Department for Business Innovation & Skills

Practical and legal issues related to limiting the rights of short-term shareholders during takeover bids

Note of BIS roundtable

OCTOBER 2014

BIS Roundtable: Practical and legal issues related to limiting the rights of short-term shareholders during takeover bids

Executive Summary

1. The House of Commons' Business, Innovation and Skills Select Committee conducted an inquiry into the Kay Review, culminating in a report in July 2013. The report included a recommendation that Government study the feasibility of a policy to restrict the role of short-term shareholders during a takeover bid.
2. In its response to the report, the Government indicated support for the objective of ensuring that the interests of those seeking short-term returns from a merger or acquisition do not override the long-term interests of the companies involved. However, we made clear that, while not opposed in principle to such a policy measure, our analysis had identified significant practical obstacles. Our conclusion was that such a measure would be both practically difficult to introduce and largely ineffective in achieving this objective. We published a summary of this analysis as part of the Government response. This is available at: http://www.publications.parliament.uk/pa/cm201314/cmselect/cmbis/762/76206.htm
3. Additionally, the Government response also included a commitment to test this analysis further by inviting comments from interested parties and convening a roundtable of expert stakeholders.
4. We invited a variety of expert stakeholders, seeking to ensure a full range of views were represented. A list of those who attended, and those who were invited but were unable to attend, is at **Appendix 1** below.
5. Our approach to the meeting was to seek to define the disenfranchisement measure specifically, and then focus on whether and how such a measure could work in practice. The meeting explicitly set aside as far as possible the question of whether such a measure would be desirable.
6. Overall, the discussion reached a broad consensus, in line with the Government's previous analysis, that:
    - there were a series of legal and technical implementation issues which would be extremely difficult to overcome;
    - the practical consequences and impacts of a disenfranchisement measure risked being at best ineffective and at worst damaging; and
    - it appeared unlikely that a disenfranchisement measure would eliminate the influence of short-term shareholders in a takeover bid.
7. Further details of our approach to the roundtable, and a summary of the discussion and the conclusions reached, are set out overleaf.

Our approach to the roundtable

8. For the purposes of the roundtable discussion we set aside the question of whether or not it would be desirable to disenfranchise, or otherwise restrict, the powers of short-term shareholders. Instead we focussed on whether and how such a measure could work in practice. Our goal was to seek to identify the obstacles and issues which might emerge and determine the extent to which these might be overcome.
9. In order to provide a clear focus for the discussion, we defined the measure as follows:

> A legislative mechanism to specify that, from the commencement of an offer period, shareholders' ability to influence the outcome of a bid, or to vote on a scheme of arrangement resolution, would be limited to those rights which they held at the offer period commencement date.
>
> Any shares sold after that point would result in the loss of the voting rights attached to those shares for those purposes. Any shares purchased after that point would not have voting rights for those purposes for the duration of the offer period.
>
> Accompanying rules would need to be written which might reasonably exempt certain types of transactions, such as the recall of lent stock, transfers of shares in wills and from trusts, etc.

10. We also had suggestions, in advance of the roundtable, that we might also explore the merits of mandating either:
    - the use of qualifying periods on all shares before voting rights (on takeover bids or other matters) accrue to shareholders; or
    - the use of loyalty based ownership structures under which shareholders receive additional voting rights, enhanced dividends or further shares after a certain period.
11. We noted that UK company law is sufficiently flexible to permit these approaches to rewarding long-term shareholding, should companies and their shareholders wish to introduce them. So far there is little demand for, and indeed significant opposition to, such approaches from both companies and investors, at least with respect to publicly traded company equities. In the interests of framing this discussion, we therefore decided to exclude these measures from the roundtable discussion.
12. The roundtable was conducted on the basis that the main points of the discussion would be recorded and made public, but not attributed. Those attending were asked to share their views and expertise in a personal capacity: their views did not necessarily reflect the positions held by their respective organisations.

Summary of discussion

13. The discussion focused in turn on the legal and technical obstacles to the policy measure, as well as the practical consequences and impacts on the actions of market participants. The main points are recorded below.

