Department for Business Innovation & Skills

EMPLOYEE OWNERSHIP & SHARE BUY BACKS

Implementation of Nuttall Review - Recommendation V: Government response to consultation

FEBRUARY 2013

Contents

Executive Summary

(i) Evidence suggests that employee owned businesses are more resilient in tough economic times and provide benefits to employers and employees. Graeme Nuttall, one of the foremost experts on employee ownership, published an independent review in July 2012 that set out a framework for removing barriers to increase the take up of employee ownership. At the end of October 2012 the Government published its response to the Nuttall Review, accepting wholly or in part all 28 of its recommendations.

(ii) One of these recommendations was for the Government to consult on improving the operation of internal share markets to support companies using direct share ownership.

(iii) The Employee Ownership and Share Buy Backs consultation, held between 30 October and 16 November, sought views on proposals to:

- lower the requirements for shareholder authorisation of off-market buy backs of a company's own shares from special resolution (requiring over 75% approval) to ordinary resolution (over 50% approval);
- allow private limited companies to pay for its own shares by instalments;
- allow private limited companies to hold shares it buys back in treasury and to treat them as treasury shares.

(iv) The consultation also sought evidence on the cost of compliance with existing regulations and the benefits of changes to the regulations on holding shares in treasury.

(v) The majority of the responses agreed with the consultation proposals. There was also support for the following additional proposals to:

- allow for companies to approve in advance multiple off-market buy backs via a single ordinary resolution, where these are connected to an employee share scheme;
- introduce a simplified regime (solvency statement and special resolution) for enabling private limited companies to finance buy backs connected to an employee share scheme out of share capital;
- allow private limited companies to finance the buy back of shares using small amounts of cash that does not have to be identified as distributable reserves; and
- allow all companies limited by shares (including private and unlisted public companies) to hold their own shares in treasury.

(vi) The Government has accepted these additional proposals and will enact secondary legislation to make the necessary changes to the Companies Act 2006 in 2013.

(vii) A Post Implementation Review, due three years from enactment of this legislation, will review: the effectiveness of these changes; whether there have been any adverse impacts; whether there is scope for further changes; and any evidence of monetised or non-monetised costs or benefits.

Introduction

1. The independent Nuttall Review of employee ownership set out the economic and social benefits achieved by employee owned companies, and made recommendations to Government on removing barriers to increase the uptake of employee ownership in the private sector.

2. The Nuttall Review set out two basic models for administering employee ownership: direct share ownership – where employees hold shares in the company; and indirect share ownership – where an employee trust is established to hold shares in the company on behalf of the employees.

3. Companies using direct share ownership will often seek to buy back shares from employees who are leaving or who have left the company in order to re-distribute them to new employees or new joiners to the share scheme and to avoid the risk that over time shares earmarked for allocation to employees become predominately owned by former employees or others outside the company.

4. Buy back arrangements are discretionary and depend on the departing shareholder (the seller) and the company (the buyer) mutually agreeing a price and/or arrangement. Once a buy back is agreed, companies must comply with a number of Company Law provisions that regulate the process.

5. The Nuttall Review concluded that these provisions are overly burdensome, and recommended that Government simplified them in order to remove barriers and disincentives to direct employee ownership.

6. Specifically, the Review made the following recommendation to Government: “Recommendation V: The Department for Business, Innovation and Skills should consult upon the operation of internal share markers to support companies using direct share ownership, including holding private company shares in treasury and facilitating share buy backs.”

7. The Government, having accepted this recommendation, held a consultation to obtain views and evidence on: the extent to which the Company Law rules on buy backs were an impediment to employee ownership; changes to the rules on the authorisation and financing of share buy backs, the holding of shares in treasury; the costs of compliance with existing regulations and potential benefits of being able to hold treasury shares for subsequent re-issue (rather than having to cancel these shares and issue new ones); and potential problems or unintended consequences.

8. The Consultation period lasted from 30 October to 16 November 2012. The Consultation was launched alongside the Government response to the Nuttall Review, with the consultation paper, the response form, draft impact assessment, and the draft Statutory Instrument available on the BIS website. Graeme Nuttall also actively promoted the consultation at the Employee Ownership Association Conference on 15 November 2012.

