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UK PUBLIC COMPANY/AIM MARKET

Listing Rules ("LR") and Disclosure Rules and Transparency Rules ("DTRs") Consultation

On 28 January 2010, the Financial Services Authority ("FSA") published a consultation paper that includes proposals to amend the FSA's rules to accommodate the introduction of the revised Combined Code on Corporate Governance ("Combined Code") (see below) as from 29 June 2010. In particular, the FSA's proposals include:

- amending the Listing Rules to refer to the revised Combined Code from the date it becomes effective;
- removing the reference to Section 1 of the Combined Code in the Listing Rules, to reflect the fact that the Financial Reporting Council ("FRC") intends to remove Section 2 (Institutional Shareholders) from the revised version, subject to the development of a Stewardship Code for institutional investors (see below); and
- including transitional provisions in its rules, including the LR and DTR, to reflect the fact that the old version of the Combined Code will continue to apply to accounting periods beginning before 29 June 2010.

Disclosure of major shareholdings: CESR proposal to extend regime

On 9 February 2010, the Committee of European Securities Regulators ("CESR") published a consultation paper on extending the major shareholding notification regime in the Transparency Directive (*2007/14/EC*). Whilst currently, the Transparency Directive requires (at certain thresholds) the disclosure of holdings of voting rights attached to shares and voting rights a person is entitled to acquire, it does not require any disclosure of instruments that create a similar economic effect to holding shares without giving the right to acquire voting rights, such as contracts for difference.

CESR is now proposing that the regime for the notification of major shareholdings should be extended to include all instruments that give a similar economic effect to holding shares and entitlements to acquire shares. In the UK, rules (FSA's DTRs) have already been introduced dealing with the aggregation of holdings of financial instruments that have a similar economic effect to financial instruments with entitlements to acquire shares.

CESR's proposals entail the following possible changes to the Transparency Directive:

- the extension of the Transparency Directive to include all instruments that give a similar economic effect to holding shares or entitlements to acquire shares whether an instrument is settled in cash or physically;
- the inclusion of a non-exhaustive list of such instruments to serve as guidance to the market;
- a prohibition on the netting of long and short positions in calculating percentage interests for disclosure purposes; and
- the possible inclusion of specific exemptions, on the basis that the proposed expansion of the disclosure regime will lead to a significant increase in disclosures.

Responses to CESR's consultation paper are invited by 31 March 2010.

Issue 1 of Inside AIM

On 15 December 2009, the AIM Regulation team of the London Stock Exchange published Issue 1 of "Inside AIM", a publication designed to keep the AIM adviser community informed of key AIM policy and technical matters. The AIM Regulation team ("AIM Team") expects to publish Inside AIM bi-annually or as required.

Issue 1 of Inside AIM contains technical guidance on the following AIM Rules, said to be those Rules on which the AIM Team receives most requests for clarification. Matters dealt with include the following:

- *AIM Rule 13: aggregation of directors' participation in a related party transaction:* Where more than one director participates in the same transaction with a company, for example in a share placing, it may be appropriate to aggregate their participations when calculating the class tests to see whether AIM Rule 13 applies (requiring an announcement where the transaction exceeds 5% on any of the class tests in the AIM Rules, including a statement by the directors (other than any director involved in the transaction), that having consulted with the nominated adviser, they consider the terms of the transaction to be fair and reasonable insofar as shareholders are concerned).

- *Purchase of own securities:* Currently, the AIM Rules do not deal specifically with any requirement for a tender offer by a company wishing to purchase its own shares. In particular, there is no requirement, as in the Listing Rules, for a tender offer if the company is purchasing more than 15% of its own securities. However, the AIM Team considers that if an AIM company does decide to use a tender offer, then it should comply nonetheless with the requirements in the Listing Rules.