Legal issues

14. The discussion initially considered whether the defined measure would be compatible with legal requirements for the equal treatment of shareholders. It was noted that such requirements are present in the Takeover Code and the Listings Rules, and are specified in EU law, as follows:

- Article 17 of the Transparency Directive specifies that: "*The issuer of shares admitted to trading on a regulated market shall ensure equal treatment for all holders of shares who are in the same position.*"
- Article 3.1(a) of the Takeovers Directive requires that: *"all holders of the securities of an offeree company of the same class must be afforded equivalent treatment."*

15. There was no clear agreement among the lawyers present on this question. Some argued that it would not be compatible with the requirement for equal treatment. Others expressed the view that the measure could be designed in a way which was consistent with this principle, for instance by providing that all shares of a particular class had a condition attached which limited the rights of those buying such shares after the commencement of a takeover offer period. It was noted that there was a similar lack of consensus among academic and city lawyers more generally, and that any measure would likely be challenged on these grounds, thereby causing uncertainty.

16. It was also noted that many takeovers are in fact effected via a scheme of arrangement under Part 26 of the Companies Act 2006, rather than via a takeover offer. It was agreed, as specified in the definition of the measure, that it would be necessary to apply the disenfranchisement measure in such circumstances as well. This would necessitate changes to the Act.

Technical issues

17. There was broad agreement with the point expressed in the Government's analysis paper that intermediation in shareholding structures was a significant barrier to operating, and indeed enforcing, a disenfranchisement rule. It was agreed that the central difficulty would be the need to identify precisely, at any given time, which shares have been disenfranchised and which shares still carry the right to accept a takeover offer.

18. It was noted that most shares are held electronically via CREST, and normally by a custodian or "nominee" account on behalf of the investor. It is usually this custodian which appears on the register of members of the company. While some investors may hold shares in a segregated account with a custodian, it is more common for shares to be pooled with the shares of other investors in a single omnibus account.

19. This means that it is possible, and indeed frequently the case, that the underlying beneficial ownership in the shares of a company will change without any corresponding change in the share register. It was also noted that an investor may decide to move from one custodian to another, triggering a change of name on the register, despite the fact that the underlying ownership of the shares remains the same.

20. There was also acknowledgement of the point made in the Government's analysis paper that significant problems would arise due to the fungibility of shares: i.e. the fact that UK shares are not individually identifiable.
21. It was noted that the receiving agent normally manages the receipt of acceptances to a takeover offer on a bidder's behalf. In doing so their current practice is to accept the information given to them by custodians. If the measure were introduced they would need to look beyond the custodians to determine who had exercised the right to decide whether to accept the offer, and whether or not that person had acquired that right since the start of the offer period.
22. There was a discussion about whether it was sufficient to identify the asset manager or other intermediary making this decision or whether there would be a need to also identify their clients: the end investors. Some suggested this would be needed, in particular for institutional investors. Others said this simply would not be practical. There was agreement that this demonstrated the difficulties inherent in accurately tracking rights in real time in an intermediated chain.
23. It was suggested that the provisions in Part 22 of the Companies Act, which enable companies to identify those with an interest in their shares beyond those named on the register, might be relevant for this purpose. However it would be necessary to identify who held the relevant interests in shares with complete certainty at any time to ensure that the acceptances received were valid. This would need to be auditable down to a single share because acceptance of a takeover offer would depend on determining whether the 50% + 1 share threshold for a successful takeover had been reached. While the Companies Act provisions were seen as useful for companies to understand and effectively communicate with investors more generally, it was agreed that they did not provide information nearly quickly enough for this purpose.
24. This situation would be further complicated by the fact that, as shares were transferred and thus disenfranchised during a bid, the denominator by reference to which the acceptance condition threshold would be determined would inevitably change during the course of the bid period.
25. Moreover, it was suggested that the measure was too simplistic because it focused only on the market for shares themselves and disregarded equity derivatives, through which investors could legitimately hold an economic interest in those shares. These markets were important for investors seeking to manage risk. Their existence meant that underlying "ownership" (in the sense of "interests" in shares) was often notionally greater than 100% of the share register. This was not an issue provided that the decision of the named shareholder on the register was relied on when managing receipt of acceptance to a takeover offer.
26. It was also pointed out that it was far from straightforward to write rules to exempt certain types of transactions from disenfranchisement, as the definition of the measure proposed. In reality the list of circumstances in which one might reasonably exempt transactions was long. The authorities would, some felt, almost certainly get this wrong, with decisions between different types of transactions being made on a somewhat arbitrary basis. In any case it would add still further complexity to the task of identifying disenfranchised shares in an accurate and timely fashion.
27. Given the incentives on shareholders to avoid disenfranchisement, such a measure would also need to include some sort of system of monitoring and enforcement. It was suggested that this might be achieved by: getting custodians to certify the nature of a

given transaction and whether the shares involved should be disenfranchised; and by strengthening the rules governing disclosures of material shareholding in companies such that separate disclosure would be required of disenfranchised and enfranchised shares. But concern was expressed that self-certification would not be sufficient: some form of regulatory enforcement would probably be needed, as the Takeover Panel would need to be certain that the process of identifying which shares retained the right to accept a takeover offer was accurate and timely.

