the USA, many of the doctrines and concepts of South African company law were inherited from or shared with nineteenth century English law. Over time, these have been modified or abandoned and new concepts developed. Some of those changes are reflected in the differences between the Companies Act, 1973 (“the 1973 Act”) and the 2008 Act.

In terms of the 1973 Act, a share was defined as meaning:

“…a share in the share capital of that company and includes stock; and in relation to an offer of shares for subscription or sale, includes a share and a debenture of a company, whether a company within the meaning of this Act or not, and any rights or interests (by whatever name called) in a company or in or to any such share or debenture….”

Section 91 went on to describe the nature of a share as “…movable property, transferable in the manner provided by this Act and the articles of the company.”

The 2008 Act now defines a share as “one of the units into which the proprietary interest in a profit company is divided”. This is almost identical to the wording of the Model Act and it is significant that the reference to ‘share capital’ that was evident in the 1973 Act has been done away with. It thus appears that with the 2008 Act, South African company law has undergone a shift away from its UK roots (which is still bound into the concept of share capital) and has moved towards a more North American sensibility. By no longer regarding ‘share capital’ as an integral part of the nature of a share, the 2008 Act now focuses instead on the rights which are associated with that share. The new definition also confirms the status of the company as a separate legal person which is capable of owning assets. As in the UK and

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23 Cassim et al (n 1) 3.
24 See s 1 of the 1973 Act.
25 See s 1 of the 2008 Act.
the USA, a share in South African law grants its holder a proprietary interest in the company only and not a proprietary interest in the assets of the company.\textsuperscript{26}

On the specifics of the nature of a share, section 35(1) of the 2008 Act follows the precedent of the 1973 Act by declaring that “[a] share issued by a company is movable property, transferable in any manner provided for or recognised by this Act or other legislation.”

Our courts have also grappled with the question of how a share can be defined. In \textit{Randfontein Estates Ltd v The Master}\textsuperscript{27} the court held that shares “…are simply rights of action – \textit{jura in personam} – entitling their owner to a certain interest in the company, its assets and its dividends.”\textsuperscript{28} This decision was followed in \textit{Standard Bank of South Africa Ltd and Another v Ocean Commodities Inc and Others}\textsuperscript{29} where Corbett JA declared that:

“…a share in a company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends….Normally the person in whom the share vests is the registered shareholder in the books of the company and has issued to him a share certificate specifying the share, or shares, held by him.”\textsuperscript{30}

In \textit{Cooper v Boyes NO and Another}\textsuperscript{31}, after examining the various cases and authorities on the subject, including the seminal case of \textit{Borland’s Trustee v Steel Brothers & Co Ltd}, which was discussed above, Van Zyl J was forced to conclude that:

“…it is clear that there is no simple definition of a share. The various definitions emphasise a complex of characteristics which are peculiar to it. The gist thereof is that a share represents an interest in a company, which interest consists of a complex of personal rights which may, as an incorporeal movable entity, be negotiated or otherwise disposed of. It is certainly not a consumable article, such as money, even though a money value can be placed on it. Nor can it, by any analogy, be likened to a debt which may give rise to a claim of some kind or another, even though the debt and related claim may eventuate in an award of money being made to the claimant in respect of such debt.”\textsuperscript{32}

\textsuperscript{26} Pretorius, Delport, Havenga and Vermaas \textit{Hahlo’s South African Company Law Through the Cases} (1999) 148.
\textsuperscript{27} 1909 TS 978.
\textsuperscript{28} Ibid 981.
\textsuperscript{29} 1983 1 SA 276 (A).
\textsuperscript{30} Ibid 288.
\textsuperscript{31} 1994 4 SA 521 (C).
\textsuperscript{32} Ibid 535.
In *Tigon Ltd v Bestyet Investments (Pty) Ltd* the court held, amongst other things, that a shareholder's rights were personal, not real, rights; that it was important to draw a distinction between the share itself (which was incorporeal movable property) and the bundle of personal rights to which the share gave rise; and that these personal rights included the right to vote and the right to receive dividends.

Specifically on the subject of the voting rights of shareholders, the case of *Ben-Tovim v Ben-Tovim and Others* declared that “[t]he right to vote is attached to the share itself as an incident of property which may be exercised by the shareholder in his or her own interests.”

Faced with the long history of the courts wrestling with the question of what a share actually is, some commentators have conceded that, in South Africa at least, there is no simple definition, and that the concept of a share encompasses a number of different functions.

It is possible, however, to at least make some deductions from all of this. Firstly, a share in a company is not a corporeal object but represents a complex of incorporeal rights and duties; and secondly, that those rights and duties that accrue to the shareholder can be found in a combination of the constitutional documents of the company and statutes. As a general rule, the most common rights that are afforded to a shareholder include the right to receive dividends when they are declared, the return of capital on the winding-up of the company, and the right to attend and vote at meetings of shareholders.

This dissertation concentrates specifically on the right to exercise a vote in a meeting of shareholders.

### 1.3 Certificated and uncertificated shares

In the latter part of the twentieth century, there was a move from a paper certificate environment to a paperless, or electronic, environment. The reasons for this change, and how it was done, will be discussed in the next chapter. What is important at this juncture is to

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33 2001 4 SA 634 (N) 642-643.
34 2001 3 SA 1074 (C) 1075.
35 Pretorius et al (n 26) 150.
37 *Letseng Diamonds Ltd v JCI Ltd and Others; Trinity Asset Management (Pty) Ltd and Others v Investec Bank Ltd and Others* 2007 5 SA 564 (W) 573.
examine whether the nature of a share changes once it becomes electronic, or uncertificated, as it is commonly called.\textsuperscript{38}

As we have seen, the share is an incorporeal object. It is clear, also, that a share certificate is not an incorporeal object but is fully material. It is therefore apparent that the rights that attach to the share must necessarily be independent of the certificate.\textsuperscript{39} Furthermore, if the rights to the share are independent of the certificate, then it is possible for a share to exist without such a certificate, and for that share to have the same rights and duties as if the certificate existed. This is a principle which must, by logical deduction, be found in the United States, the United Kingdom and in South Africa.

Curiously, the UK Companies Act does not make any direct mention of the equivalency between certificated and uncertificated shares. Perhaps this is due to the primacy of \textit{Borland's Trustee v Steel Brothers & Co Ltd}. Unlike in South Africa, where the matter is not so settled, it appears that the nature of a share as proclaimed in the \textit{Borland}-case is so widely accepted in British law that it is possible that the legislature did not feel it necessary to clarify the position of uncertificated shareholders \textit{vis-a-vis} their certificated peers.

However, it is more likely that the application of the principle is evidenced in legislation, but in an indirect way. In this regard it is instructive to review the way that shareholding is recognised in the UK. As evidenced by sections 113 and 127 of the UK Companies Act, the UK follows a registered security legal system. In terms of this practice, only the person whose name is entered in the share register of the company can fully enjoy the rights which accrue to that share.\textsuperscript{40} Thus section 113 states that a register of members must be kept by each company which contains, amongst others, the names of each person who holds shares in the company and the number of those shares. Section 127 then states that this register of members is \textit{prima facie} evidence of the matters inserted in it. This system of registered securities must be distinguished from the practice of bearer securities, where the holder of the security is awarded all of the rights accruing to the share merely by holding that share.\textsuperscript{41}

\textsuperscript{38} In the discussion which follows it is presumed that the shares are of the same class, and that it is only the form which they take, certificated or uncertificated, that is different.
\textsuperscript{39} Vermaas \textit{Aspekte van die Dematerialisasie van Genoteerde Aandele in die Suid-Afrikaanse Reg} (1995 thesis SA) 22.
\textsuperscript{40} Diathesopoulos “Interests in securities under a comparative law approach” 2010 \textit{PFESR Annual Review} 2010 8.
\textsuperscript{41} Ibid.
The UK Companies Act does not say whether it is possible to record uncertificated shares in the register of members. However, regulation 20(3) of the Uncertificated Securities Regulations, 2001 (hereafter called the “UK Uncertificated Securities Regulations”) allows for an approved operator of an electronic securities transfer system\(^{42}\) to maintain a register of members holding the uncertificated securities of a company.\(^{43}\) Regulation 20(4) then states that for the purposes of any enactment, the uncertificated register of members, together with the register of members maintained by the company, shall together be regarded as the register of members.

It is in this way that the equivalence between certificated and uncertificated shares (of the same class) is established in the UK. If the proprietary rights of shareholders are determined by reference to a register, and both certificated and uncertificated shares form part of that same register, then by necessity the nature of those shares and the rights and duties that accrue to them must be also the same.

Examining the situation that prevails in the USA requires no such feats of reasoning. Section 6.25(a) of the Model Act states bluntly that:

“shares may but need not be represented by certificates. Unless this Act or other statute expressly provides otherwise, the rights and obligations of shareholders are identical whether or not their shares are represented by certificates.”

It is thus immediately clear that the rights of shareholders who hold uncertificated shares will not be prejudiced merely through the fact of those shares being held in an electronic form.

Article 8 of the UCC does not present quite the same level of simple, clear drafting as the Model Act, but the results are the same. In the UCC, both ‘certificated security’ and ‘uncertificated security’ are defined (as securities represented by a certificate or not represented by a certificate, as the case may be\(^{44}\)), but it appears that in every instance where a procedure is prescribed for one, a corresponding, comparable procedure is also prescribed.

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\(^{42}\) See regulation 2 of the UK Uncertificated Securities Regulations.\(^{43}\) See par 4 of schedule 4 of the UK Uncertificated Securities Regulations.\(^{44}\) See s 8.102(4) and s 8.102(18) of the UCC.
for the other. In this way the equivalency between the paper and electronic shares is maintained.

In South Africa, the principle that the shareholder of an uncertificated share should be placed, as far as possible, in the same position as the shareholder of a certificated share was recognised from the inception of the electronic environment. Thus section 91A(1)(c) of the 1973 Act stated that the subregister, which is the register of uncertificated shares maintained by approved participants in the electronic settlement system, formed part of the register of members of a company. It has been held that this structure ensures equivalence in that an entry on the uncertificated subregister is the same evidence of membership as would be the case for an entry of certificated shares on the main register. This is much the same reasoning to establish equivalence as we have seen above in the UK Uncertificated Securities Regulations.

Under the 2008 Act, the legal nature of an uncertificated share has not changed. However, in this respect too there appears to be a shift in influence from the UK-based approach, which relies on inference and interpretation, to an American approach, or perhaps, more accurately, a North American approach. Thus, like the Model Act, the 2008 Act now follows the direct method and states explicitly in section 49(3) that:

“Unless to the extent that this Act expressly provides otherwise-
  a) the rights and obligations of security holders are not different solely on the basis of their respective securities being certificated or uncertificated; and
  b) any provision of this Act applies with respect to any uncertificated securities in the same manner as it applies to certificated securities.”

This kind of directness and simplicity in drafting is to be welcomed as it will assist all stakeholders to correctly assess their rights and obligations. Hopefully, this will result in a corresponding reduction in costs and time that would normally be incurred in trying to interpret such policies through the courts.

46 Ibid 341.
This paper will be considering the circumstances surrounding the voting rights of holders of uncertificated shares only.
CHAPTER 2
FROM PAPER TO ELECTRONIC SHARES

2.1 The ‘Paper Crunch’

The company law of the United Kingdom and the United States both had their origins prior to the seventeenth century. The first attempt at formalised corporate legislation occurred in 1720 with the implementation of the English Bubble Act, and the first true companies legislation can be dated to the early-to-middle part of the nineteenth century. It is not surprising, therefore, to find that the commercial system that was established in that period was based on paper, and that the law was written to cater for a paper environment.

Thus, when shares were bought or sold, it was paper share certificates that were exchanged by brokers. The checks and confirmations that were required to be conducted on the trades were done manually by clerks in the back-offices of the brokerage firms. Messengers were then employed to deliver the physical scrip to the new shareholders, and more manual processing was required to maintain the share registers and brokerage accounts.