9. The consultation received 48 responses. This document is the summary of the consultation responses received and Government’s formal response to the consultation.

Summary of Responses

10. The consultation received 48 responses. Of these, 25 responses included a completed response form, 6 responses contained detailed comments on some or all of the consultation questions, and 17 responses signalled support for the proposals, the Nuttall Review, or the focus on employment on Employee Ownership.

11. The respondents included a number of legal representatives and other intermediaries involved in accountancy, insurance, consultancy, and share plan or investment fund management. There were also some responses from business representatives and trade bodies and from individuals and businesses, many of which appear to be employee owned. There was insufficient information provided in the responses to provide a more meaningful breakdown by company size.

12. Below is a breakdown of the responses to each of the questions, a summary of the comments and submissions, and the Government responses. The questions are mostly grouped by category. As questions 2, 6 and 12 each ask for estimates of costs or benefits they are summarised together in the Costs and Benefits section.

Question 1: Do you agree that Company Law regulations on share buy backs and treasury shares can act as an impediment to further uptake of employee ownership? If so, to what extent?

<u>Commentary</u>

13. The prevailing view was that the Company Law regulations on share buy backs and treasury law can act as an impediment to increase take up of employee ownership, at least to some extent. Many of the respondents to this question referred to the complexity of the regulations and bureaucracy involved in buying back shares, and the costs involved in establishing and maintaining an Employee Benefit Trust (EBT) as being significant disincentives to buying back shares from departing employees or undertaking employee ownership at all.

14. However, one respondent considered that it was easy to set up an EBT, and another took the view that requiring employees to relinquish shares on departure was more about remunerating employees than genuine ownership.

Authorisation of Buy Backs

Question 3:

a) **Do you agree that allowing private companies to arrange share buy backs should be subject to an ordinary resolution rather than a special resolution?**

	Yes	No	Not Sure	No Option Ticked	Total
Number	**18**	4	3	0	25
Percentage	**72**	16	12	0	100

b) Would this change simplify the authorisation process, help remove unnecessary costs, and make employee ownership easier to administer?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**18**	2	4	1	25
Percentage	**72**	8	16	4	100

Question 4: Do you agree that this proposal provides shareholders with adequate oversight and discretion over the activities of companies in the respect of share buy backs?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**20**	3	1	1	25
Percentage	**80**	12	4	4	100

Question 5:

a) Are there any potential issues or unintended consequences that could arise from implementing this proposal?

	Yes	No	Not Sure	No Option Ticked	Total
Number	7	8	8	2	25
Percentage	28	32	32	8	100

b) Are there more effective alternatives?

	Yes	No	**Not Sure**	No Option Ticked	Total
Number	5	5	**12**	3	25
Percentage	20	20	**48**	12	100

Commentary

15. There was general agreement with the proposal that it should be possible for the authorisation of share buy backs by private limited companies to be subject to approval by ordinary resolution rather than special resolution.

16. Some respondents did express a preference for retaining the requirements for approval by special resolution citing concerns about possible implications for corporate governance particularly with regard to minority shareholders who could be out-voted by majority shareholders if the threshold for shareholder approval was lowered.

17. To mitigate this concern it was suggested that there should be an ‘enabling’ or ‘opt in’ special resolution which would approve the transition to future approvals by ordinary resolution.

18. Other respondents stated their preference for use of EBTs as a means of managing the transfer of shares to and from employees.

19. It was also mentioned that due to Association of British Insurers (ABI) rules in practice many publicly listed companies require approval by special resolution rather than ordinary resolution as permitted by the Companies Act for market purchases.

20. Overall the proposal for authorisation by ordinary resolution was welcomed as a deregulatory step and it was felt that the remaining protections for shareholders and creditors such as director's duties and the ability for shareholders to alter the Articles of Association were sufficient.

21. A number of respondents also pointed out that this change, while welcome as a deregulatory step, would not in lead to significant costs savings to individual businesses. The cost for holding a shareholder resolution is not usually greatly different between those where the threshold for approval is a simple majority or over 75%.

