Chapter Eleven
Consequences of being a shareholder

Shareholders are the true owners of the company, so they have lots of rights. For a start, in theory they appoint both the board of directors and the auditors. In practice the directors do both and shareholders have all too often supinely agreed to everything done in their name. Even great institutional holders who know the law and accounting principles and are sophisticated investors have been lax in exerting their power and have generally more often sold the shares than spoken up or done anything for the business. This has been changing: some institutions are using their influence and it is becoming less easy for the board to dismiss awkward questions at the annual meeting, but still too many private individuals consider any questioning of the board as an unseemly delay of their free drinks.

As owners, shareholders are entitled to be given a wide range of information, and to participate in the company's success.

Information

The information the owners must have includes regular financial facts. Every year the company must produce an account of its finances (the phrasing in law is a little more complicated but that is what the rules amount to) and this must be sent to all registered shareholders. (See Chapter 7 for what the useful information is in those annual reports and accounts and how to extract it.) Shareholders must also have notice of important events affecting the business. That includes details of major acquisitions and disposals, demergers and reorganizations.

Annual general meeting

The annual general meeting is a legal obligation and shareholders must be notified in advance. There is, however, no legal insistence that the meeting is held in a convenient spot, so if the directors are feeling bloody-minded they could hold it in the upstairs room of a pub on Stornoway. Curious times and inconvenient places for meetings, plus company announcements on Christmas Eve, are good signs to shareholders that all is not well with the business.

At the meeting they are called on to approve the accounts by voting, can ask questions and have a vote on a number of other resolutions including the reappointment of auditors and directors. Most shareholders neglect this privilege, either throwing away the voting card altogether or just sending back the enclosed proxy form giving the chairman carte blanche to vote on their behalf.

Extraordinary general meeting

Shareholders representing at least 10 per cent of the equity may demand the convening of an extraordinary general meeting.

Consultation

There is a legal obligation to consult shareholders on matters that affect the company's future. They have the right to vote on major decisions, including actions that may dilute their holdings such as rights issues and employee share options schemes. If they can muster 5 per cent of the company's equity or 100 shareholders to back them, they can even introduce their own resolutions at the meeting.

Dividends

Shareholders are entitled to take part in the company's success and profits. Normally shareholders participate in the company's profits by way of dividends, which are usually paid twice a year, but this is not a legal right since a company may decide to reinvest its profits in the business for faster growth. In practice few have the courage to refrain from paying altogether. The cheque, or notification of payment into an account, shows the size of holding and rate of dividend. Preference shares are normally entitled to a dividend, and if the company cannot for a time afford to pay, that entitlement is normally only deferred and has to be paid later when the money is available.

Scrip issues

This looks like a burst of spontaneous generosity by companies that give investors some extra shares for nothing. Sometimes they are in place of cash dividends and sometimes as a supplement to them. In fact it is a simple bookkeeping exercise that should have no effect on the share price or the value of the company – some of the retained earnings are capitalized and shifted from one line in the books to another. That is also the reason they are called ‘capitalization issues’. Sometimes issuing scrip is called a ‘bonus issue’ and surprisingly enough, contrary to logic, the share price sometimes rises at the time. Shareholders may then find it hard to calculate the cost of the holding for capital gains tax when they sell.

Rights issues

Companies wanting to raise additional capital sometimes turn to existing shareholders first. There are several reasons for this. The first is obvious: shareholders by definition must like the company, so if it says it can see opportunities for useful investment to allow it to grow but needs additional cash, they are more likely to take a friendly view. Second, it is only fair to allow existing holders to take action against having their holdings diluted by the issue of further shares. Third, the institutions that own most of the shares on issue in Britain are especially insistent on being given the chance to maintain the percentage of the company they have decided was right for that portfolio – this is called their ‘pre-emption right’.

It is a long and expensive business for a company since it must print extensive literature and post it to all holders, and the merchant banks and accountants cost a fortune in fees. A placing – ringing round funds known to be interested and asking if they would like to buy extra shares – works out a lot cheaper and can be very quick.

The opportunity to buy the new shares is allocated as a ratio of existing shares owned. It is something like the right to buy three new shares for every 11 already held, or some such formula depending on how much the company is trying to raise and how deep a discount it is offering. The issue will dilute the value of the existing shares because profits and dividends will be distributed over a larger number of shares.