In the latter half of the twentieth century, however, commercial activity in the developed economies of the world increased dramatically. This increased activity began to place a strain on the capabilities of the brokerage firms to successfully and efficiently process the number of trades being executed on a daily basis. Being the world’s largest and most economically developed country at the time, it was the United States which first encountered what has become known as the ‘Paper Crunch.’

By April 1968, trading volumes on the New York Stock Exchange had reached as high as 15 million trades a day. The resulting flood of paper into the back-office operations at the brokerage firms led to piles of unprocessed share certificates on the floors. The logistical

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48 Gower (n 9) 1370.
49 6 Geo 1 c 18 1719.
50 In 1811 the state of New York passed the Manufacturing Companies Act, NY Sess. Laws 1811 c 67, while in 1844 and 1855 England passed the Joint Stock Companies Act, 1844 7 & 8 Vict. c 110, and the Limited Liability Act, 1855 18 & 19 Vict. c 133, respectively.
52 Diathesopoulos (n 40) 3.
53 Ibid.
pressure led to many certificates being delivered to the wrong addresses, or possibly even lost. By 1969, the unsettled transactions at some brokerage firms amounted to as much as 200% of the firm’s total assets, and over 100 firms were eventually forced into insolvency or were bought out by their competitors. The crisis also compelled the exchanges to operate on reduced hours, close entirely on Wednesdays, and increase their settlement cycle from two days to five days in an attempt to alleviate the problem.

While the ‘Paper Crunch’ was first encountered in the USA, the continued growth in economic activity around the world meant that it was only a matter of time before a similar problem arose in other countries. For the United Kingdom, the increased trade volumes that accompanied the stock market crash of 1987 proved to be the tipping point. It was estimated at the time that each day of trading at the London Stock Exchange produced about 100 000 individual pieces of paper, while the backlog in unsettled transactions during this period amounted to almost £10 billion.

In South Africa, it took until the late 1990s before the problem arose. A much smaller market than either the USA or the UK, the ‘Paper Crunch’ hit when trading volumes on the Johannesburg Stock Exchange reached an average of 10 000 trades a day. Unsettled trades amounted to between forty and forty-five percent of all transactions concluded, and by 1999 South Africa was being ranked the worst country in the world in terms of settlement and operational risk.

For all these countries, and across the world, once the ‘Paper Crunch’ hit it became immediately apparent that the paper certificate environment was no longer a viable way to trade in shares, and that an alternative needed to be created. The solution was found by converting paper records into electronic records, although the methods adopted by each country to achieve this objective varied.

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54 Diathesopoulos (n 40) 3.
55 Ibid.
56 Ibid.
57 Vermaas (n 39) 177.
58 Ibid 177 and 178.
60 Ibid.
61 Ibid 15. The ranking was conducted by GSCS Information Services Limited, a UK company that advises institutional investors on transaction cost measurement and analysis.
2.2 The structure of electronic markets

2.2.1 Immobilisation and dematerialisation

Principally, there are two different solutions to the problem of converting paper-based transactions to electronic ones, namely immobilisation and dematerialisation.

With immobilisation, the share certificates continue to exist, but they are no longer physically transferred from purchaser to seller. Instead, the shares are converted into a few ‘jumbo’ certificates which represent large blocs of shareholding, and these are then deposited into a central securities depository.\(^{62}\) Transfer of interests in the shares occurs by book-entry in the accounts of the custodians of these ‘jumbo’ certificates.\(^{63}\)

Dematerialisation, on the other hand, involves the complete replacement of paper share certificates with electronic records, so that the share only exists in electronic form.\(^{64}\) Dematerialised shares are also known as uncertificated shares, which is the preferred term in South African law. These electronic records are maintained in a central securities depository and the shares themselves are transferred from one holder to another by means of book-entries in the accounts of the custodians.\(^{65}\)

It is important to note that, regardless of whether shares are immobilised or dematerialised, custody of the shares by market intermediaries is a fundamental part of an electronic share environment.\(^{66}\)

One of the disadvantages of full dematerialisation is the complexity and cost of maintaining the technical infrastructure necessary to enable the system to function effectively.\(^{67}\) Faced with this cost in the early 1970s, when computer processing power was expensive to come by, the United States adopted the immobilisation route. The decision was made easier by the fact that immobilisation did not require any legislative amendments to be made, bearing in mind that any such amendments would need to be adopted by each individual state in order to

\(^{62}\) Vermaas (n 47) 93.
\(^{63}\) Diathesopoulou (n 40) 4.
\(^{65}\) Ibid.
\(^{66}\) Vermaas (n 47) 94.
\(^{67}\) Diathesopoulou (n 40) 4.
be effective. Thus the Depository Trust and Clearing Company (“DTCC”) was established as the central securities depository, and all the shares of almost all the listed companies in the country were registered by way of ‘jumbo’ certificates in the name of its nominee, ‘Cede & Co’.

According to some authors, immobilisation should only be used as a transitional phase in the conversion from a physical certificate environment to a dematerialised one, and this was the intention when it was adopted by the USA. Nearly 40 years later, however, it remains in place, and appears to have become entrenched as the permanent legal and technical framework in that country.

Other countries, which faced the ‘Paper Crunch’ at a later stage than the USA, chose to adopt a fully dematerialised system when the time came for their reform. In the United Kingdom, dematerialisation was first properly introduced in 1995 with the passing of the first Uncertificated Securities Regulations in that year. The current central securities depository is Euroclear UK & Ireland Limited, which operates the electronic settlement system known as CREST. For purposes of the regulations, Euroclear UK & Ireland is an approved operator and, as discussed previously in this paper, it may thus maintain the register of members for uncertificated securities of a company.

In South Africa, a fully dematerialised model was also followed. I shall discuss the South African market structure more fully hereunder.

2.2.2 Direct and indirect holdings

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68 Diathesopoulos (n 40) 5.
69 Ibid.
70 Ibid 6.
71 Ibid 5.
72 Ibid.
73 France, in 1981, was the first country to fully dematerialise its shares. See Diathesopoulos (n 40) 10.
74 An earlier attempt in the 1980s through the TAURUS system was unsuccessful. See Vermaas (n 39) 187.
75 Diathesopoulos (n 40) 16.
76 From the Euroclear UK & Ireland website. Retrieved from https://www.euroclear.com/site/public/ EUI/ut/p/c5/04_SB8K8xLLM9ASSzPy8xBz9CP0os3gz08BgH3MPIwN3X3dTAyM_Y38vAxdnY3dX1_1wkA7eKznNI f5GOIcJgb6fR35uq5Bdmaa6oOfgDVTa5G/dl3/d3/LidQSEvUUt3QS9ZQnZ3LzFrNjVRU0w3SDlwOFZMO DAyVEbQOVTieAwMj (21-11-2012).
77 See regulation 20(3) of the UK Uncertificated Securities Regulations.
Another distinguishing factor among various settlement systems is whether that system operates as a direct holding system or as an indirect holding system.

Under a paper environment, the shareholder holds his certificates himself and can choose where he stores them: in a safe deposit box at a bank; in trust with his attorneys; in his own private safe at home; or even under his bed. This is a prime example of a direct holding system. Under an electronic environment is introduced it is not possible for the shareholder to maintain custody of his own shares, as these now exist only in the electronic systems of the various market players. All shareholders will therefore hold their shares through various intermediaries (such as brokers, banks, participants and central securities depositories), and the definition of a direct or an indirect system is then defined in terms of the shareholder’s direct or indirect relationship to the issuing company.

Under an indirect model, all shares are held through a relatively small number of omnibus accounts operated at various levels by the market players. As an illustration, we can use the example of an investor who opens an account at his broker to hold his shares. The broker, in turn, will open only one omnibus account at the next tier, the participant, to hold all of the shares of all of the broker’s clients. The participant, for its part, will then only open one account at the next tier up, the central securities depository (“CSD”), to hold all of the shares of all of its broker clients. In the electronic share register of the issuer, operated by the CSD (for the purposes of our example), our original investor is not recorded as the holder of the shares. Rather, the nominee company, in whose name the participant’s omnibus account is opened, is regarded as the holder of those shares. Our original investor is now termed the ‘beneficial owner’ or ‘beneficial holder’ of the shares, not the actual owner or holder.

The personal rights on these shares are recorded as book-entries in the various tiers that make up the chain of intermediaries between the investor and the issuing company. Likewise, transfer of the shares (or, more accurately, the interests in those shares) also occurs by book-entry and physical delivery is no longer required.

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78 Vermaas (n 47) 94.
79 Ibid 95.
80 Diathesopoulos (n 40) 22.
81 Ibid.
The advantages of the indirect model include a reduction in the total cost to the investor (due to the low number of accounts that need to be maintained) and increased efficiency in the transfer of shares.\textsuperscript{82} It can be argued that the larger the number of shares transferred at once, the greater the benefits in terms of cost reduction and increased efficiency will be experienced.

When considering these advantages, it is not surprising to find that during the ‘Paper Crunch’ and the adoption of immobilisation in the United States, an indirect model was chosen.\textsuperscript{83} The United Kingdom\textsuperscript{84} initially followed suit and so did South Africa when dematerialisation was first implemented.\textsuperscript{85}

A direct holding model, by contrast, records the name of the end investor at the level of the CSD.\textsuperscript{86} Such a system is regarded as a transparent system in terms of the UNIDROIT reports,\textsuperscript{87} but the terms are not synonymous.\textsuperscript{88} The underlying objective of transparent systems is to ensure that the rights of the end investor are reflected in the account at the highest tier.\textsuperscript{89} A direct holding model is one way to achieve this goal, but the UNIDROIT reports describe other ways that achieve the same purpose. For example, the CSD (at the upper level) could maintain the accounts in the name of the intermediary that occupies the position between the CSD and the investor (usually the participant, but the reports refer to it as the “middle entity”). These accounts will then be divided into sub-accounts for each of the individual investors and the participant will maintain a separate set of client accounts for the investors. Another example exists where the CSD holds an omnibus account in the name of the participant which reflects the combined holdings of all of the clients of that participant. The participant, in turn, maintains separate accounts for its underlying clients. To ensure that the model remains transparent, account information is regularly consolidated between the CSD and the participant to ensure that the CSD always has an up-to-date view on what the investor has in his individual account.

\textsuperscript{82} Diathesopoulos (n 40) 22.
\textsuperscript{83} Ibid 23.
\textsuperscript{84} Ibid.
\textsuperscript{85} Vermaas (n 47) 95.
\textsuperscript{86} Diathesopoulos (n 40) 35.
\textsuperscript{88} Many of the terms and definitions used to describe the different market structures are not standardised amongst the authors, especially with regard to direct and indirect systems versus transparent and non-transparent systems. For the sake of simplicity we have attempted to consolidate these differences into our broad categories.
\textsuperscript{89} UNIDROIT (n 87) 2.
Under the legal framework of the 2008 Act, South Africa now operates a mixed structure which has elements of both direct and indirect holding models. The UK now also operates a mixed system which allows the investor to choose whether his securities are held in a direct or an indirect manner.\(^{90}\)

### 2.2.3 Centralised or fragmented holdings

A further factor to be considered when deciphering the structure of a particular electronic custody and transfer system is whether it is a centralised or a fragmented system.

Under a centralised system, the transfer of shares occurs in the same place as where the legal record of ownership is held,\(^{91}\) namely at the CSD level. By contrast, under a fragmented system the electronic register of the issuer is dispersed among the various participants (in other words, at a lower level than the CSD), while settlement still occurs at the upper level with the central securities depository.\(^{92}\)

Under the initial adoption of a dematerialised environment in 1999, South Africa opted for a fragmented structure where the legal record of ownership was held at participant level by way of subregisters.\(^{93}\) Under the legal framework of the 2008 Act, South Africa now operates a mixed system where the legal record of ownership may be held either at the participant tier or at the upper CSD tier.\(^{94}\) A more detailed analysis of the South African electronic share environment follows below.