28. Several of those present argued strongly that at present it would not be possible to accurately and rapidly identify eligible shares, nor oversee and enforce this process. Accordingly it was agreed that the measure would not be feasible without amending the current shareholding system.

29. A number of possible options were discussed to potentially facilitate the task of real-time identification of disenfranchised investors. It was suggested that to make this technically possible it would be necessary to introduce a system of numbered shares. It could also be necessary either to introduce unique identifiers for all legal entities or to prohibit the use of "pooled" accounts by custodians.

30. Some argued that seeking to achieve this level of transparency would be disproportionate. The UK already has relatively high levels of disclosure of beneficial ownership in public companies, given the provisions in the Companies Act and disclosure requirements prescribed in the Takeover Code. At the same time the "name on register" system provides clarity and certainty about the target threshold for a takeover. Even if these options were found to be workable, some argued that problems with uncertainty would remain: fully identifying interests would ultimately be too difficult to do quickly and accurately enough. There was a risk of introducing very costly and complex systems which ultimately achieved very little.

31. Others however suggested that these ideas should be explored further, if not in the context of the specific measure being discussed, then in response to wider problems they had observed with identifying beneficial ownership in the intermediated investment chain. These problems sometimes prevented end investors from exercising their voting, information and other rights, and from engaging with companies.

32. The discussion also touched on whether the measure as defined should apply to all takeover offers, or only where a bid was contested by the target company. Some suggested that its scope should be limited to the latter. Others expressed a strong view that this would be impractical and ineffective, given that the recommendation of the target company board might change during the course of the takeover process.

Practical consequences and impacts

33. There was a wide ranging discussion about how market participants might respond to the measure in practice.

34. Participants broadly agreed that the measure would not necessarily reduce the likelihood of a takeover proceeding on the basis of short-term shareholder interests. Specifically, it was acknowledged that any measure could have unintended consequences such as to:

- prevent existing long-term shareholders, seeking to reject a takeover, from strengthening their opposition by acquiring more shares;
- similarly prevent "white knights" from purchasing shares;

- reduce the demand for a company's shares, which would mean a takeover might be more likely to succeed at a lower price, to the detriment of long-term shareholders;
- reduce the absolute threshold for an offer to succeed, as shares were transferred and thus disenfranchised during a bid; and
- risk concentrating power in the hands of one or a small number of shareholders in the target company. This might reduce the role of takeovers as an effective check on company management, entrenching existing management against the interests of other shareholders.

35. Furthermore, the discussion acknowledged that the measure would be unlikely to be effective in reducing the influence of short-term investors. In some cases, such investors could obtain a speculative position in a company before a takeover bid offer period commenced, and so would not be affected.

36. This prompted discussion of how long shareholders would be disenfranchised. Clearly it would not be reasonable to disenfranchise shareholders indefinitely. However if a bid was unsuccessful, and the shares which had been disenfranchised during that bid were then re-enfranchised, it would be likely that the bidder would be in a position to secure changes to the board of the company and take control. Alternatively they might subsequently make another offer for the company which would likely be successful, given that any previously disenfranchised shareholders would this time retain their right to accept a bid. While it might be possible to change the Takeover Code to extend the time during which a failed bidder was not permitted to "re-bid" for the same company, this could not be done indefinitely.

37. It was also observed that, as it would not be possible to impose (or enforce) the measure on overseas companies it would be simple for companies to avoid it if they wished by incorporating outside the UK.

38. The Government's previous analysis had reached the conclusion that it would be easy for investors to avoid "disenfranchisement", as a measure of this kind would create an incentive not to trade in shares but rather to trade off market in the economic interest in, and control of, the shares. This would be very difficult to police. The discussion acknowledged this point and agreed that this might be done illegitimately by characterising a trade as exempt from disenfranchisement. However it might equally be done legitimately, for instance by arranging for the custodian to internalise the transfer with another investor, via a depositary receipt, or using equity derivatives. Even if greater transparency of underlying investments were introduced it would be very easy to acquire shares on a long settlement date and agree with the seller that they would accept a bid.

39. The overall conclusion of this part of the discussion was that the practical impacts risked being at best ineffective and at worst damaging. Most argued that it would not be sensible to proceed with the measure, because it would be very unlikely to bring about the desired outcome of reducing the influence of short-term shareholders in a takeover bid, and the practical consequences would be undesirable.