Rights issues are normally offered at a discount to the prevailing share price to give people the illusion that they are getting a bargain. So if the shares stand at 200p, the company might offer one new share for every four already held at a price of 150p. So for every four shares, worth £8, they can buy another for £1.50. If investors do buy they have a holding worth £9.50 (assuming the price does not move) and the four continuing shares would be worth £7.60 (four-fifths of £9.50), but on that calculation the right would be worth 40p, so they would be back to the original £8 holding. One complication is that the money received for the rights may be taxable, and another is that the market price will react to the announcement.

Shareholders faced with a rights issue can take it up in full and pay for the new issue of shares. They can sell the nil-paid rights, which have a value on the stock market. Or they can compromise by selling enough nil-paid rights to maintain the value of the portfolio by using the proceeds to buy new shares. The nil-paid price is the difference between the discounted rights issue share price and the ex-rights price.

Nominee accounts

Many people hold their shares in nominee accounts – for SIPPs and ISAs they have to. These are held in a number of places and are a convenience to prevent shuffling of papers or to speed up the processes of buying and selling. For instance, the dealing stockbroker may hold an account for an investor, who does not therefore have to wait for share certificates to arrive before being able to sell them, and does not have to store and find the necessary papers. Some brokers offer the service free as a way of reducing their own administration; some charge a flat fee or one based on the value of the shares; yet others charge per transaction; and some large companies have instituted their own systems.

Regulated markets

In addition to their rights in relation to the company of which they own a piece, investors have a right not to be ripped off by the financial community. This is the part that is mainly watched over by the regulatory authority. It regulates British brokers and dealers, whether they are in a City office or dealing via the internet, but nobody regulates the internet. Inevitably, the net has been a happy playground for some shady operators, ranging from various types of fraudsters to people operating pyramid schemes. Some have set up bogus websites to look like the pages operated by real investment companies, in the hope of getting unsuspecting people to part with their money. In addition, the net is awash with rumours, many of them carefully placed to drive the price up or down so the instigator can sell or buy as needs be and make a killing. The authorities in the more responsible countries pursue these people, but the net is too vast to be watched.

The London Stock Exchange also regulates its own market. The Exchange's computer has a sophisticated program trying to spot unusual patterns, and if there are untoward movements in advance of an official announcement (eg a sharp rise just before a bid is disclosed), the Exchange authorities investigate. Despite some apparently suspicious circumstances, however, they hardly ever find anything untoward. Prosecutions for insider trading are rare, and convictions even rarer.

Relying on somebody else to pick up the pieces and fight the battles for feckless or foolish investing is a mistake. A little elementary care can prevent a lot of mistakes and save much effort trying to assert one's rights later. For instance, you should use only authorized businesses to act on your behalf, and that is easy to check on the register of the regulatory authority. Before starting any transactions, check the costs and fees. The first rule is, if there is anything you do not understand – go on asking for an explanation until it is crystal clear. It is much better to seem foolish by asking questions than to be foolish by not having the answers.

Codes of conduct

The apathy of most shareholders has allowed company boards so much latitude that they seemed beyond reasonable control. To fill this vacuum the City has produced a series of codes of conduct to guide directors on best practice. The latest of those, the Hampel Report (following the Cadbury and Greenbury Reports), which is backed by the Stock Exchange, suggested for instance, that:

- the task of chairing the board and the work of chief executive should be separate;
- directors should stand for re-election every three years;
- board members should not have a service contract of more than two years;
- a third of the board should be non-executives who should be independent of the company;
- shareholders should be told at least 20 days in advance of an annual general meeting;
- when raising new capital the company should give existing investors first refusal;
- any questions not answered at the annual general meeting should get written answers soon afterwards.

Takeovers

Usually, you say thank you very much. Bids for companies are almost invariably well above the price of the shares just before the bid, so shareholders benefit. On the other hand, what may well have tempted a predator is precisely that the price was standing way below any rational basis of valuation, for instance the net asset value, so it would be worth buying a business just to sell off its assets at a profit. In that case it is worth resisting, if only to get a better price.

Sometimes the offer is resisted fiercely by the target company, and the scheme for some inverted reason is then called a 'hostile takeover'. The defence usually says the bid is unwelcome and opportunistic as it undervalues the company's prospects, and the company could perform far better on its own, given the chance. The private shareholder cannot tell whether this opposition is motivated by a desire for independence, a fear of directors' losing their jobs, an attempt to get the bidder to increase the price, or a genuine feeling that shareholders would do better with the existing regime. It is, however, worth remembering that the directors' legal duty is to act in the best interests of shareholders.