#### 2.3 The South African electronic share environment

##### 2.3.1 The creation of Strate

By the time the ‘Paper Crunch’ was felt in South Africa, it had the advantage of hindsight regarding the experiences of other countries. The approach was therefore not to blindly adopt

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\(^{90}\) Ibid 3.

\(^{91}\) Vermaas (n 47) 95.

\(^{92}\) Ibid.

\(^{93}\) Ibid.

\(^{94}\) See s 50(3) of the 2008 Act.
the systems used elsewhere, but to examine local market conditions and legal precedents and create a system that was usable in South Africa for South African market players, while still complying with international standards.\(^95\)

During the late 1990s the JSE Limited, the operator of the Johannesburg Stock Exchange ("JSE"), and an association of the largest banks in South Africa,\(^96\) joined forces to co-operate on the development of an electronic custody and transfer system.\(^97\) From this collaboration the STRATE\(^98\) project was born, which had, as its object, the replacement of the existing manual settlement process for transferring shares listed on the stock exchange.

By September 1998, the legislative amendments to enable electronic settlement had been put in place (as discussed below), and in November of the same year Strate Limited ("Strate") was incorporated. At this stage the project was almost derailed when it became apparent that the risk of ‘tainted scrip’ in the market could impose serious financial liabilities on the banks.\(^99\) Tainted scrip occurs when share certificates are lost by, or stolen from, the legitimate holder and another person uses a forged document to acquire those shares. The shares may then be bought and sold a number of times by other investors acting in good faith. It is also possible that the original holder of the share may not even know that he has been ‘dispossessed’ of his holding until he presents his share certificate for dematerialisation and discovers that his shares are already entered in the electronic securities register in the name of someone else. As the dispossession could have occurred many years previously, and as there could have been dozens of good faith transactions of the shares in the interim, the evidential burden of proving who was, in fact, the legitimate holder would be extremely difficult, if not impossible, to satisfy. In addition, the protection of the good faith purchaser is one of the fundamental principles of an electronic system, as it ensures market integrity and the sacrosanctity of the electronic register (thus avoiding precisely these kinds of issues, which are prevalent in the paper environment).\(^100\) It would therefore not be possible to substitute the current holder with the dispossessed holder in the electronic securities register.

\(^{95}\) Vermaas (n 45) 337.
\(^{97}\) Strate Equities Handbook (n 59) 15.
\(^{98}\) STRATE was an acronym for “Share TRansactions Totally Electronic”. In 2003, with the merger of Strate, Universal Exchange Corporation Limited and Central Depository Limited (which were responsible for the electronic clearing and settlement of bonds) the acronym was officially dropped and it is no longer in use.
\(^{99}\) Strate Equities Handbook (n 59) 17.
\(^{100}\) Vermaas (n 47) 113.
The amount of tainted scrip in the market was valued at the time to be in the region of R130 million. The only perceived solution was to set up a trust to handle the compensation claims of those who had been dispossessed and, as such, the Dispossessed Members’ Fund Trust was established. The fund purchased insurance to the value of R2 billion and braced itself for the inevitable deluge of claims which, ultimately, never happened. By the time the fund was deregistered in 2010, the number of claims it had received totalled less than R1 million.

With this obstacle out of the way the project could proceed once more, and the first dematerialisation and settlement of electronic shares in South Africa occurred in November 1999 (the issuing company was Harmony Gold Limited). Over the course of the next few years, there was a measured process to dematerialise the shares of all the remaining companies listed on the JSE, and by January 2002 all shares listed on the exchange had been converted into uncertificated form in Strate.

2.3.2 The legal framework

2.3.2.1 The Companies Act, 1973

The changes that were proposed represented a fundamental change in both the structure of South African share markets and our principles of company law. In many instances, the existing legislation was an obstacle to the implementation of the new order. For instance, the 1973 Act required physical delivery of share certificates and transfer forms as a formality for the transfer of shares. The 1973 Act also stipulated that a company is not required to recognise a shareholder and grant him the benefits of membership until that shareholder is entered as a member in the company’s register of members. Thus, while cession of the rights that constitute a share would have been sufficient to transfer the rights between seller and purchaser, the company was not bound to recognise such a transaction if the formalities

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101 Strate Equities Handbook (n 59) 17.
102 Ibid.
103 Ibid 18.
104 Ibid 19.
105 Vermaas (n 45) 338.
106 Ibid 339.
prescribed by the Act were not complied with. From this it can be concluded that a company was also not bound to recognise any nominee arrangements or the rights of beneficial holders.

The legal framework necessary to operate an electronic share environment therefore had to be created in order to permit the system to operate as intended. The required amendments to the 1973 Act were introduced through the Companies Second Amendment Act, 1998, which inserted, among others, a new section 91A that dealt specifically with uncertificated securities.

Section 91A did not require that shares be issued in uncertificated form - the underlying premise was always that a company or an investor could choose to hold either certificated or uncertificated shares - but once a share was held in uncertificated form then section 91A would be applicable.

Section 91A(1) provided definitions of the most important entities in the electronic environment - ‘central securities depository’ and ‘participant’ - both of which we have discussed previously. Importantly, it also created and defined the concept of the ‘subregister’, which is an electronic register of uncertificated securities, maintained by the participant, and which now formed part of the main register of members maintained by the company. Thus an entry in the electronic subregister which shows that a person holds uncertificated shares in a company has the same evidence of membership as that person would have had if the entry had been made in the main register in respect of certificated shares.

Section 91A(4) introduced the capability to transfer these uncertificated shares by simply debiting and crediting the relevant subregister accounts of the seller and buyer. Thus ownership is transferred by book-entries effected by the participant in the subregisters, and with no other formalities being required. Since it is of fundamental importance that a

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107 Ibid 339.
108 Ibid.
109 The definition of securities in s 91A of the 1973 Act was wide and included shares, warrants, options and debentures (see Strate Equities Handbook (n 59) 42). As stated previously, the focus in this paper is on shares only.
110 Vermaas (n 45) 339.
111 Ibid 341.
112 Ibid.
modern share-trading environment offers certainty to buyers and sellers, section 91A(4)(c)
sought to provide a good faith purchaser with final and irrevocable title to the shares even if
the transaction was tainted by fraud or illegality.\(^{113}\) Naturally, this protection did not apply if
the purchaser was himself a party to the fraud or illegality, or knew about it.\(^{114}\)

2.3.2.2 The Securities Services Act, 2004

The legal framework for uncertificated shares rests on a number of pillars. With the
fundamental principles of company law being changed in the 1973 Act to accommodate
electronic shares, the second pillar, the regulation of the main players in the uncertificated
securities market, was addressed in the Securities Services Act. This act sought to consolidate
the fragmented regulatory environment that was prevalent at the time in the securities market.
For instance, the Custody and Administration of Securities Act, 1992, the Stock Exchanges
Control Act, 1985, the Financial Markets Control Act, 1989 and the Insider Trading Act,
1998 all regulated small parts of the financial markets. The Securities Services Act replaced
all of these acts and consolidated their provisions into one source, as well as updating their
content to make the South African markets more competitive internationally.\(^{115}\)

The overall regulation of the financial securities market is conducted by the Registrar of
Securities Services, which, for the purposes of the Securities Services Act is the Executive
Officer of the Financial Services Board.\(^{116}\) The Financial Services Board is a state organ
established in terms of the Financial Services Board Act, 1990 in order to “supervise and
enforce compliance with the laws regulating financial institutions and the provision of
financial services”.\(^{117}\) However, the Securities Services Act goes further and establishes a co-
regulatory regime in terms of which the entities that are licensed to operate as the central
securities depository or the exchange are also recognised as ‘self-regulatory organisations’ or
SROs.\(^{118}\) While the Financial Services Board directly regulates the SROs, it also delegates
some of its regulatory functions to them. This is presumably to allow for a more effective
regulatory regime, as it is difficult for an outside entity to keep abreast of developments in the
highly fluid and complex world of financial securities. Thus the SROs are tasked with the

\(^{113}\) Vermaas (n 45) 343.
\(^{114}\) See s 91A(4)(c) of the 1973 Act.
\(^{115}\) See s 2(d) of the Securities Services Act.
\(^{116}\) See s 5(1) and (2) of the Securities Services Act.
\(^{117}\) See s 3(a) of the Financial Services Board Act.
\(^{118}\) See s 1 of the Securities Services Act and the definition of a ‘self-regulatory organisation’.
duty of regulating their segments of the market, in other words the behaviour of participants (for the CSD), authorised users (for the exchange), issuers and clients.\(^{119}\) In order to achieve this end, the SROs are obliged to make and enforce rules that govern their respective market segments.\(^{120}\) They may also issues directives to regulate the functions that are performed by the market players when interacting with the systems of the SROs.\(^{121}\)

An examination of these three levels of regulation reveals that, in practical terms, the Securities Services Act establishes the framework for the regulation of the market, the CSD and Exchange Rules, as secondary legislation, provide the principles under which the market segments will operate, while the Directives provide the detail for the day-to-day functionality of the systems.

2.3.2.3 The Companies Act, 2008

As we have seen, the 1973 Act introduced a shareholding model based on the concept of a subregister operated and maintained by participants. While in theory the rights of the shareholder entered as such in the subregister are equivalent to the rights of the holder of certificated shares, in practice the use of a subregister model results in the majority of accounts being opened in the name of a nominee of the participant, and not in the name of the shareholder himself. The rights of the end investor can therefore only be exercised through a nominee, and not directly. The system is thus a non-transparent, indirect holding model.

The UNIDROIT Convention identified a number of legal risks and issues that arise from non-transparent systems.\(^{122}\) Since the shares are registered in the name of the nominee (or intermediary, to use the generic term preferred by the drafters of the convention), the nominee enjoys all of the rights that attach to that share. Specific sections of the Securities Services Act and the rules issued by Strate as a central securities depository (“Strate Rules”) require the intermediary to pass those rights down to the underlying investor,\(^ {123}\) but additional problems arise when there is more than one intermediary in the holding chain. In such cases,

\(^{119}\) See s 18(4) and s 39(4) of the Securities Services Act.
\(^{120}\) See s 11 and s 33 of the Securities Services Act.
\(^{121}\) See s 11(c) and s 33(d) of the Securities Services Act.
\(^{122}\) See articles 19, 20, 22, 24, 25 and 26 of the UNIDROIT Convention.
\(^{123}\) See s 39(2)(f) of the Securities Services Act and rules 5.6 and 5.7 of the Strate Rules.
each intermediary is only aware of the details of its immediate clients, and has no knowledge of those further down the holding chain, including who the ultimate investor is.\textsuperscript{124}

In the event of the insolvency of one of the participants, the ability of the end investor to prove his ownership of the shares held at the participant would be compromised by the lack of any direct records of such ownership at the participant level.\textsuperscript{125} And since the shares are not registered in the name of the investor, an insolvency at any of the intermediaries in the chain may result in those shares being ‘quarantined’ from further trade until the insolvency administrator is able to unwind the complex web of holdings and correctly allocate them to the right investors. This may have financial consequences for the investor.

It has been argued that many of these problems can be resolved through the use of a transparent holding model, where the owner of the shares is recorded in a central register operated by the CSD.\textsuperscript{126} In such a system, the identity of the investor and his holdings are held at the highest tier, and any insolvency of a lower intermediary will have no effect on the ability of the investor to prove his ownership, and only a minimal effect on the ability of the investor to continue trading (all that would be required is the transfer of the maintenance of the portfolio from the insolvent intermediary to another intermediary).\textsuperscript{127}

To address these concerns, the 2008 Act moved away from the restrictive approach of the 1973 Act.\textsuperscript{128} Instead of prescribing the custody model that had to be applied by the market, the 2008 Act adopted an enabling approach which allowed both transparent and non-transparent systems. Thus section 50(3) now reads that:

“\textit{If a company has issued uncertificated securities, or has issued securities that have ceased to be certificated, as contemplated in section 49 (5), a record must be administered and maintained by a participant or central securities depository in the prescribed form, as the company's uncertificated securities register….”} [own emphasis]

Equally, section 53(1)(a) states that the transfer of uncertificated securities in an uncertificated securities register may be effected only “by a participant or central securities

\begin{footnotesize}
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\item[\textsuperscript{124}] Vermaas (n 47) 99.
\item[\textsuperscript{125}] Ibid 100.
\item[\textsuperscript{126}] Ibid.
\item[\textsuperscript{127}] Ibid.
\item[\textsuperscript{128}] Ibid.
\end{itemize}
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depository”. The 2008 Act thus creates a flexible framework which will allow the securities market to choose the model most appropriate to it.\(^{129}\) This will allow it to adapt to changing circumstances and remain competitive in a global environment. As such, this change should be welcomed.

