Herbert Smith

Mike Penry, Esq.,
Department for Business Innovation & Skills
1 Victoria Street
London SW1H 0ET

Herbert Smith LLP
Exchange House
Primrose Street
London EC2A 2HS

Our ref
2327
Your ref

Date
26th January 2011

Dear Mike,

We are writing this letter of response to the Call For Evidence:

- First, in support of the points made by the City of London Law Society's Company Law Sub-Committee and the Law Society of England and Wales' Standing Committee on Company Law, which we have seen; and

- Second, to identify a limited number of issues on which we have particular views which we wanted to submit to BIS. These relate to:

1. the suggestion of a requirement for an offeror shareholder vote on a takeover;

2. the question of adequacy of disclosure to companies of beneficial holders:

3. the question of whether the UK can do more to facilitate structures for long termism in corporate decisions and shareholder engagement by supporting alternatives to one share one vote structures;

4. some thoughts on shareholder voting; and

5. the question of prohibiting compensation to sacked directors without shareholder approval.

1. Offeror Shareholder Vote (Question 16)

We strongly urge BIS not to pursue this initiative. Our objection has nothing to do with the suggestion that this would make takeovers harder (more "grit" in the system) but rather because we believe it will not work to achieve its intended outcome. In particular:

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- it would in many cases be unlawful if applied generally (see further below);

- it would be irrational to have such a requirement just for public bids: all material transactions are already subject to a sophisticated regulatory regime for UK premium listed companies, requiring shareholder approval for "class 1" and "related party" transactions. It would make no sense to add to the current regime for material transactions an additional regime just focussed on public takeovers in the UK (which are no more likely to be material to shareholders than such transactions in other jurisdictions or for private companies, which are all already regulated by the Listing Rule requirement for shareholder approval for transactions representing 25% of the value, assets or profits of the UK listed company);

- it would fundamentally favour bidders in takeovers, at the expense of target shareholders, by giving bidders a new right to walk away from a takeover bid after launching it (as they would be able to advise their own shareholders to vote down the transaction). That flies against one of the key target shareholder protections (making it hard for bidders to walk away from a takeover offer because of a change of mind); and

- imposing a requirement mainly on UK bidders would just penalise them when competing against non-UK or privately owned bidders.

We believe that these points are not properly understood by supporters of this idea. We would be keen to convey our concerns direct to Ministers if this proposal is sustained, to ensure they at least clearly understand the significance of the problems in such a proposal and the criticisms that we believe it would give rise to, if developed to the next stage.

We refer above to potential illegality of a generally applied proposal: we are concerned that a general application to all bidders, including those from other EU jurisdictions, would infringe EU law as a disproportionate barrier to free movement of capital and an interference in what should properly be matters for the EU state of incorporation of the relevant bidder.

Further, any such requirement generally applied ignores the multiplicity of different ownership structures of bidders, from listed public companies to private companies and from investment funds to sovereign wealth funds, to name a few. A test of shareholder approval is meaningless in substance for many of these, then putting those who would be subject to such a substantive requirement at a competitive disadvantage.

In essence, the issue of protecting shareholders of bidders is, we believe, properly and thoughtfully dealt with by the shareholder approval requirements under the Listing Rules: they represent the longstanding regulatory protection from precisely the concerns raised by proponents of this idea.

2. Disclosure of Beneficial Holders (Question 2)

It is in our view clear that companies have sufficient access to this information. Holders of 3 per cent interests (including derivatives) are required to be disclosed, as are holders of 1 per cent interests during takeover periods. Any other holder can be required by section 793 Companies Act 2006 notice by the company to disclose the nature of its interest. Extending mandatory disclosure further would create significant compliance costs for shareholders (far in excess of costs to issuers

of their section 793 programmes), not justified by the value of such information (which can be obtained if the company serves the relevant notices anyway).

3. Alternatives to One Share One Vote Structure (Question 17)

We have consistently supported flexibility in permitted corporate ownership structures, on the basis that no one structure is consistently superior to others. In comparing legal structures for corporations one needs also to compare practical application in the jurisdictions of those structures: eg, Germany has a form of one share one vote requirement, but many public companies still have controlling shareholders or shareholder blocks.

Ultimately investors will have the strongest influence over preferred structures, but we support the suggestion that alternative corporate models to the one share one vote public company have differing benefits and should not be entirely dismissed, as often as seems to be the case in practice: accordingly, a system allowing flexibility in corporate control structures seems to us the right one. We confirm our view that different voting rights, for example by reference to duration of holding, could be implemented under English law, albeit with some material practical challenges.

4. Shareholder Voting (Question 17)

(a) Mandatory shareholder voting

There has already been much public debate on this issue. Two points we believe are sometimes overlooked, but which are fundamental to any debate on this issue are:

- mandatory voting by "institutional investors" will, we believe, drive mechanical processes for voting, not greater application of judgement or control: this would be counter-productive. In particular we believe it will lead to a tendency for investors just to follow recommendations of self-appointed governance bodies (potentially with their own commercial agendas), and less engaged and thoughtful shareholder/company interaction; there is considerable evidence of such delegation of voting responsibility in the US, with problems resulting in practice; and

- there is no "one size fits all" solution: shareholdings of institutions can be large or small, can be a large proportion of the investor's funds or a tiny proportion, can be held by an investor actively managing a small number of holdings, or a fund broadly or specifically following indices, and can be invested by a large sophisticated fund, or a small group of pension trustees (as a few examples): different sizes of investments by different bodies may bear the cost of different levels of active management: disproportionately onerous requirements on investors could make access to smaller sums of capital harder, or could force smaller managers to cede funds to the control of bigger investment groups.

(b) Beneficial holder identification

We strongly oppose further obligations to extend corporate duties to deal with beneficial holders. There are a vast array of different ways in which interests behind the registered holder can be owned, under any foreign law: the nature of these interests is highly complex and frequently involves multiple levels of interest in the same shares. Companies would be exposed, in our view,

to disproportionate cost and to legal risk if they are forced by law to maintain awareness of beneficial holders or treat them as their owners: disputes arising from lack of clarity between shareholder interests would cause cost (and risk of loss) to the companies required to deal with such persons. This was extensively considered in the context of the Companies Act 2006 and explains why only limited rights were given for beneficial holders to receive information directly, and such rights are – from the companies' perspectives – a matter for the registered holder to pass on.

5. Compensation to Dismissed Directors (Question 13)

The proposal for a vote on compensation to dismissed executives does not and will not work. Dismissed executives, if directors, cannot receive "compensation for loss of office" but only contractual damages for the breach of their contracts by early termination.

Pension payments currently fall outside that restriction.

The only effective way to reduce pay outs on termination is to reduce directors' contractual entitlements: any requirement for a shareholder vote on compensation effectively negates the assurance a director has of a notice period in relation to his or her employment contract: without some such protection as employees, overseas employers would have a competitive advantage in recruiting and retaining senior executive directors, as an employee would not normally accept or rely on a commitment that could be overturned by shareholders.

Indeed where a director is dismissed from executive employment for "cause", no compensation is typically paid: compensation is only paid where "cause" cannot be clearly established.

Yours sincerely,

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James Palmer
Partner