The decision is made even more complicated if the offer is wholly or in part in the form of the bidder's shares. The choice is then cluttered with other considerations such as whether one wants those shares, whether the valuation of the buyer's equity is fair or realistic, and whether selling might crystallize an unwelcome capital gains tax liability.

The takeover process is monitored by the City Takeover Panel, which has no power, legal or otherwise, but manages to have its way because all the City people support it. So anybody who tries to flout its rulings would be ostracized, and once frozen out of the financial community doing business would be impossible. Being non-statutory also gives the panel the signal advantage of being able to act quickly. Moreover, it can tell participants it does not like the way they are acting – it has been known to reprimand people not for failing to follow the letter of the City Code but for neglecting its spirit. In addition it can take instant action to change the Code when a loophole has been discovered.

The panel charges offer documents and related papers of over £1 million between 0.2 per cent and 11 per cent. It also charges savers to supervise companies at £1 on share deals of over £10,000 which is collected for the panel by stockbrokers.

It can be almost as good to own shares in a company that is in the same sector as a highly publicized acquisition. As soon as one estate agent, retailer, computer assembler, brewer or whatever has been bought, the market usually assumes a ripple of parallel acquisition activity will overtake its competitors. Their shares jump as a result. Since the flurry of copycat activity rarely materializes, especially once the targets have become expensive, it may then be a good time to sell.

Insolvency

Investing in shares is risky. There is no way of getting away from this. One of the reasons the stock market produces a higher average return than, say, putting the money into a building society or a bank savings account, is to offset this danger by compensating investors. But note the word 'average'. Some shares are more risky than others and, short of buying into hundreds of companies, the investor will be involved in shares that are a mixture: some are a success – if lucky, some of those spectacularly so; some are pretty ho-hum performers; and some, rarely, are complete collapses.

Occasionally collapses are signalled well ahead. The shares show a steep and pretty continuous slide, and the statements from the company mix profit warnings with promises of restructuring, refinancing, searching for alliances, appointing new executives and new policies on the way. This usually ends in a suspension of dealings in the shares, a move that is commonly said to be to help shareholders. Pure bunkum: it is a complete disaster for shareholders who cannot therefore sell shares at any price to rescue even a tiny portion of their investment money. The people it helps are the stock market traders who are fearful of dealing without adequate information and cannot face being swamped by people stampeding out of the company.

Companies seldom return from that sort of suspension. There are other reasons for suspension, such as during the final stages of a major acquisition, but those really are benign and are to prevent total market chaos when there is not enough known about the deal details to set a fair price. But being suspended because the company has run out of money offers few roads back.

By the time the shares are suspended they are seldom worth more than a few pence in any case. But not all collapses are so well signposted. Are there any more covert signs of impending doom that canny shareholders may be able to spot? Many people have tried drawing up signs, including Britain's top liquidator in the 1960s, Bill Mackie. The specifics of his warning signals, including flamboyant headquarters and profligate top management, may now seem dated, but the underlying principles are still sound. We may no longer have flagpoles and tanks of tropical fish but there are plenty of other loud signals that the organization thinks appearance more important than efficiency.

Investors should be monitoring the business and how it is managed. Profit margins are a good sign, so one should check whether they are as high as they were and at least as great as those at other similar companies, and whether the business is generating sufficient cash for its needs and ambitions. When external money is being raised through loans, rights issues and the like, it should be for expansion rather than baling out the current problems. Accounts being late or fudged, lack of information on auditors' qualifications, suggestions of window-dressing in the accounts and extremely sophisticated financial dealings are causes for concern.

With small businesses, most of that does not apply and you have little recourse but to judge by the managers. The point about small businesses is that the profit can be spectacular but the collapses sudden.

When a company's share dealings are suspended, that is commonly a sign that the company's managers, bankers and set of insolvency accountants are going into confab. One route is for the company to try for a voluntary arrangement under which its creditors hold off knocking bits off the corporate structure to sell as a way of recovering their money and allow it to try trading out of its problems. Courts can appoint an administrator who also continues to trade and holds off creditors.