2.3.3 The current structure in South Africa

An analysis of the history, theoretical models and legal frameworks of the electronic share environment in South Africa allows us to understand the current structure, entities and functions of the various players in the market today.

The main role player in the electronic custody and settlement environment is the central securities depository.\(^{130}\) Its functions include overseeing, managing and controlling the dematerialisation process as well as the electronic custody and settlement system and the processes that surround that.\(^{131}\) In terms of the Securities Services Act, the CSD is also a self-regulatory organisation.\(^{132}\) This means that the CSD, although not a government agency, is tasked with regulating the conduct of other market players.\(^{133}\) Strate is the licensed CSD in South Africa and is thus tasked with these functions.\(^{134}\) As the CSD, Strate holds the electronic records for all uncertificated securities.\(^{135}\) This includes both companies that are listed on the exchange as well as unlisted companies who have opted voluntarily to have their shares dematerialised into Strate.\(^{136}\)

At the next tier down are the central securities depository participants (or CSDPs). Entities that wish to become CSDPs must apply to Strate for authorisation to do so, and only those applicants that meet the entry criteria receive such authorisation.\(^{137}\) The current authorised CSDPs in the equities environment are banks (ABSA Bank Limited, FirstRand Bank Limited,
Nedbank Limited, The Standard Bank of South Africa Limited, Standard Chartered Bank – Johannesburg Branch, Citibank N.A – South Africa Branch, and Societe Generale – Johannesburg Branch) or companies involved in the transfer secretarial business (Computershare Limited and Link Investor Services Limited).\(^{138}\) The CSDPs open and maintain electronic accounts for their clients, which can be brokers or investors. Investors have the choice of having a direct relationship with their chosen participant, or appointing a broker, who will then interact with the participant on behalf of the investor.\(^{139}\) Only participants may communicate directly with Strate.\(^{140}\)

The certificated and uncertificated systems continue to run in parallel and it is left up to the investor to choose which he prefers.\(^ {141}\) It has always been the intention of the legislature that the conversion into uncertificated shares is a voluntary procedure and that an investor is entitled to reconvert his shares back into certificated form if he so wishes.\(^ {142}\) However, in order to ensure that the objectives of dematerialisation are met, primarily to overcome the ‘Paper Crunch’, the JSE Equities Rules and listings requirements make it mandatory that all transactions on the exchange must be settled electronically through Strate.\(^ {143}\) Thus an investor may hold his share in a listed company as a certificate, but if he wishes to sell it he will first be required to dematerialise it into Strate.

If a company has uncertificated shares that are in issue, the record of those shares must be maintained and administered by either a participant or by Strate. This record forms the company’s uncertificated securities register.\(^ {144}\) While the non-transparent subregister model is still the most prevalent way in which accounts are held, there has been a small move in the direction of a transparent system of the type now enabled by the 2008 Act. In 2012 Strate introduced the segregated depository account,\(^ {145}\) which is an account that can be opened by an investor directly in the records of the CSD and which is clearly segregated and


\(^{139}\) Cassim et al (n 1) 254.

\(^{140}\) Ibid.

\(^{141}\) Ibid.

\(^{142}\) See s 91A(7) of the 1973 Act and s 54(1) of the 2008 Act.

\(^{143}\) See JSE Equities Rules 10.30 and JSE Listings Requirements (Service Issue 14) s 3.51(b).

\(^{144}\) See s 1 of the 2008 Act.

distinguished from any account held by a participant.\textsuperscript{146} Although a participant is responsible for the administration of the account on behalf of the investor, the assets of that investor are not co-mingled with the assets of the participant.\textsuperscript{147} Furthermore, in order to aid in the portability of the investor’s assets in the event of the insolvency of the participant, the Strate Rules provide a mechanism whereby the investor can pre-appoint a ‘secondary participant’.\textsuperscript{148} If the primary participant becomes insolvent, the investor can immediately transfer his portfolio to the appointed secondary participant and continue trading with minimal disruption.\textsuperscript{149} As the shares in the account are all registered in the name of the investor at the highest tier, the transfer of administration of the account from one participant to another does not constitute a transfer of ownership.\textsuperscript{150} Thus it can be argued that the uncertificated custody model in South Africa now has elements of both a transparent and a non-transparent system.

Transfer of shares occurs by debit and credit entries in the accounts held by either the participant or Strate, whichever is applicable, and depending on whether the investor is holding the account at subregister level or at segregated depository account level.\textsuperscript{151}

The success of the dematerialised share environment now in place in South Africa can perhaps best be illustrated by comparing the settlement numbers that occurred pre-dematerialisation and post-dematerialisation. As we have seen, the securities market ground to a standstill in the paper environment when trades reached approximately 10 000 a day. By contrast, electronic share trades on the exchange in 2011 numbered 26,5 million, or an average of 106 000 per working day.\textsuperscript{152} Strate reports that its technology availability during the year was at 99.9\%,\textsuperscript{153} which suggests that at no stage was the settlement system under any stress to process those transactions. The total value of uncertificated shares held in Strate now exceeds R4.8 trillion.\textsuperscript{154}

\textsuperscript{146} See rule 1 of the Strate Rules.
\textsuperscript{147} See rule 6.3.5 of the Strate Rules.
\textsuperscript{148} See rule 6.13.4 of the Strate Rules.
\textsuperscript{149} See rule 6.13.7.1 of the Strate Rules.
\textsuperscript{150} See rule 6.13.7.2 of the Strate Rules.
\textsuperscript{151} See rules 6.11.3 and 6.13.8.1 of the Strate Rules.
\textsuperscript{153} Ibid 5.
\textsuperscript{154} Ibid 8.
CHAPTER 3
SHAREHOLDER VOTING

3.1 The importance of shareholder voting

Corporate governance deals with the structures and processes surrounding the management, decision-making and control of organisations.\(^{155}\) Good corporate governance is founded on principles of effective leadership, which in turn is underpinned by the ethical values of responsibility, accountability, fairness and transparency.\(^{156}\) Adopting the practice of good governance can enhance a company’s ability to implement sustainable growth. It can assist in identifying and mitigating potential liabilities, and it can also boost the reputation of the company in the eyes of the public.\(^{157}\) By contrast, a company which does not practice sound corporate governance could find its reputation harmed, with knock-on effects on its share price and its sustainability.\(^{158}\) It has been observed that practising good corporate governance is not only critical for the well-being of a company, but that an overall culture of good corporate governance in a country can attract foreign investment and thus benefit the economy as a whole.\(^{159}\)

The high number of corporate scandals and failures in recent years, both in South Africa and internationally, has highlighted the deficit of good governance in corporate culture. This has prompted a broad movement to develop better governance principles and practices.\(^{160}\)

While the responsibility for good corporate governance rests on the board of directors of a company,\(^{161}\) shareholders play an important part in the process. Ultimately, shareholders have three fundamental powers they can use to influence the management of a company:

a) they can exercise their voting rights to elect directors and approve or disapprove major corporate decisions;

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\(^{155}\) Cassim et al (n 1) 472.
\(^{156}\) King Report on Governance for South Africa 2009 (“King III Report”), chapter 1, principle 1.1, par 1.
\(^{157}\) Cassim et al (n 1) 473.
\(^{158}\) Ibid.
\(^{159}\) Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd and Others 2006 5 SA 333 (W) 351.
\(^{160}\) Cassim et al (n 1) 473.
\(^{161}\) King III Report (n 156), chapter 1, principle 1.1, par 7.
b) they can sell their shares and potentially negatively affect the company’s share price; and
c) they can sue the directors in court if there has been a breach of fiduciary duties towards the company.\(^{162}\)

Of these three powers, it is the right to vote that allows the shareholder to most effectively govern the behaviour of a company and protect his interests, since by selling shares the shareholder leaves the company, and by suing management the shareholder passes control to the courts.\(^{163}\) It is only by exercising his right to vote that the shareholder influences the behaviour of the company and remains engaged with it.

Consequently, one of the cornerstones of good corporate governance is that shareholders should play an active part in the process. Policy-makers themselves are increasingly coming to regard such participation as important.\(^{164}\) Ideally, shareholders must not be mere speculators in the shares of the company, but should be genuine owners concerned with the health and sustainability of the company.\(^{165}\) Unfortunately, one of the consequences that arises out of the fact that the right to vote is a right of property, is that the shareholder may choose not to exercise that vote at all.\(^{166}\) In the same way that shareholder activism can be said to improve corporate governance, shareholder passivity can undermine good governance.

Shareholder passivity can manifest for a number of reasons, one of which may be a perception among shareholders that their vote will not result in any noticeable change in the company.\(^{167}\) It has been argued that this phenomenon can be attributed to the separation of ownership and control, which was first identified by Berle and Means in the 1930s.\(^{168}\) In many private companies the shareholders and directors are the same persons, and thus ownership and control are unified. However, in most public companies the management of the company is in the hands of the board while the ownership of the shares lies with the shareholders. Ownership and control are thus split. The separation of ownership and control


\(^{163}\) Ibid.


\(^{166}\) Cassim et al (n 1) 497.

\(^{167}\) Rademeyer and Holtzhausen (n 165) 769.

\(^{168}\) Bratton “Berle and Means reconsidered at the century’s turn” 2000-1 Journal of Corporation Law 737.
can result in a conflict between the interests of the shareholders and the interests of the directors. This conflict can then be further compounded by the broad spread of shareholding that is common in large public companies. When no single shareholder or group of shareholders is able to exercise control over the directors then it is common to find shareholder passivity or indifference. Equally, if there is no-one to effectively control the directors, good corporate governance can be undermined.

Another reason that has been advanced as to why a shareholder may be apathetic is that the shareholder may lack knowledge of his legal rights, or may simply have a lack of knowledge about the company. Sometimes it is difficult for shareholders to gain access to information that would alert them to any breaches of good corporate governance policies by the directors. Furthermore, if a shareholder disagrees with the conduct of the directors, or with a particular course of action chosen by the company, the effort of being an active shareholder and opposing such conduct is more often than not out-weighed by the ease of just selling the share. A further issue that may discourage shareholder activism may be the costs involved in attending meetings, especially in the case of multinational companies where the meetings could be held in a different country to that in which the shareholder lives.

With all of these incentives not to be active, it is therefore essential that, as far as possible, the systems that regulate shareholder voting should encourage participation rather than hinder it.

3.2 The problem with intermediation

As we have seen, the indirect holding model relies on a number of intermediaries that hold the uncertificated shares on behalf of the investor. The registered owner of the shares (being the entity registered in the share register of the issuing company) will be the intermediary, and not the investor (who is now referred to as the beneficial owner of the share). Since the rights and duties that attach to a share arise from the relationship between the shareholder and the company, as governed by its constitutional documents, it follows that a person who is not

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169 Cassim et al (n 1) 498.
170 Ibid.
171 Ibid.
172 Rademeyer and Holtzhausen (n 165) 769.
173 Ibid.
174 Ibid 770.
recognised as a shareholder will not be entitled to the rights of a shareholder. Therefore the beneficial owner will not have the right to vote in the governance of the company.  

