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LEGAL AND REGULATORY COMMENT

New company law reform bill

Power to order greater disclosure of exercise of voting rights by institutional investors

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Abstract

Purpose – To address the practical implications of the new company law reform bill.

Design/methodology/approach – Explain the objectives of the Bill.

Findings – The current government position is a continuing preference for disclosure on a voluntary basis by firms but Clause 866 of the Bill leaves room for alternative action, shared a voluntary disclosure regime fail to deliver progress.

Originality/value – In its current draft from Clause 866 embraces the public at large, not just institutional clients, and therefore the latter are tacitly advised to act now rather than later, if its termed are to be binding on themselves alone, to the exclusion of the general public.

Keywords Company law, Disclosure, Investors

Paper type Viewpoint

Company law reform bill

Now that implementation of the Financial Services and Markets Act 2000 is complete, and regulated firms concentrate on developing the systems and compliance changes needed to implement the host of EU and international level legislative and regulatory initiatives in the financial sector such as the Basel II Capital Accord and the various implementing measures arising out of the Markets in Financial Instruments Directive (2004/39/EC "MFID"), those regulated firms that have corporate status could well be forgiven for balking at the prospect of getting to grips with yet another significant and substantial legislative reworking of the broader business environment in which they subsist. Yet the 558 pages, 885 clauses and 15 schedules of the company law reform bill published on 3 November 2005 and introduced into Parliament that same day will require scrutiny and reflection as their practical implications.

The timing of the Bill's metamorphosis from its previous (incomplete) draft versions in 2002 and March 2005 has taken some (including this commentator) by surprise and has certainly come at an inconvenient stage in the academic year! However, the company law reform consultative process has been visible and ongoing since Spring 1998 and so cannot possibly be said to fall into the "Dangerous Dogs" category of reactive and hasty legislation. The objectives of the new Bill are four fold:

> ... enhancing shareholder engagement and promoting a long term investment culture; ensuring better regulation and a "Think Small First" approach; making it easier to set up and run a company; and providing flexibility for the future[1]

Although each one of those objectives should be of interest in to readers of this Journal it is to a single clause proposed to further the first objective that this update

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note is addressed. For other parts of the company law reform bill have already received and will continue to receive extensive explanatory and critical comment elsewhere, in particular, those provisions which seek to broaden out the scope of the exercise of Directors' duties by their statutory restatement, those provisions which affect statutory auditors and the statutory audit, and those provisions which affect the ability of shareholders to bring derivative actions on behalf of the company. These provisions will affect all companies, irrespective of the business sector in which they operate. However, as far as many readers of this Journal are concerned, it is the appearance of the reserve statutory power in Clause 866 whereby HM Treasury or the Secretary of State for Trade and Industry may compel disclosure about exercise of voting rights held by institutional investors that is of particular interest.

The new provision – get ready to vote and report back in detail

Clause 866 in its current form provides:

Institutional investors: information about exercise of voting rights

(1) The Treasury or the Secretary of State may make provision by regulations requiring institutions to which this section applies to provide specified information about the exercise of voting rights attached to shares to which this section applies.
In this section "specified" means specified in the regulations.

(2) This section applies to –

- unit trust schemes within the meaning of the Financial Services and Markets Act 2000 (c. 8) in respect of which an order is in force under Section 243 of that Act;
- open-ended investment companies incorporated by virtue of regulations under Section 262 of that Act;
- companies approved for the purposes of Section 842 of the Income and Corporation Taxes Act 1988 (c. 1) (investment trusts);
- pension schemes as defined in Section 1(5) of the Pension Schemes Act 1993 (c. 48) or the Pension Schemes (Northern Ireland) Act 1993 (c. 49);
- undertakings authorised under the Financial Services and Markets Act 2000 to carry on long-term insurance business (that is, the activity of effecting or carrying out contracts of long term insurance within the meaning of the Financial Services and Markets (Regulated Activities) Order 2001);
- collective investment schemes that are recognised by virtue of Section 270 of that Act (schemes authorised in designated countries or territories).

(3) Regulations under this section may –

- provide that this section applies to other descriptions of institution;
- provide that this section does not apply to a specified description of institution.

(4) The regulations must specify by whom, in the case of any description of institution, the duty imposed by the regulations is to be fulfilled.

(5) The shares to which this section applies are shares –

- of a description traded on a specified market, and
- in which the institution has, or is taken to have, an interest.

Regulations under this section may provide that this section does not apply to shares of a specified description.

(6) For the purposes of this section an institution has an interest in shares if the shares, or a depositary certificate in respect of them, are held by it, or on its behalf.
A "depositary certificate" means an instrument conferring rights (other than options) –

- in respect of shares held by another person ("the depositary"), and
- the transfer of which may be effected without the consent of that person.