22. Instead a real benefit to businesses seeking to buy back shares would be to not require approval of each contract individually. It was proposed that private limited companies should be allowed to approve in advance buy backs by ordinary resolution in the same way that public companies can. In such cases the ordinary resolution sets the conditions under which shares may be bought back subject to a maximum number of shares, price range and within a set maximum time period (statutory maximum of 5 years).

23. Another proposal was to allow resolutions at short notice by removing the requirement for each contract to be on display for 15 days prior to approval (or circulated contemporaneously with any written resolution that purports to grant approval).

24. Respondents expressed mixed views on whether or not there could be potential problems or unintended consequences, or more effective solutions could be available.

<u>Government response</u>

25. Having considered the responses the Government intends to proceed with the consultation proposal of lowering the threshold required to approve a shareholder resolution by a private limited company to buy back shares to ordinary resolution. We remain of the view that there are sufficient safeguards to protect shareholder interests.

26. In addition, the Government sees merit in creating a more level playing field with public companies by extending the ability to authorise in advance multiple share buy back contracts to private limited companies. However, we propose to limit this measure to private limited companies engaging in buy backs connected to an employee share scheme.

27. In deciding to proceed with proposals to allow for authorisation of multiple buy backs in connection with an employee share scheme the Government has determined that the current notice periods for displaying resolutions should be retained in the interests of transparency for shareholders.

Financing of Buy Backs

Payment by Instalments

Question 7: Do you agree that payments by instalments are:
a) A useful flexibility for companies?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**25**	0	0	0	25
Percentage	**100**	0	0	0	100

b) An acceptable risk for general creditors

	Yes	No	Not Sure	No Option Ticked	Total
Number	**23**	0	1	1	25
Percentage	**92**	0	4	4	100

c) An acceptable risk for selling shareholders?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**21**	0	3	1	25
Percentage	**84**	0	12	4	100

Question 8:
a) Do you agree that the maximum time period over which payments may be made should be solely a matter of negotiation between the buying company and the selling shareholder?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**18**	0	5	2	25
Percentage	**72**	0	20	8	100

b) Or should a maximum time period be specified in statute?

	Yes	**No**	Not Sure	No Option Ticked	Total
Number	2	**16**	5	2	25
Percentage	8	**64**	20	8	100

Commentary

28. The general consensus was that the ability to pay for bought back shares by instalments would be a useful flexibility particularly for smaller companies who, while otherwise solvent, may struggle to afford to buy back shares in full on purchase. Payment by instalments was deemed to be an acceptable risk to creditors and selling shareholders, with some respondents suggesting that this should not be limited to employee share schemes.

29. Some respondents did express concerns about: the relative bargaining position of the selling shareholder vis à vis the board; how valuations would be arrived at, including whether an independent valuation should be required; whether the departing shareholder should be entitled to receive interest and whether to set a default rate of interest; and the ranking of debt in the event of insolvency.

30. There was very little appetite for imposing statutory maximum time limits for completing such payments, except as a possible long stop to protect selling shareholders. Where a maximum period was mentioned it ranged from 2 to 10 years with most such responses stating 3 to 5 years. Others pointed to practical difficulties in imposing and policing such limits, for instance what would happen should the company fail to complete the payments within the statutory period or both parties agree a time period that exceeded the statutory maximum. Several respondents pointed out that there is no time limit for the redemption of shares and accordingly there should be no set limit for payment by instalment.

<u>Government response</u>

31. Having considered the responses the Government proposes to allow private limited companies the flexibility to pay for bought back shares by instalments where the buy back is in connection with an employee share scheme. In doing so, we emphasise that the use of payment by instalments requires the agreement of both the selling shareholder and the company, either at the time of sale or as defined in the contract at the time issued or in the Articles of Association.

32. We expect that payment by instalments will be used in circumstances where a company would find it difficult to pay for bought back shares upfront, rather than this method becoming the default position for buying back shares.

33. The Government does not have reason to believe that companies that may use the option to pay by instalments in connection with an employee share scheme are at any greater risk of acting unfairly towards its departing employees or of becoming insolvent than other companies.