This situation causes a division between the political and economic rights that attach to the shares. Due to the contractual relationship between the underlying investor and his intermediary, the investor retains all of the economic benefits that shareholding brings. However, the political rights vest in the intermediary. The result is that the intermediary has all of the voting powers required to influence the company, but no economic incentive to exercise those powers for the good of the company - all of the economic benefits will accrue to the underlying investor. Equally, the underlying investor has all the economic incentive to exercise his power and ensure that the company is governed well, but no political rights with which to do so.

Clearly, this is a situation which would need to be resolved in every country that valued corporate governance and that recognised the value of shareholder activism in such governance.

3.3 The specific experiences of the United States, United Kingdom and South Africa

3.3.1 The United States of America

In the USA, the Model Act provides for all companies to issue registered shares, as opposed to bearer shares. It appears that this provision has been adopted unanimously in all of the states that make up that country. The same principle is to be found in section 8-207 of the UCC, which states that an issuer “may treat the registered owner as the person exclusively entitled to vote, receive notifications, and otherwise exercise all the rights and powers of an owner.” Accordingly, USA law defines the shareholder as the person who is registered as

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177 An example of such a contract is the client mandate prescribed by rule 5.6 of the Strate Rules.
178 Nolan (n 176) 570.
179 Ibid.
180 See the definition of ‘shareholder’ in s 1-40 of the Model Act.
181 Donald (n 162) 1.
such in the records of the company, and not the person who has title to that share (who is instead called the “entitlement holder”).  

As we have noted previously, when the USA adopted an uncertificated model to address the short-comings of the paper-based environment, it chose to immobilise shares (rather than go for full dematerialisation) in an indirect, non-transparent holding structure. In practice, this led to almost all shares being registered in the name of only one nominee, namely Cede & Co., which is the nominee of the central securities depository DTCC. It is entirely possible that a large company listed on the New York Stock Exchange may have Cede & Co. as its one and only registered shareholder.

The benefits in efficiency that this approach brought are beyond question. However this efficiency came at the cost of the relationship between the company and its shareholders. Once a corporation’s shares are immobilised and registered in the name of Cede & Co., it no longer has a list of its ‘true’ shareholders. It is precisely this list, though, that is required to enable proper communication between the company and its investors. Moreover, since USA law provides that only the registered shareholder is considered a shareholder, those who invest in them through Cede & Co. no longer have any legal legitimacy as shareholders. Instead, they are granted a ‘security entitlement’ which is defined as the rights and property interest of an entitlement holder with respect to a financial asset which is held through an intermediary. The nature of a security entitlement appears to be a complex of rights that includes a property interest consisting of a pro-rata claim to the fungible pool of shares held by the intermediary. It also includes a number of rights against the intermediary which oblige the intermediary to pass the legal and economic rights of ownership of the share to the entitlement holder.

This structure has come under criticism from a number of authors due to the disenfranchising effect it has on the entitlement holders (or beneficial owners as they are more commonly

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182 Ibid. Also see s 8-102(a)(7) of the UCC.
183 Donald (n 162) 16.
184 Ibid 3.
185 Ibid 16.
186 Ibid 3.
187 See s 8-102(a)(17) of the UCC.
188 Rogers (n 51) 692.
189 Ibid.
known). Donald calls this system a ‘heart of darkness’ and maintains that its institution effectively and legally separated investors from the companies in which they invested, that it undermined the transparency of ownership which was previously inherent in registered shares, and that ultimately corporate governance was hurt. Donald calls this system a ‘heart of darkness’ and maintains that its institution effectively and legally separated investors from the companies in which they invested, that it undermined the transparency of ownership which was previously inherent in registered shares, and that ultimately corporate governance was hurt. An up-to-date list of beneficial owners is essential for corporate governance as it enables the company to notify shareholders of annual general meetings, it determines who may vote at those meetings, and it allows shareholders to contact each other to organise and exercise their rights more effectively.

In order to overcome these problems, the Securities and Exchange Commission (‘SEC’), which oversees and regulates the securities markets in the United States, published rules on shareholder communication. These were aimed at re-enfranchising beneficial owners by adapting a recognised mechanism, namely proxy voting, to the new uncertificated market. In essence, proxy voting gives the registered shareholder the right to appoint another person, the proxy, to attend a general meeting and vote on his behalf. It is thus an authorisation to exercise voting rights given by a shareholder to another person. When applied to intermediated shares, the intermediary who is the registered shareholder appoints the beneficial owner as a proxy. The beneficial owner is then entitled to cast the number of votes equivalent to the number of shares to which he has a security entitlement, which will be only a portion of the total number of shares actually held by the intermediary.

In practice, proxy voting in the USA involves an extremely complex mechanism which is open to abuse and errors. At the heart of the problem is the fact that the procedures do not allow for any direct relationship between the company and its beneficial owners. The issuer is therefore forced to obtain all the shareholder information from the various intermediaries. As this information is only provided to the issuer by specific inquiry, and not as a matter of course, this has knock-on implications on the time available to collect the proxy votes of the beneficial owners and accurately count them. The Model Act allows a maximum of 60 days notification of a shareholder meeting, and it has been suggested that this is not a sufficient

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190 Donald (n 162) 3.
191 Ibid 16.
193 Cassim et al (n 1) 365.
194 Donald (n 162) 20.
195 See s 7-05(a) of the Model Act.
time period to effectively process all of the enquiries, distributions and voting instructions accurately.\textsuperscript{196}

A summary of the procedure as documented by Donald illustrates this point:\textsuperscript{197}

Step 1: The issuer must contact DTCC to obtain a list of the participant firms that hold its shares.

Step 2: DTCC furnishes the list to the issuer.

Step 3: The issuer contacts the participant firms and requests the number of proxy materials (usually a proxy statement, the annual report of the issuer, and a voting instruction form that must be completed by the beneficial owner) it must provide to each of them based on the number of beneficial owners they represent.

Step 4: The participant firms provide the number of proxy materials they require to the issuer.

Step 5: If the participant has indicated that it is also acting on behalf of a respondent bank, it must provide those details to the issuer and the issuer must also contact the respondent bank for the number of proxy materials that it requires.

Step 6: The participant receives the proxy materials and distributes them to the beneficial owners that it directly represents, or to the brokers of those beneficial owners that it does not directly represent.

Step 7: The brokers distribute the proxy materials to the beneficial owners that they represent.

Step 8: The beneficial owner must consider the proposal, complete the voting instruction form and send the documents back to the broker or participant, as the case may be.

Step 9: The participant or broker must gather all the voting instructions they receive and forward them on to the issuer for counting.

Gathering the names of beneficial owners is further complicated by the fact that investors can choose to be classified as either a “non-objecting beneficial owner” (NOBO) or an “objecting

\textsuperscript{196} Donald (n 162) 21.

\textsuperscript{197} Ibid 23.
beneficial owner” (OBO). When a beneficial owner chooses OBO status, he objects to his name and address being disclosed to the issuer. Some 75% of all beneficial owners choose OBO status, and their holdings amount to between 52% to 60% of all publicly listed shares. This places a significant hurdle on the ability of the issuer to determine who its beneficial owners are and how to communicate with them.

As a result of the complexity of the system, proxy service firms that manage the process from start to finish dominate the market, bringing with them extra fees which are ultimately borne by investors.

As the number of intermediaries increases, the time available for each intermediary to complete its statutory duties decreases, with the result that errors become prevalent. Kahan and Rock have identified a number of ‘pathologies’ that are inherent in the system. The first group of pathologies are those of complexity, which results in materials not arriving, votes that are not counted, and an inability to verify the votes that have been cast. The second group of pathologies relate to who actually owns the shares. This is most evident in the field of securities lending, where the lender, who may regard himself as the beneficial owner, will not be able to vote due to the structure of the lending arrangement. It can also be found where there is over-voting due to short-selling, which can arise due to double-counting the shares that have been loaned to cover the short position. The third group of pathologies are as a result of a misalignment between voting rights and economic rights. This occurs when those with voting rights do not have an economic interest in the results, or those with an economic interest do not have any voting rights. As a result of this misalignment, votes may not be cast at all due to apathy (which we have already discussed briefly above under shareholder passivity), or even more seriously, voting may be used as a device to deliberately harm the company.

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199 Ibid.
201 Donald (n 162) 23.
203 Kahan and Rock (n 200) 1249-1255.
204 Securities lending and borrowing arrangements are often structured as purchase and sale agreements, with an underlying obligation on the purchaser to sell back equivalent (but not necessarily the same) securities in the future. See Kahan and Rock (n 200) 1256.
205 Ibid 1258.
206 Ibid 1263-1267.
A significant contributor to some of these pathologies is when the ‘record date’ is determined.\textsuperscript{207} Put simply, the record date is the date when registered owners are identified and their voting entitlements set.\textsuperscript{208} The Model Act states that the record date should not be more than 70 days before the meeting.\textsuperscript{209} In practice, the record date is usually between 30 and 60 days before the general meeting is held, depending on state law.\textsuperscript{210} The long period that elapses between the identification of those entitled to vote and the actual meeting creates the risk that the holders will have sold or lent their shares in the interim. In the first instance, the person who has sold the shares will still be identified as the one entitled to vote, even though he is no longer the owner and has no further interest in the governance of the company. In the second instance, due to the nature of the transaction, the lender does not retain the right to vote and the borrower is not able to place the lender in an equivalent position since a vote can only be cast once.\textsuperscript{211}

It is obvious that there are substantial problems with the way the proxy-voting system is structured in the United States. The SEC itself acknowledges the difficulties and concedes that concerns have been raised “regarding the accuracy, reliability, transparency, accountability, and integrity of this system….\textsuperscript{212} It remains to be seem what reforms will be introduced and whether these will substantially correct the flaws that have been highlighted.

It should be noted that the Model Act has attempted to address the problem of the relationship between the issuer and the beneficial owner (or rather, the lack of it). Thus section 7-23(a) allows a company to “establish a procedure by which the beneficial owner of shares that are registered in the name of a nominee is recognized by the corporation as the shareholder.” The company may also determine the types of nominees to which it applies, the rights or privileges that the beneficial owner may enjoy in terms of the procedure, and the information that is pertinent to the procedure, among others.\textsuperscript{213} This provision, however, is entirely discretionary, and requires positive action by both the company and the shareholder to make

\begin{footnotesize}
\begin{enumerate}
\item Gullifer and Payne (n 175) 203.
\item Ibid.
\item See s 7-07(b) of the Model Act.
\item Gullifer and Payne (n 175) 203.
\item Ibid.
\item Securities and Exchange Commission (n 198) 9.
\item See s 7-23(b)(1),(2) and (4) of the Model Act.
\end{enumerate}
\end{footnotesize}
it effective. As such, it does not provide the solution that appears to be so desperately called for in the USA.

3.3.2 The United Kingdom

In the UK, the legal presumption is that all of the rights attaching to shares are held and exercised by the registered holder. Such holders are regarded as registered members of the company. Section 126 of the UK Companies Act states that “no notice of any trust, expressed, implied, or constructive, shall be entered on the register of members…or be receivable by the registrar.” This section means that a company is not obliged to recognise any relationship of trust that has been established in relation to the holding of its shares. In other words, the company is only bound to recognise the registered legal owner of the shares, and not any beneficial owners.

It has been argued that section 126 performs a valuable function in modern UK company law. For instance, it preserves security of title and transfer in that one can immediately determine the identity of the legal owner of the shares merely by inspecting the register. Security of title and transfer is essential for the sustainability of the company. If there was uncertainty in this area, it could result in claims for a breach of duty towards trusts and beneficiaries and liabilities to the company which could threaten its financial health. As we have noted before, certainty of title and transfer is also essential for the efficient operation of modern stock exchanges. However, the widespread use of intermediated shares in the UK has resulted in unintended consequences that were not foreseen when the underlying principle was established in the nineteenth century, namely that beneficial owners in an uncertificated environment would be disenfranchised. The problems faced by the regulators in the UK are therefore much the same as those faced by regulators in the USA.