Conclusions

40. In view of the legal, technical and practical issues that had been raised, the Chair therefore asked those present to suggest others areas the Government should consider.

41. It was suggested that, rather than limiting rights of short-term shareholders, it would be preferable either to consider relaxing the rules which restrict the actions of company directors to prevent them frustrating a takeover bid, or to increase the minimum threshold of acceptances required from shareholders in the target company. In discussion, neither of these suggestions received widespread support from the group. (Note: The Takeover Panel consulted on the second of these suggestions in 2010 and found significant opposition to it). In addition, as tax rules were also a factor in the outcomes from takeovers it might be useful to further review the incentives they created. But participants also cautioned that care should be taken to ensure that any measures were based on evidence of the impact of takeovers as a whole rather than on concerns arising from a single takeover.

42. Participants also agreed with the Kay Review conclusions that:

- the role of short-term "arbitrageurs" is not the central issue because they can only control shares that others have recently sold to them;
- incumbent shareholders are often willing to accept offers, even if they believe the offer price does not represent the long-term value of the shares, because they are too often focussed on short-term relative returns;
- the best means to prevent this is to encourage more asset managers and institutional investors to adopt investment approaches based on stewardship and the pursuit of absolute long-term returns.

43. There was general support for work to follow up on the Kay Review, and particularly for the focus on encouraging equity investors with long time horizons to embrace stewardship, and clarification of the law on fiduciary duties in the investment chain. Stewardship was characterised as a focus on companies' capacity to deliver value over the long-term, through more effective engagement between investors and companies in support of that goal underpinned by relationships based on transparency and trust. This approach would mean progress was gradual rather than immediate. But this was preferable to legislation such as the measure discussed.

44. A number of those present also returned to issues around underlying investors, notably whether the use of pooled accounts and delegated voting via custodians in an intermediated investment chain prevented them from exercising effective stewardship and engagement.

Appendix 1:

Chair:

Richard Carter	Director, Business Environment, Department for Business, Innovation and Skills

List of those attending:

Peter Butler	Founder Partner, Governance for Owners
Peter Clark	Capita Asset Services / ICSA Registrar's Group
Alastair Cowie	Assistant Director, Corporate Governance, Department for Business, Innovation and Skills
Charles Crawshay	Deputy Director General, The Takeover Panel
John Dawson	Head of Investor Relations, National Grid / Chair of the Investor Relations Society
Peter Evans	Deputy Director (Legal), Department for Business, Innovation and Skills
Matthew Fell	Director for Competitive Markets, Confederation of British Industry
Daniel Godfrey	Chief Executive, Investment Management Association
Jane Hanrahan	Deputy Director (Legal), Financial Services Reform and Stability, HM Treasury
Robert Hingley	Director of Investment Affairs, Association of British Insurers
Christopher Hobley	Deputy Director, Corporate Governance, Department for Business, Innovation and Skills
Simon Howard	UK Sustainable Investment and Finance Association
Alexander Justham	CEO, London Stock Exchange plc
Prof. David Kershaw	Professor of Law, London School of Economics
Jiri Krol	Deputy CEO, Head of Government and Regulatory Affairs, Alternative Investment Managers Association
David Lawton	Director of Markets, Financial Conduct Authority
Melanie McLaren	Executive Director, Codes and Standards, Financial Reporting Council
Prof. Scott Moeller	Director of the M&A Research Centre, CASS Business School
Peter Montagnon	Professor Corporate Governance, CASS Business School
Dr. Tunde Ogowewo	Professor of Law, King’s College London
James Palmer	Chair FCA Listing Authority Advisory Committee
Will Pomroy	Head of Corporate Governance, National Association of Pension Funds

Philip Robert-Tissot	Director General, The Takeover Panel
Peter Swabey	Policy & Research Director, Institute of Chartered Secretaries and Administrators
Lara Thomassen	Policy Adviser, Confederation of British Industry
Tim Ward	Chief Executive, Quoted Companies Alliance
Richard Ufland	Law Society Company Law Committee
William Underhill	Chair of the City of London Law Society Company Law Committee
Janet Williamson	Senior Policy Officer, Trades Union Congress
Sarah Wilson	CEO, Manifest

Apologies:

Peter Cadbury	Corporate Finance Adviser
John Clayton	Senior Business Development Manager, CREST
Ben Mathews	Member of the Executive Committee of the GC100 (Association for the Company Secretaries and General Counsels of the FTSE 100 Companies / Group Company Secretary of HSBC Holdings plc

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