(7) Where an institution has an interest –

- in a specified description of collective investment scheme (within the meaning of the Financial Services and Markets Act 2000 (c. 8)), or
- in any other specified description of scheme or collective investment vehicle,

it is taken to have an interest in any shares in which that scheme or vehicle has or is taken to have an interest.
For this purpose a scheme or vehicle is taken to have an interest in shares if it would be regarded as having such an interest in accordance with subsection (6) if it were an institution to which this section applies.

(8) The information required is such information as may be specified about the exercise or non-exercise of voting rights on specified occasions during specified periods.

(9) The regulations may require the information to be provided, in such manner as may be specified, to such persons as may be specified, or to the public, or both.

(10) The duty obligation imposed by regulations under this section is enforceable by civil proceedings brought by –

- any person to whom the information should have been provided, or
- a specified regulatory authority.

(11) Regulations under this section –

- may make different provision for different descriptions of institution, different descriptions of shares and for other different circumstances; and
- are subject to affirmative resolution procedure.
Depending on whether, and how it is used, then such a power has the potential to have an impact upon internal systems and costs of fund managers, insurers, collective investment schemes and pension schemes.

This wide empowering clause is addressed to resolving the perceived problem for securing more active and committed corporate governance behaviour that arises as result of the passivity of many institutional investors and fragmentation [2]
The economic, legal and institutional reasons for the existence of (and the extent of) this passivity have been the subject of much debate in the corporate governance literature. One set of reasons for the fact that the company law review's finding that institutional investors did not vote the shares whose voting rights they controlled as openly, often or as independently as the model of shareholder democracy that underpins Anglo-American company law would like, is the fragmentation and length of the "investment chain". The sheer numbers of nominees, custodians, and other legal persons who are interposed between an investee company's registrar and the ultimate beneficial owner of the pot of money which is invested via savings and investment products (i.e. the saver or investor whose money is channelled into UK plc) is awesome. Many of those layers are in fact required by tax and other constitutive and regulatory legislative requirements. The more people are involved in the chain between the point at which the financial investment is originally made and the point at which a voting form is sent out in relation to a specific company share then the more likely it is that the incentive to vote and the interest in voting

will weaken. This is the problem to which Clause 866 is addressed, and that is evident in the Government's statement accompanying its publication:

> The basis of the proposal is that institutional investors either own or manage assets on behalf of clients or members, and have an obligation to manage the assets in their interests. Voting is central to the exercise of ownership control and an important element in adding value to an investee company. However, the ability of clients or members to monitor institutional investors and hold them accountable for their stewardship is limited in practice. The Government's view is that these retail investors should, in principle, be entitled to information on how assets owned on their behalf are voted. Access to such information could be expected to improve retail investors' confidence in the governance exercised by institutional investors.
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> In addition, voting transparency could be expected to enhance the efficiency of institutional investment. First, it will reduce the risk of conflicts of interest – which institutional investors may face when voting shares – from distorting voting decisions. Secondly, it will increase the accountability of institutional investors to retail investors, both for voting shares and for the signals being sent to company management by voting.[3]

On the same day the Bill was published the Investment Management Association gave a cool response to its inclusion of this reserve power, stating a firm preference for a continuing voluntary approach and taking issue with the Government's costing in its regulatory impact assessment of this provision. The Government estimates an average annual cost per disclosure of £1,000-1,500 and points to the availability of web site publication as a means to disclosure or referring to the disclosure by another of the exercise of votes in shares managed on behalf of the institution.

The current Government position is a continuing preference for disclosure to be made on a voluntary basis by firms but leaves very clear room for future use of the power in Clause 866 should "a voluntary disclosure regime [fail] to deliver progress . . ."

As it is currently drafted then, Clause 866 permits for detailed, specific disclosure to be ordered to the public at large, not just to institutions' client, and to be backed up by civil enforceability and regulatory sanction. Institutional investor should therefore be aware of the potential this clause has, for if its scope is to be narrowed then now is the time to do it, not when the power is on the Statute book in 2007.

Notes

1. Page 2 Guidance on Key Clauses of Company Law Reform Bill (Parliamentary Publications 1 November 2005).
2. This problem is explored and explained in numerous commentaries on the role of institutional investors in corporate governance. E Ferran Company Law and Corporate Finance (OUP, 1999), GP Stapledon Institutional Investors and Corporate Governance (Oxford, Clarendon Press, 1996).
3. Explanatory Statement Accompanying Clause 866 Company Law Reform Bill (8 November 2005).

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