It appears that the difficulty in enfranchising indirect investors is to allow them to exercise some of the rights attached to the shares, but to leave others in the hands of the intermediary

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214 American Bar Association (n 17) 7-40.
215 Gullifer and Payne (n 175) 195.
216 Nolan (n 176) 571.
217 Gullifer and Payne (n 175) 196.
218 Ibid.
that is the registered holder.\textsuperscript{219} Thus any attempt to give beneficial owners the right to vote must not jeopardise the obvious benefits of the system, such as the security of title and transfer.\textsuperscript{220} Payne argues that there is no theoretical difficulty in doing just that: the registered member can delegate its voting power to the beneficial owner while retaining the property rights attached to the share, including the right to title and transfer.\textsuperscript{221} In practice, this can be achieved in a number of ways. One solution that was suggested was to amend section 126 so that companies would be able to recognise the voting rights of the underlying beneficial owner, but would remain blind to the existence of the beneficial owner when considering other rights.\textsuperscript{222} Another method would be to recognise the voting rights of the beneficial owner in the articles of the company itself.\textsuperscript{223} It would then be incumbent on the company to correctly identify the beneficial owners of its shares and provide appropriate mechanisms for enabling and giving effect to their votes.\textsuperscript{224} Both of these methods focus on the relationship between the company and the underlying investor.

This is not, however, the approach that was finally adopted in the UK Companies Act. Instead of focusing on the relationship between the company and the underlying investor, it chose to focus on the relationship between the underlying investor and the intermediary. Two mechanisms were created: the first relied on the intermediary acting on behalf of the beneficial owner and putting into effect voting instructions received from him, and the second relied on the intermediary delegating the right to vote to the beneficial owner by appointing him as a proxy.\textsuperscript{225} This appears to be similar to the system adopted in the USA which has had such unfavourable consequences. We shall therefore examine these two approaches more closely.

The first approach - where an intermediary carries out voting instructions received from the underlying investor - is enabled by section 152 of the UK Companies Act. This states that where a registered shareholder (the intermediary) holds shares on behalf of more than one

\textsuperscript{219} Ibid 195-196.
\textsuperscript{220} Company Law Review Steering Group “Modern Company Law for a Competitive Economy – Final Report Volume 1” (URN 01/942 and 01/943) 2001 151.
\textsuperscript{221} Gullifer and Payne (n 175) 196.
\textsuperscript{222} For instance the Company Law Review Steering Group suggested that companies should be allowed to recognise the rights of the underlying beneficiary, but subject to the exclusive right of the registered holder to make title transfer. See Company Law Review Steering Group (n 220) 153 par 7.4.
\textsuperscript{223} Nolan (n 176) 576.
\textsuperscript{224} Gullifer and Payne (n 175) 197.
\textsuperscript{225} Ibid 196.
person, the rights attached to those shares do not all need to be exercised in the same way. This provision caters for the common situation where an intermediary hold shares on behalf of a number of investors. Each of these investors may wish to exercise their vote differently, and this section authorises the registered holder to split his holdings and vote both for and against a resolution in proportion to the voting instructions received from the investors.\textsuperscript{226}

At first glance this appears to be an elegant solution. Under trust law, the trustee manages the trust estate for the benefit of all the beneficiaries.\textsuperscript{227} Applied in the context of intermediated shares, the beneficial owner, as the beneficiary, can instruct the registered owner, as the trustee, how to deal with the shares, including how the votes attached to the shares should be exercised.\textsuperscript{228} If the shares are held through more than one intermediary in a chain, then each intermediary owes a duty to the client immediately below, and voting instructions are passed up the chain from the beneficial owner through each intermediary until they finally reach the registered owner.\textsuperscript{229} The onus of verifying the identity of the immediate client and the validity of the voting instructions passed on rests with each intermediary in the chain. Since under trust law there is already an obligation on an intermediary to know the identity of the trust (and thus also the beneficiary), this should not be a burden.\textsuperscript{230} Furthermore, since the company is absolved from the validation and verification process, the validity of its decisions cannot be challenged if irregularities occurred further down the chain.\textsuperscript{231}

In practice, however, this method has flaws. Firstly, the onus rests on the beneficial owner to provide the intermediary with voting instructions, and there is no counter provision which requires the intermediary to actively ask for instructions as to how the votes should be cast.\textsuperscript{232} As we have noted, high shareholder participation is an essential element to sound corporate governance, but this provision does not encourage such behaviour. If the beneficial owner has no knowledge of an upcoming meeting, he will not instruct his intermediary on how to vote. Secondly, although each intermediary in the chain is aware of the identity of the person immediately below and immediately above them, the distance between the top of the chain

\begin{itemize}
\item \textsuperscript{226} Gullifer and Payne (n 175) 197.
\item \textsuperscript{227} Ibid.
\item \textsuperscript{228} Nolan (n 176) 574.
\item \textsuperscript{229} Ibid.
\item \textsuperscript{230} Ibid 575. The intermediary is also required to gather this information in order to comply with the Principles of Business issued by the Financial Services Authority.
\item \textsuperscript{231} Gullifer and Payne (n 175) 198.
\item \textsuperscript{232} Hainsworth “The shareholder rights directive and the challenge of re-enfranchising beneficial shareholders” 2007 Law and Financial Markets Review 11 14.
\end{itemize}
and the bottom of the chain means that there is often no way for the registered owner to know
the identity of the beneficial owner.\textsuperscript{233} As a result, the registered owner is not in a position to
determine the actual origins of the voting instructions and cannot verify their authenticity.\textsuperscript{234} Under current UK law, there is no requirement of transparency of holdings between
intermediaries.\textsuperscript{235} This is a significant point and one that must be borne in mind in the
discussion on the South African position below. Thirdly, and much like in the USA, the
number of intermediaries in the chain increases the complexity of vote gathering and
forwarding. As a result, some votes can be lost in the process.\textsuperscript{236} In order to address this
particular problem, the UK Companies Act requires that the results of any poll at a general
meeting of the company must be published on a website.\textsuperscript{237} The members of the company can
also require that the directors obtain an independent report of any poll taken at a general
meeting.\textsuperscript{238} These provisions are intended to introduce some form of transparency into the
system so as to improve confidence in its integrity and effectiveness.\textsuperscript{239}

The second approach – where the intermediary delegates the right to vote to the beneficial
owner by way of proxy – is enabled by section 324(1) of the UK Companies Act. Section
324(2) allows a registered owner to appoint more than one proxy for a meeting, provided that
each proxy must be appointed to exercise the rights attached to different shares. This is much
the same approach as that followed in section 152, in that it allows an intermediary who holds
shares on behalf of multiple investors to split the voting rights according to their proportional
holdings.\textsuperscript{240} Proxies have the right to attend, speak and vote at meetings through either poll or
by a show of hands.\textsuperscript{241} Payne points out that while this is an important provision in the
enfranchisement of beneficial owners, it could produce anomalous results. For example, if a
vote is held on a show of hands and only the registered owner is present, the entire bloc of
shares would reflect one vote. However, if ten proxies also decide to attend the meeting then
the same bloc of shares would reflect eleven votes.\textsuperscript{242} This type of anomaly can be avoided
by amending the articles of association of the company to limit the number of proxy votes

\textsuperscript{233} Ibid 15.
\textsuperscript{234} Gullifer and Payne (n 175) 199.
\textsuperscript{235} Ibid.
\textsuperscript{236} Myners “Report by Paul Myners to the Shareholder Working Group” January 2004 \textit{Review of the}
\textit{Impediments to Voting UK Shares 1}.
\textsuperscript{237} See s 341 of the UK Companies Act.
\textsuperscript{238} See s 342 of the UK Companies Act.
\textsuperscript{239} Gullifer and Payne (n 175) 200.
\textsuperscript{240} Ibid 202.
\textsuperscript{241} See s 324(1) read with s 285 and s 329 of the UK Companies Act.
\textsuperscript{242} Gullifer and Payne (n 175) 202.
that can be cast in this way, or alternatively, by always conducting a vote by poll (where one share equals one vote).\textsuperscript{243}

It will be recalled that some of the pathologies identified in the USA by Kahan and Rock relate to the long period that elapses between the record date and the actual shareholders’ meeting. In the UK, the UK Uncertificated Securities Regulations attempt to mitigate these consequences by prescribing that the record date must be a maximum of 48 hours before the meeting,\textsuperscript{244} a significant difference from the 70 days set by the Model Act. Myners, however, noted that a concern was raised that the 48 hour period is, in fact, too short. Principally, due to the time it takes to transmit voting instructions, shares may be required to be voted before the entitlements have even been properly calculated.\textsuperscript{245} While this provided the motivation to increase the record date to no more than 96 hours before a meeting, Myners ultimately did not recommend such a change due to the fact that there was no consensus in the market.\textsuperscript{246} Nevertheless, we should bear this view in mind for the discussion on record dates in the South African context.

In addition to the two approaches mentioned above, the UK Companies Act has introduced a number of other measures aimed at improving the enfranchisement of indirect investors. For example, section 145 allows a company to make provision in its articles for a registered member to nominate another person or persons to exercise and enjoy all of the rights that would normally accrue to the member. This delegation of rights can be exercised by an intermediary in favour of a beneficial owner, and since the section is phrased in broad terms, the delegation can be for any and all of the rights of a member, and not just the right to vote.\textsuperscript{247} As such, it can be seen as a far more powerful enfranchising tool than the appointment of the beneficial owner as a mere proxy.\textsuperscript{248} However, much like the provision for the recognition of beneficial owners in the Model Act in the USA, the efficacy of this section suffers due to the fact that it is a voluntary provision. In fact, it requires two voluntary acts in order to come into force: the first on the part of the company to amend its articles to allow for such a nomination; and the second on the part of the registered member to actually

\textsuperscript{243} Ibid.
\textsuperscript{244} See regulation 41(1) of the UK Uncertificated Securities Regulations.
\textsuperscript{246} Ibid 7.
\textsuperscript{247} See s 145(3) of the UK Companies Act.
\textsuperscript{248} Gullifer and Payne (n 175) 205.
make the nomination. Due to the administrative burden that this will entail for all parties, it is unlikely that such an election will be made by large public companies.\textsuperscript{249}

In a further development that has enhanced the rights of indirect investors, the UK Companies Act has introduced information rights. As we have noted, shareholders have a significant role to play in corporate governance, most of which is exercised through their right to vote. However, in order to exercise that right effectively, indirect investors need to receive information that is relevant to the issue to be decided.\textsuperscript{250} Thus section 146 now provides that, in the case of companies that are traded on an exchange, an intermediary may nominate the beneficial owner to receive all of the corporate communications which would normally only be sent to the registered member. This includes the right to receive the company’s annual accounts and reports.\textsuperscript{251} Significantly, this provision does not require any consent on the part of the company - it requires only the nomination by the intermediary to be effective.\textsuperscript{252} The beneficial owner may be in a position to insist on such a nomination depending on the terms of the custody agreement he has with his intermediary. While a nomination exercised under section 145 will substitute the rights of the beneficial owner for the rights of the intermediary, a nomination under section 146 will not. Thus both the intermediary and the nominated beneficial owner will be entitled to receive all relevant communications from the company.\textsuperscript{253}

The final provision introduced by the UK Companies Act to enhance the rights of indirect shareholders is to be found in section 153. This section states that where specific minimum thresholds are prescribed before certain actions can occur, indirect investors must be counted towards such a total.\textsuperscript{254} By way of example, section 314 stipulates that a company is obliged to circulate a written statement explaining a certain issue to be resolved at a meeting, if 100 members, who on aggregate hold at least £100 of shares each, demand it. Under section 153, indirect investors can be counted towards this number provided that their identity and shareholding is disclosed, among other details. This is presumably to ensure that they are legitimate beneficial owners and that their shares are not double counted.\textsuperscript{255}

\begin{itemize}
\item \textsuperscript{249} Ibid.
\item \textsuperscript{250} Company Law Review Steering Group (n 220) 55-56.
\item \textsuperscript{251} See s 146(4) of the UK Companies Act.
\item \textsuperscript{252} Gullifer and Payne (n 175) 206.
\item \textsuperscript{253} Ibid.
\item \textsuperscript{254} See s 153(2) of the UK Companies Act.
\item \textsuperscript{255} Gullifer and Payne (n 175) 206-207.
\end{itemize}
It can thus be seen that although the UK approach appears similar to the problematic USA approach, a number of key provisions have been introduced in order to mitigate the worst effects of the system. These provisions also enhance the protection of indirect shareholder rights and encourage their participation in the governance of the company. One major weakness persists, however: there is still no relationship between the company and the beneficial owner. This means that the registered member cannot be compelled by the company to pass its rights on to the beneficial owner - it remains a purely voluntary act on the part of the intermediary. In reality, therefore, whether or not a beneficial owner will have the rights he should be entitled to will depend on the contractual relationship he has with the intermediary. While the departure point in a trust relationship is that the trustee must act in accordance with the instructions of an absolutely entitled beneficiary, it is also true that the trustee can still legitimately limit its obligations through such a contract. Accordingly, it appears that it is common practice in the UK for intermediaries to restrict their obligations to beneficial owners to custody services only, and not to provide corporate action and voting services. In order to improve the rights of indirect investors, and by so doing improve the overall standard of governance in companies, this outstanding issue must be addressed.