34. For these reasons we expect that companies will put in place sensible arrangements for agreeing valuations, interest payments if applicable, and payment schedules, and do not intend to put in place time limits for completing payments.

Greater range of financing options

Question 9: Are the current financing restrictions an unreasonable limitation to companies seeking to buy back shares for the purposes of an employee share scheme?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**17**	3	5	0	25
Percentage	**68**	12	20	0	100

Question 10: Do you agree that the current restrictions be removed without issues or unintended consequences for the remaining shareholders?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**16**	2	5	2	25
Percentage	**64**	8	20	8	100

Commentary

35. Most respondents found that the current restrictions are an unreasonable limitation and could be removed without unintended consequences for remaining shareholders.

36. For those respondents who consider that the current rules are justified and should be retained, their concern lay around the removal of protections for shareholders and creditors in allowing shares to be financed out of capital without shareholder approval, in particular approval by special resolution.

37. Others took the view that the procedure introduced by the Companies Act 2006 for private companies to reduce their capital based on a solvency statement could provide the means by which a company could purchase its own shares where it has no or insufficient distributable profits and no ability to make a fresh issue of shares. This will mean that companies no longer have to provide an auditor's report where they wish to use capital.

38. Another respondent put forward a proposal for a 'de minimis' exemption from the source of funds requirements for a buy back and/or redemption of shares. This would introduce a general exception in relation to both buy backs and redeemable shares where shares are bought back either: (a) at par value, or (b) for a total amount (in a defined period, say, a financial year) less than, say, £15,000. In such cases there would be no need for any of the three sources of finance (distributable profits, fresh issue of shares, or capital) to be identified in such situations.

39. This respondent explained that this 'de minimis' proposal will benefit small companies that might not wish to establish an EBT, and other companies, such as public service mutuals, with large numbers of employees holding low value shares, could buy in shares without having to wait for or identify distributable profits.

Government response

40. The Government proposes to take forward the proposal to allow private limited companies seeking to buy back shares in connection with an employee share scheme to finance the purchase out of capital through the simplified regime that applies to the general reduction of capital. This will enable such buy backs out of capital to occur subject to approval by special resolution supported by the signing of a solvency statement. At present the requirements are for provision of a director's statement and auditors report; approval by special resolution; public notice of proposed payment; and for the directors' statement and auditor's report to be available for inspection. However, private limited companies undertaking such buy backs may choose to continue with the existing regime if that is preferable.

41. The Government proposes to take forward an amended version of the 'de minimis' proposal. This will allow private limited companies seeking to buy back small amounts of shares – the lower of £15,000 or the equivalent of 5% share capital in any financial year – without having to specify that the cash is from distributable profits, and where there is provision in the company's Articles of Association to do so. We judge that these thresholds are low enough to pose little or no risk to shareholders or creditors but still allow smaller companies in particular greater flexibility to finance share buy backs. Where there is currently no such provision in a company's Articles of Association, shareholder approval by special resolution will be required to enable these transactions to take place.

42. The Government believes that these proposals are targeted deregulations of the requirements for financing share buy backs which also retain adequate controls to remain in place to protect shareholders and creditors by maintaining the need for approval by special resolution.

After Share Buy Back (Treasury Shares)

Question 11: Do you agree that private companies should be able to hold shares in treasury?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**22**	1	1	1	25
Percentage	**88**	4	4	4	100

Question 13: Do you agree that shareholders will have sufficient oversight over private companies if they are able to hold shares in treasury?

	Yes	No	Not Sure	No Option Ticked	Total
Number	**20**	2	3	0	25
Percentage	**80**	8	12	0	100

Commentary

43. The proposal to allow private limited companies to hold shares in treasury was generally welcomed. Many responses also suggested that all companies including unquoted public companies should also be allowed to hold treasury shares. It was pointed out that most other EU countries already allow private limited companies to hold shares in treasury.

44. Although one respondent noted that if all private companies are allowed to buy back shares and hold in treasury (irrespective as to whether it is pursuant to an employee ownership scheme) then further thought would be needed surrounding the statutory pre-emption provisions on the sale of treasury shares and whether transitional arrangements would be required.