Another route is taken by secured creditors, normally the banks, which have run out of patience with the company's excuses and are worried their loans could soon become irrecoverable. They appoint a receiver with the sole task of keeping the business going just long enough to recover the banks' money. Tax authorities have also been pretty active in this route to make sure their money is paid. Occasionally the directors ask for the appointment because they can see a default on debts looming or because they are in danger of 'overtrading', which is the criminal offence of continuing in business once the company is insolvent. A specialist accountant is then appointed and moves in to run the business briefly to extract some money or sell assets for paying the debt. In theory the administrator then moves out and the company reverts to business as usual. That seldom happens in practice because the receiver's task entails selling off the assets against which the money was lent, or trading long enough to generate the cash to pay off the loan. That usually does not leave much, and the company is often passed to a liquidator.

As that name implies, the liquidator's job is to turn anything saleable into something more liquid like cash. Fire sales like that seldom produce anything like the book value of assets.

In all of these procedures there is a hierarchy of creditors, and the holder of ordinary shares stands at the back of the queue. The government takes its taxes off the top, and is followed by secured lenders with a claim on the property and employees, and the banks with other guarantees. Then there are bond holders and owners of preference shares. Once all these people have had their take there is seldom anything left for the holders of ordinary shares.

The one comforting thought is that relatively few quoted companies do actually go bust. And if your investment happens to be one of them, try and look for the silver lining: you can cash in some really profitable investments and set off the capital gains against the losses on the crashed company.

Chapter Twelve
Tax

It is galling that the government takes another slice on dividends and capital gains after it has already charged additional tax on investing taxed income. But reconcile yourself with the thought that at least you have profits to be taxed.

Tax is always complicated, and huge manuals have been written on how to cope or get the best deal possible to frustrate the efforts of HM Revenue & Customs (HMRC). This chapter represents the merest skimming of the surface and is generalized as these things change continually.

Governments have tried to steer us towards some investment vehicles by tax incentives because they think they would be good for us or for the country. It would be foolish not to take advantage of any extra benefits provided by the tax office, but it would be just as silly to invest purely for the tax break. This is especially so as the management fees for some schemes need careful scrutiny to test whether the deal is still worth it after the professionals have had their share of the cream. So weigh the alternatives and go for the one that is best, judged by your personal criteria, and only go for the savings in tax if the investment would have made sense without them.

Governments are rather good at taking money off us. There is not only tax on getting into shares – called 'stamp duty' – but also on the benefits from most kinds of investment, both on the income and the capital appreciation. Dividends, including scrip issues (see Chapter 11) and bonus shares, count as income and therefore are subject to Income Tax. Most companies pay dividends net of tax.

HMRC publishes some useful booklets on tax, including one on capital gains tax (CGT), available from all tax offices.

Dividends

Dividends on shares are almost invariably paid net of tax and the voucher that comes with the payment notification contains details of a tax credit. People who do not normally pay Income Tax cannot reclaim the tax already paid on the dividend. Those who pay tax at the basic rate need pay no further tax on the income. But people paying tax at the higher rate have to pay at 32.5 per cent of the gross, though the credit detailed in the slip is set off against this. This means that the higher-rate taxpayer will, in effect, pay top rate of tax on the gross dividend paid by the company. This complicated way of handling things means that about a quarter of the net dividend is due in tax for higher-rate payers.

So, for instance, someone owning 400 shares in Quilp & Heep Intercontinental, which pays a 15p dividend, would get a cheque for £60. Since the tax credit is 10 per cent, this represents 90 per cent of the gross dividend, which would have therefore been £66.66 (60/90 × 100). As a result, the tax credit notified with the cheque would be £6.66. Payers on the standard rate of tax are then all square, but payers at the higher rate, obliged to pay 32.5 per cent of the gross, must now calculate 66.66 × 32.5/100, which works out to £21.66. Setting off the £6.66 already paid leaves a liability of £15 to be sent to HMRC.

Scrip issues of shares in lieu of dividend (see Chapter 11) are treated in a pretty similar fashion. There is no additional tax due for people on the standard rate, and those paying the higher rate are assumed to have had a 10 per cent tax credit.

If the company buys back shares, the money received is treated as a dividend – covered by Income Tax, not CGT.

Capital profits

A profit on the sale of shares is liable to tax for profits above the basic tax-free allowance. This is a pretty handsome chunk as far as most small investors are concerned. CGT is a problem only for people dealing in largish amounts or who have really struck it lucky with one of their stocks. In other words, if the profit is so great that CGT is due, you have done so well that a bit for the exchequer seems less painful. Windfall shares received from demutualized building societies or insurance