### 3.3.3 South Africa

In South Africa, it is Part F of Chapter 2 of the 2008 Act which deals with the governance of companies and the manner in which shareholder votes are collected, tallied and accounted for. Interestingly, the South African legislature has tailored a specific definition of ‘shareholder’ purely for the purposes of regulating voting rights. According to section 1 of the 2008 Act, a shareholder means “the holder of a share issued by a company and who is entered as such in the certificated or uncertificated securities register, as the case may be”. However, this definition is made subject to the provisions of section 57(1), which states that:

“In this Part [F], ‘shareholder’ has the meaning set out in section 1, but also includes a person who is entitled to exercise any voting rights in relation to a company, irrespective of the form, title or nature of the securities to which those voting rights are attached.”

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256 Hainsworth (n 232) 14.
257 Ibid.
258 Gullifer and Payne (n 175) 207.
259 Ibid.
It is submitted that the use of this definition reveals that the South African legislature is well aware of the complexities that surround voter rights in an extensive nominee environment, and is using this wording in an effort to achieve a high level of equivalence between the voting rights of those shareholders who appear on the securities register, and the beneficial owner who does not.260

Much like the situation that is prevalent in both the United States and the United Kingdom, the South African market has adopted and modified the traditional proxy voting procedure as the primary method of ensuring that beneficial owners are able to cast a vote in an uncertificated, intermediated environment, even though they are not recorded on the securities register.

Section 58(1) of the 2008 Act authorises a shareholder of a company to appoint any individual, including someone who is not a shareholder in the company, as a proxy. Again, in provisions that are similar to those found in the UK, a proxy who is so appointed may participate in, speak, and vote at a shareholders’ meeting on behalf of the shareholder.261

Furthermore, in terms of section 58(3)(a), unless prohibited by the company’s Memorandum of Incorporation, a shareholder may appoint two or more proxies at the same time, and can also appoint more than one proxy to exercise voting rights that are attached to different securities held by the shareholder. Section 58(3)(b) then goes on to state that, subject to any restriction in the proxy instrument, an appointed proxy may further delegate that proxy authority to yet another person. The net result of these provisions is that in the uncertificated environment, an intermediary nominee that is recorded as the shareholder in the securities register of a company can appoint any number of beneficial owners as proxies to attend and vote at the meeting of shareholders. These beneficial owners will be entitled to speak at such meetings and vote according to the number of shares that they hold as investors. In addition, the act recognises the existence of multiple levels of intermediaries and has made provision for that in the powers of delegation. Thus, if underneath the participant nominee one finds not

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260 The extended definition is also intended to cater for the exercise of voting rights attached to debt instruments and other securities as provided for in s 43(3)(a) of the 2008 Act. See Cassim et al (n 1) 242. However, it should be noted that Schedule 10 of the JSE Listings Requirements requires that the Memorandum of Incorporation of a listed company must prohibit the issuing of debt instruments with special privileges such as voting rights.

261 See s 58(1)(a) of the 2008 Act.
the beneficial owner but a further nominee (such as a broker nominee), the proxy authority can be passed all the way down through the chain of custody until it reaches the beneficial owner.

This ability by the beneficial owner to attend at meetings and participate in the discussions is a crucial part in ensuring that the rights of the underlying investor are protected. It is also submitted that good corporate governance is enhanced immeasurably by the physical attendance of investors at meetings. It is far more difficult for directors to ignore criticism when the critic is actually in the room.

The 2008 Act also provides for the manner in which voting is conducted at shareholder meetings. Specifically, section 63 provides that voting may occur by either a show of hands or by polling.262 If voting is by show of hands, a shareholder or a proxy who is present at the meeting has only one vote, no matter the number of voting rights that person may actually hold.263 This provision has the potential to create exactly the same voting anomalies as are present in the UK under the similar regime of the UK Companies Act. Therefore the passing or rejection of a resolution may be determined by how many proxies the shareholder has appointed to attend the meeting in person. As in the UK, such anomalies in South Africa can be mitigated through an amendment to the company’s Memorandum of Incorporation to place a limit on the number of concurrent proxies that are allowed (as contemplated in section 58(3)(a) of the 2008 Act). On the other hand, if voting is by way of poll, the shareholder or proxy may vote the full number of voting rights actually held by that person, thus avoiding the issue entirely.264

As has been noted in the discussion on the systems in place in the USA and UK, the matter of when the record date is set can have significant implications on the complexity of determining who has the right to vote in an uncertificated environment. We have seen that in the USA the record date is set between 30 and 60 days before a meeting, while in the UK it is only 48 hours.

262 See s 63(4) of the 2008 Act.
263 See s 63(5) of the 2008 Act.
264 See s 63(6) of the 2008 Act.
On the face of it, South Africa appears to walk the middle road compared to these two jurisdictions. According to section 59 of the 2008 Act, the record date may be set by the board of a company for the purposes of determining, among others, which shareholders are entitled to participate in and vote at shareholders’ meetings.\(^{265}\) If the company sets the record date, then it may not be retroactive and it may not be more than ten days before the event.\(^{266}\) Conversely, if the company does not set the record date then, in the case of a meeting, the record date is the latest date by which the company is required to give shareholders notice of that meeting, unless it’s Memorandum of Incorporation or rules provide otherwise.\(^{267}\) Section 62 then provides that in the case of a public company, notice of a meeting must be delivered to each of the shareholders at least fifteen business days before the meeting is to begin, and at least ten days before for any other company, again subject to any other period that may be prescribed in the company’s Memorandum of Incorporation.\(^{268}\) If we discount this flexibility to choose any period at all in the Memorandum of Incorporation, then it would appear that the accepted timeframe in which to set a record date in South Africa, based on the different requirements of section 59 and 62, would either be fifteen days before the meeting, or less than ten days before the meeting.

However, this is not actually the case for all companies. The Companies Regulations, 2011\(^{269}\) (“Companies Regulations”) make provision for a different timescale to be used. Regulation 37(1) states that if “any securities of a particular company are in uncertificated form, or otherwise subject to rules of a central securities depository, the company must set the record date in accordance with those rules.” The Companies Regulations thus delegate the authority of setting particular record dates for uncertificated shares to Strate.\(^{270}\) Unfortunately, these provisions in the 2008 Act are not clearly drafted. Section 59(2)(b) clearly provides that the manner of publication of the record date to shareholders may be determined by any prescribed requirements. In other words, such details may be set out in a regulation or notice made in terms of the Act.\(^{271}\) However, there is no corresponding clause that allows for the record date to be set according to such a regulation or notice. It therefore follows that the delegation in regulation 37(1), allowing the central securities depository to set the record date.

\(^{265}\) See s 59(1)(b) of the 2008 Act.

\(^{266}\) Delport, Vorster, Burdette, Esser and Lombard Henochsberg on the Companies Act 71 of 2008 2011 227

\(^{267}\) See s 59(3) of the 2008 Act.

\(^{268}\) See s 62(1) and (2) of the 2008 Act.

\(^{269}\) GG 34239 (26 April 2011).

\(^{270}\) Cassim et al (n 1) 362.

\(^{271}\) See the definition of ‘prescribed’ in s 1 of the 2008 Act.
date, may be *ultra vires*. Despite these uncertainties in the drafting, however, this delegation is fully accepted and applied in practice. It is submitted that if the authority of the central securities depository were limited to only issues of publication, there would be little to no benefit to stakeholders over and above the requirements already contained in the Act. By issuing regulation 37, it would appear that the intention of the Minister was to allow the central securities depository to regulate the uncertificated market effectively, and by so doing create uniformity and consistency in procedures. This delegation furthermore creates a large amount of flexibility and allows the South African market, led by Strate, to monitor local practices, take cognisance of international trends, and make such adjustments as are necessary to reduce risks and increase certainty.

If we follow the trail of crumbs set by the Companies Regulations, we find that the Strate Rules further delegate the setting of a record date to the Strate Directives. Rule 3.20 states that the “manner in which an Issuer of Eligible Securities may set the record date…is stipulated by Directive.” The relevant Strate Directive is called “Directive SC.5 Proxy Voting Procedure – Domestic Companies – Equities”. This directive defines both a ‘Record Date’ and a ‘Meeting Record Date’. As expected, a ‘Record Date’ is the date on which the holdings, upon which voting rights are based, are ascertained, while a ‘Meeting Record Date’ means “the Record Date used for the purposes of determining which Shareholders are entitled to participate in and vote at a Shareholders meeting”\(^{272}\). It is immediately apparent that record dates are an essential element in the proper exercise of voting rights and, by implication, in the protection and entrenchment of the voting rights of beneficial owners who are acting through an intermediary. Contrary to the provisions of sections 59 and 62 of the 2008 Act, however, Strate Directive SC.5 obliges companies to publish a meeting record date which is at least three business days prior to the meeting.\(^{273}\) Where a company does not publish such a date, the meeting record date is then deemed to be three business days prior to the meeting.\(^{274}\)

It can therefore be argued that the accepted South African time period for setting a record date for companies with uncertificated shares is approximately three business days before the meeting. This is quite close to the UK model of 48 hours before a meeting. As we have seen, the closer the record date is to the actual meeting, the fewer problems arise when it comes to determining the rights of shareholders and beneficial owners. At the same time, if the period

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\(^{272}\) See clause 1 of Strate Directive SC.5.

\(^{273}\) See clause 2.13 of Strate Directive SC.5.

\(^{274}\) See clause 2.14 of Strate Directive SC.5.
set for the record date is too short, the administrative problems identified by Myners (that voting may occur before the entitlements have been accurately calculated) may manifest themselves. It is submitted that the three day period prescribed by Directive SC.5 is an effective compromise that both maximises the benefits and minimises the disadvantages that may occur at either end of the spectrum. As such, this element of the South African uncertificated regulations must be commended for its contribution in bringing certainty to companies, shareholders and beneficial owners alike.

Of course, it is not only necessary to cater for those beneficial owners who wish to attend a shareholders’ meeting in person. If shareholder involvement in meetings is to be encouraged, there must also be a mechanism to allow them to participate and vote even if they are not physically able to be at the meeting. Therefore section 63 of the 2008 Act provides that a shareholders’ meeting may be conducted either entirely by electronic communication or, alternatively, that shareholders or their proxies can participate electronically in any part of a meeting that is being held in person.275 As this section also falls under Part F of Chapter 2, a shareholder would include a beneficial owner under the extended definition of shareholder.