45. Other respondents suggested that if private companies are allowed to buy back shares and hold in treasury one or more of the following should be required: a shareholder

resolution; annual director's statement; or ABI Investor Guidelines 'headroom' limits and other Listing and AIM rules which some listed companies are complying with. Indeed some of those in favour of the proposal suggest that the same protections as those for public companies should be applicable to private limited companies e.g. must appear in register of members, restrictions on the use of shares whilst in treasury and the way in which they can be sold out of treasury.

Government response

46. The Government plans to allow private limited companies and un-listed public companies to hold its shares in treasury, on a similar basis as permitted public companies already do. In effect, all companies limited by shares will be able to hold its own shares in treasury and to deal with such shares as treasury shares.

Costs & Benefits

Question 2: What estimate do you make of the time or cost of complying with this regulation in your company / the companies you represent; or of operating alternative arrangements such as an employee trust?

Question 6: What estimate do you make of the time or cost of complying with this regulation in your company/ the companies you represent, or of operating alternative arrangements such as an employee trust?

Question 12: If you agree that it would be helpful for private companies seeking to administer employee ownership to have an ability to hold shares 'in treasury', can you estimate the extent of this benefit?

	Yes	No	**Not Sure**	No Option Ticked	Total
Number	8	4	**10**	3	25
Percentage	32	16	**40**	12	100

Commentary

47. Relatively few of the respondents were able or willing to provide an estimate of costs in response to one or more of the three cost related questions above. Those responses received indicated that the costs of operating an employee owned trust could typically range between £2,000 and £10,000 per annum and in one case as much as £20,000 per annum.

48. As a number of respondents pointed out that these costs are greatly variable depending on the size of business, the scale of share scheme, the distribution of shares amongst employees, the turnover of staff, and therefore the quantity of shares to be repurchased at any period of time.

Government response

49. The consultation yielded insufficient information to provide a detailed estimate of the financial costs or benefits of the consultation proposals. The figures reflect potential savings should an employee owned business switch from indirect employee ownership through an EBT to a direct form of employee ownership.

50. It is not possible to estimate any costs or benefits associated with a non employee owned business taking up direct employee ownership.

51. Given the deregulatory and voluntary nature of the proposals we anticipate no major costs will result from compliance, and any familiarisation would be small.

Next Steps

Proposed legislative changes

52. The Government intends to amend the Companies Act 2006 by secondary legislation to implement the proposals outlined below. These measures will come into force during 2013.

53. In relation to authorising share buy backs these amendments will:
    - Allow off-market share buy backs to be authorised by ordinary resolution; and
    - Allow for the prior approval of multiple off-market share buy backs for the purposes of or pursuant to an employee share scheme to be authorised by a single ordinary resolution.

54. In relation to financing share buy backs these amendments will:
    - Allow private limited companies to pay for its own shares in instalments (where the buy back is for the purposes of or pursuant to an employees' share scheme);
    - Allow for private limited companies to finance buy backs (for the purposes of or pursuant to an employee share scheme) out of capital subject to the signing of a solvency statement by the board of directors and shareholder approval by special resolution; and
    - Allow private limited companies to the buy back shares using small amounts of cash (an amount not exceeding the lower of £15,000 or the cash equivalent of 5% of share capital in any financial year) that does not have to be identified as distributable reserves.

55. In relation to treasury shares these amendments will:
    - Allow for all companies limited by shares to hold their own shares in treasury and to deal with such shares as treasury shares.

Post Implementation Review

56. The Government intends to conduct a Post Implementation Review of the above changes three years after enactment. This review will consider the following:

    - Whether allowing authorisation of share buy backs by ordinary resolution, and in the case of buys backs in connection employee share schemes allowing prior authorisation of multiple buy backs has had any adverse consequences, and also whether there is a case for allowing short notice resolutions;

    - Whether allowing payment by instalments has been used appropriately, or whether departing shareholder and creditors have been disadvantaged, and whether further legislation is required to remove or regulate this provision;

    - Whether the proposals for simplifying the requirements for financing buy backs out of capital, and for deregulating the buy back of small amounts of shares have been effective; and

- Whether there have been any adverse impacts from extending the ability to hold treasury shares to all limited companies, and whether there are any merits in allowing shares bought back out of capital or from fresh issue to be held as treasury shares.