We have seen that in the UK the introduction of information rights for indirect investors was seen as an important way to enhance their rights. An indirect investor can only effectively take part in the corporate governance of a company if he has sufficient information to make an informed decision. Section 62 of the 2008 Act provides that a company must “deliver a notice of each shareholders meeting in the prescribed manner and form to all of the shareholders of the company as of the record date.…”.276 Once again, this section falls within Part F of Chapter 2, which means that the extended definition of a shareholder, including all persons with a right to vote, must apply. The notice of a meeting must include certain prescribed information. This comprises obvious things such as the date, time and place of the meeting, but it also requires the company to include the general or specific purpose of the meeting, a copy of any resolution that will be considered and the number of votes that will be required to pass such a resolution.277 In the case of an annual general meeting, the company must also include the financial statements and must also give directions that allow the

275 See s 63(2) of the 2008 Act. There is a proviso that such electronic communication is only permissible if all those who are participating in the meeting can communicate concurrently with each other without an intermediary, and that the meeting can be held in a reasonably effective manner.

276 See s 62(1) of the 2008 Act.

277 See s 62(3)(a) to (c) of the 2008 Act.
recipients of the notice to obtain copies of the complete annual financial statements of the
previous financial year. Finally, the notice must advise the shareholders of their right to
appoint proxies to attend the meeting as we have discussed above. The consequence of these
provisions is that the company is obliged to provide both shareholders who are on the
register, and also indirect investors, with sufficient information to allow them to make
informed decisions on the issues that will be considered. It is significant that the South
African provision has actually gone further than the corresponding provisions in the UK.
While the UK legislation requires that the intermediary must first nominate the beneficial
owner before the beneficial owner will receive the information, the South African position is
that no such nomination is necessary. In this country, the indirect investor receives the
information as a matter of right.

Like in the UK, the South African legislation also includes the voting rights of indirect
investors when it comes to determining thresholds that are required to induce certain actions.
Section 61(3) states that a shareholders’ meeting to consider a specific issue must be called
by the board of a company if a demand for such a meeting is made by at least 10% of the
holders of the voting rights that would be entitled to be exercised on the issue. Once again,
the provision is phrased in terms of voting rights and not in terms of shareholders. Thus
indirect investors with the right to vote will be counted towards this total.

It is opportune at this time to examine how the voting rights of indirect investors are actually
entrenched and protected in the uncertificated market. Section 37(9) of the 2008 Act states
that a person acquires the rights associated with any securities of a company when that
person’s name is entered in the company’s certificated securities register. It is clear
therefore that the certificated holder of a company share is directly protected by this provision
and is thus entitled to all of the rights associated with that share, including the right to vote.
For uncertificated securities, however, the section declares that such rights shall be
determined in accordance with the rules of the central securities depository. We thus need
to delve into secondary legislation, specifically the Strate Rules, to find our solution. As it
happens, the answer is inextricably wound up in one of the key concepts of the South African

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market, and one which takes the protection of indirect investors in this country far ahead of their counterparts in either the USA or the UK, namely: transparency.

The foundation of the transparency provisions in the 2008 Act can be found in the definitions contained in section 1. ‘Beneficial interest’, when used in relation to a company’s securities, is defined as meaning:

“...the right or entitlement of a person, through ownership, agreement, relationship or otherwise, alone or together with another person to-

(a) receive or participate in any distribution in respect of the company's securities;
(b) exercise or cause to be exercised, in the ordinary course, any or all of the rights attaching to the company's securities; or
(c) dispose or direct the disposition of the company's securities, or any part of a distribution in respect of the securities...”

Section 56 then sets out the basis for the recognition of beneficial interests. It states that, unless prohibited by a company’s Memorandum of Incorporation, a company’s securities may be held by one person for the beneficial interest of another, and also registered in the name of that person.281 This provision provides the legal footing for the method of holding uncertificated shares through various intermediaries, including brokers, participants and the CSD. In addition, if the securities of a public company are registered in the name of an intermediary, the intermediary is required to record the identity of the person on whose behalf it holds the securities, the identities of all those persons who have a beneficial interest in those securities, the number and class of the securities held for each of those persons with a beneficial interest, and the extent of the beneficial interest.282 This provision thus places an obligation on an intermediary to not only record the client on whose behalf it holds in the tier immediately below, but all the way down to the ultimate investor. Section 56(4) again takes the matter one step further and requires that the information on beneficial owners that has been collected must be disclosed to the company in writing on a monthly basis, or more frequently as determined by the requirements of the CSD.283

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281 See s 56(1) of the 2008 Act.
282 See s 56(3) of the 2008 Act.
283 Strate currently mandates that the disclosure to the issuer must occur on a weekly basis, thus increasing the level of transparency to the issuer even further.
It will be appreciated that this disclosure requirement establishes a type of direct relationship between the issuer and the investor that is absent from the regimes found in the USA and in the UK. By requiring each intermediary to know and record the identities and holdings of the beneficial owners all the way through the chain, and to disclose these to the company, the South African system avoids the “heart of darkness” that Donald accused the USA system of perpetuating. The South African system also makes such disclosure compulsory, which addresses the criticism levelled at the UK’s system, which leaves such decisions on disclosure to a voluntary agreement between the intermediary and the client.

The detailed regulation in preserving the voting rights of beneficial owners, in essence, the closing of the circle, can be found in the Strate Rules. Rule 5.6.3, which deals with the minimum provisions that must be included in the mandate agreement between the participant and its clients, asserts that the client is required to disclose information to the participant that concerns any beneficial, limited or other interest in the securities that are being deposited with the participant. This provision thus ensures that the participant receives the information it requires in order to comply with section 56. Rule 5.9 then declares that a person who holds a beneficial interest in any securities may vote on a matter at a meeting, provided that the beneficial interest includes the right to vote on the matter, and that person’s name is recorded in the ‘Beneficiary Download’ (which is the record of beneficial interests disclosed to the issuer in terms of section 56(4)), or that person holds a proxy appointment from the registered holder of the securities. Through this rule, the voting rights of the beneficial owner become enforceable against the intermediary that holds the shares on his behalf. At the same time, the legitimacy of such voting rights can be validated against the record of beneficial owners that is held by both participants and the issuer.

While the current South African regime for uncertificated securities holds significant advantages for the indirect investor, especially when compared to the systems in operation in the USA and the UK, there is still room for improvement. One of the concerns that remains falls under Kahan and Rock’s pathology of complexity. For all of the advancements made in terms of transparency and disclosure, the actual practice of proxy voting remains cumbersome. The process involves each participant advising the company of its holdings as at record date and the numbers of voting packs that it requires. The company then sends

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284 See rule 5.6.3.2 of the Strate Rules.
285 See clause 2.3 of Strate Directive SC.5.
the required number of voting packs to the participants who, in turn, distribute these to their clients. If the client is not the beneficial owner (for instance if it is a broker), then further distributions must occur depending on the number of intermediaries between the company and the ultimate investor. The various intermediaries must then collate the voting instructions they receive from their clients, validate these against the record of holdings, and pass them up to the next level, which then collates and validates all of the instructions it has received. Ultimately, the participants submit all of the voting instructions to the company for it to tally. In his report to the Shareholder Voting Working Group in the UK, Myners noted that an automated process is key to an efficient voting system. In South Africa, much of this process is automated and occurs electronically. However, although this system is largely effective, by its very nature it cannot be perfect. One can imagine that voting instructions could be lost, or miscounted, or improperly validated at any level of the intermediary chain, which would result in the entire voting process being flawed.

The only solution to this problem, and it is one which, as has been discussed, many countries face, is that the number of levels in the holding chain must be reduced. To do this, South Africa should move to a centralised, direct holding model for its uncertificated market. As discussed previously, such a model is one where the legal record of ownership is held at the highest tier, the CSD, and the name of the end investor is recorded at that tier. Such a system would reduce the number of intermediaries to only one, the central securities depository, which will have a correlating reduction in the complexity of voting processes. In addition, all investors will be recorded as shareholders of the company. As they will no longer be required to act through nominees and other intermediaries, this will dramatically enhance their ability to exercise their rights in a direct relationship with the issuer. This increased capacity to act should encourage shareholder activism, which, in turn, should influence the corporate governance of public companies. As we have seen, the legislation in South Africa already enables a centralised, direct holding model, and the market has taken some steps in this direction at last. It is submitted that if the country is genuinely concerned with improving the standards of corporate governance, then this transition should occur without hesitation.

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286 See clause 2.4.1 of Strate Directive SC.5.
287 See clause 2.12 of Strate Directive SC.5.
288 Myners (n 245) 5.
CONCLUSION

A share is a type of financial security. It is an incorporeal movable property that represents the shareholder’s interest in the issuing company. Each share consists of a bundle of personal rights that the shareholder can enforce against the company. The precise nature of these rights is circumscribed in statutes and in the constitutional documents of the company. Typical rights include the right to receive dividends, the right to share in the assets of the company upon winding-up, and the right to vote.

Sound corporate governance is becoming increasingly important in the modern economy. Companies with good corporate governance can be expected to prosper while those without can expect to suffer at least a loss of reputation amongst investors and the public. The high number of corporate collapses in recent times indicates that the consequences of not implementing good governance could be higher than just reputational damage.

In order to promote good governance, it is essential for shareholders to actively participate in the governance of companies. From this point of view, it is especially the right to vote that provides the shareholder with the most power to influence the direction of the company. However, since the levels of shareholder participation are currently very low, any country that wishes to promote shareholder activity must have a legal and structural framework that at the very least does not discourage a shareholder from exercising his voting rights.

During the ‘Paper Crunch’ of the 1960s, trading volumes on the world’s stock exchanges generated so many paper documents that the entire market was reduced to a virtual standstill. In response, countries around the world moved to an uncertificated environment where shares were held in electronic form and transferred by book-entries in the records of central securities depositories and their participants. A number of models for such a system have since developed, ranging from immobilised to fully dematerialised, direct to indirect, and centralised or fragmented custody. Intermediaries that hold the shares on behalf of the investor are an inherent part of uncertificated markets, but the number of intermediaries and tiers in the chain of custody differs between each model. A direct, centralised model has only one intermediary at the topmost tier, namely the central securities depository.
The United States of America operates an immobilised, indirect market. There are a number of tiers and intermediaries holding shares on behalf of investors through intermediaries. There is very little transparency; the company has no direct contact with any of its underlying investors and all communication between them, including the collection of proxy voting instructions, is conducted up and down through the holding tiers. The model has rightly been criticised as unnecessarily complex, susceptible to errors, and ultimately prone to disenfranchisement of the indirect investor.

The proxy voting model in the United Kingdom has similarities to that of the United States. However, a number of key innovations have been introduced to enhance the protection of the rights of indirect investors. Principally, the investor has the right to personally attend meetings of the company, to participate in them, and to vote. The intermediary can also choose to delegate some of its rights to the beneficial owner so that he can exercise those rights directly. Unfortunately, this delegation is a voluntary measure and the intermediary is not compelled to offer it.

In South Africa, the proxy voting procedure is much the same as in both the other jurisdictions. As in the UK, the beneficial owner has a right to personally attend, participate in, and vote at a meeting of shareholders. Even more so than in the United Kingdom, though, South Africa has initiated a number of provisions that greatly enhance the rights of beneficial owners. Firstly, the delegation of certain rights to the beneficial owner is not a matter of choice on the part of the intermediary, the intermediary is obliged to do so by statute. Secondly, the intermediary is obliged to record the name and details of the beneficial owner on whose behalf it holds shares and to submit these details to the issuing company on a regular basis. This provision creates a link between the company and its underlying investors. Such transparency positively affects the relationship between the company and the beneficial owners of its shares, and transparency is a prerequisite for good corporate governance.

South Africa should not rest on its laurels, though. As in the United States and the United Kingdom, its proxy voting procedure is overly complex due to the number of intermediaries that lie between the company and the investors. South Africa should transform its uncertificated custody model to a direct, centralised regime where the investor is recorded as the shareholder in the records of the central securities depository. This will create a direct
relationship between the company and its shareholders and will allow those shareholders to exercise their rights much more effectively.
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