57. The review will also look at any available evidence of monetised or non-monetised costs or benefits from the changes that have been made.

Annex A – List of questions in the consultation document

1. Do you agree that Company Law regulations on share buy backs and treasury shares can act as an impediment to further uptake of employee ownership? If so, to what extent?

Authorisation of share buy backs

2. What estimate do you make of the time or cost of complying with this regulation in your company/ the companies you represent; or of operating alternative arrangements such as an employee trust?

3. Do you agree that allowing private companies to arrange share buy backs should be subject to an ordinary resolution rather than a special resolution? Would this change simplify the authorisation process, help remove unnecessary costs, and make employee ownership easier to administer?

4. Do you agree that this proposal provide shareholders with adequate oversight and discretion over the activities of companies in the respect of share buy backs?

5. Are there any potential issues or unintended consequences that could arise from implementing this proposal? Are there more effective alternatives?

Financing buy backs

6. What estimate do you make of the time or cost of complying with this regulation in your company/ the companies you represent, or of operating alternative arrangements such as an employee trust?

a) Payment by instalments

7. Do you agree that payments by instalments (a) a useful flexibility for companies, (b) an acceptable risk for general creditors, and (c) an acceptable risk for selling shareholders?
8. Do you agree that the maximum time period over which payments may be made should be solely a matter of negotiation between the buying company and the selling shareholder? Or should a maximum time period be specified in statute?

b) Sources of finance

9. Are the current financing restrictions an unreasonable limitation to companies seeking to buy back shares for the purposes of an employee share scheme?

10. Do you agree that the current restrictions be removed without issues or unintended consequences for the remaining shareholders?

After share buy back

11. Do you agree that private companies should be able to hold shares ‘in treasury’?

12. If you agree that it would be helpful for private companies seeking to administer employee ownership to have an ability to hold shares ‘in treasury’, can you estimate the extent of this benefit?

13. Do you agree that shareholders will have sufficient oversight over private companies if they are able to hold shares in treasury?

Annex B – List of respondents (Alphabetical Order)

1. A.G. Parfett & Sons Ltd
2. Aber Instrument Ltd
3. Alistair Sawday Publishing
4. Associated Chemists (Wicker) Ltd
5. Baker McKenzie LLP
6. British Private Equity and Venture Capital Association (BVCA)
7. Capita Registrars
8. Castlefield (Castlefield Investment Partners LLP)
9. Central Surrey Health
10. Circle Health Ltd
11. City Health Care Partnership CIC
12. Confederation of British Industry (CBI)
13. DLA Piper UK LLP
14. Employee Ownership Association (EOA)
15. Field Fisher Waterhouse LLP
16. Freshfield Bruckhaus Deringer LLP
17. Grant Thornton UK LLP
18. Grey Convergence (Grey Consulting Limited)
19. Institute of Chartered Accountants in England and Wales (ICAEW)
20. John Stamford & Associates Ltd
21. Lewis Silkin LLP
22. Macfarlanes LLP

23. Make Ltd
24. Perkins Slade Limited
25. Pett, Franklyn & Co LLP
26. Pinsent Mason LLP
27. Postlethwaite Solicitors
28. PricewaterhouseCooper LLP (PwC)
29. Quintessa Ltd
30. Reward Management Ltd t/a Total Reward Solutions
31. RM2 Partnership Limited
32. School Trends Ltd
33. Scott Bader Company Limited
34. Share Plan Lawyers Group c/o Slaughter & May
35. Sheffield Haworth Ltd
36. Skadden, Arps, Slate, Meagher & Flom (UK) LLP
37. Sunderland Home Care Associated 2020 Ltd
38. Taylor Wessing LLP
39. The Engagement People Ltd
40. The Law Society
41. The Office of Public Management Limited (OPM)
42. TLT LLP
43. Wrigleys Solicitors LLP

44- 48. Responses from individuals

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