- *AIM Rule 14: entering into an option agreement to complete a reverse takeover:* If an AIM company is considering entering into an option agreement that would on exercise be treated as a reverse takeover, its nominated adviser must contact the AIM Team before the option is announced to discuss whether suspension of trading may be required in accordance with the guidance note on AIM Rule 14. Whether a suspension is required will depend on the terms of the option and other circumstances. If it is a call option exercisable by the company and it does not itself require disclosure as a substantial transaction then, depending on the terms of the option and other circumstances, it may be viewed as a matter in the course of negotiation and so not require notification until exercise.

- *Companies Act 2006 and AIM Rule 19:* Following the implementation of the Companies Act 2006 (the "Act"), public companies incorporated in England and Wales now have to present their accounts at their AGM and file them with Companies House within six months of their year end (rather than seven months as previously). In practice therefore, AIM companies incorporated in England and Wales will now have to send their annual accounts to shareholders before the six month deadline referred to in AIM Rule 19 if the actions required by the Act are to be completed within the six month period allowed. The AIM Team does not, however, intend to amend AIM Rule 19.

- *The AIM Note for Investing Companies:* On 1 June 2009, a revised version of the AIM Rules and the AIM Note for Investing Companies were released, following which a number of points have been raised with the AIM Team. Issue 1 of Inside AIM seeks to provide clarification on some of these points:

  (i) *Appropriate entities and security types for admission to AIM*: the following list of security/company types will not be considered as appropriate for admission to AIM: open-ended investment companies (including unit trusts), protected cell companies, partly paid shares, non-voting shares as a primary line of securities, shares redeemable on an open basis and stapled units.

  (ii) *Implementation of an investing policy following a Rule 15 fundamental disposal*: the assessment as to whether an investing company has implemented its investing policy is not necessarily the same following a fundamental disposal under AIM Rule 15, as it is for a newly admitted investing company subject to AIM Rule 8. Under AIM Rule 8 an investing company has 18 months from admission to AIM in which to implement substantially its investing policy and this will usually require that it has invested at least 50% of the funds available to it. Under AIM Rule 15, the investing company has 12 months from the disposal to make an acquisition that constitutes a reverse takeover under AIM Rule 14 or else to implement its investment policy to the satisfaction of AIM in order to avoid the suspension of its securities from AIM. In that connection the AIM Team will not necessarily consider an AIM Rule 15 company to have implemented its investment policy if it invests 50% of the cash resources available to it. Also, a commitment to invest funds in the future or to make certain expenditure is not considered equivalent to an actual investment in a target company or assets.

- *Depositary receipts:* Generally, depositary receipts ("DRs") will only be considered appropriate for admission to AIM if the company is incorporated in a jurisdiction which prohibits, or unduly restricts, the offering or admission of its securities outside the jurisdiction. If an AIM company wants to establish a market for its shares via DRs, which will be traded off-exchange on an OTC basis, the AIM Team may seek to restrict the percentage of AIM securities represented by the DRs to no more than 25%.

- *Investigations and enforcement update:* Inside AIM reports that in the 12 months to 30 October 2009, six AIM companies and two nominated advisers were privately censured and fined a total of £200,000 by the AIM Executive Panel. The actions against the AIM companies all involved breaches of AIM Rules 10, 11 and/or 31, including delays in notifying price sensitive information and failing to liaise appropriately with the company's nominated adviser. The fines imposed on the AIM companies concerned ranged from £10,000 to £25,000.

AIM Rules: February 2010 amendment

On 17 February 2010, the London Stock Exchange published AIM Notice 36 together with the February 2010 version of the AIM Rules for Companies (effective from 17 February 2010). AIM Notice 36 gives feedback on the consultation set out in AIM Notice 35 and confirms the changes to the AIM Rules proposed in Notice 35 relating to:

- *Disclosure of directors' remuneration:* Rule 19 of the AIM Rules has been amended to require disclosure in the annual accounts of directors' remuneration earned in respect of the financial year, in which context "directors' remuneration" includes cash and non-cash benefits, details of share options and other long term incentive plans and the value of contributions made to any pension scheme by the AIM company in respect of its directors. These requirements apply in respect of financial years ending on 31 March 2010, or thereafter.

- *Electronic communications with shareholders*: Amendments have been made to the guidance notes to AIM Rules 14 and 19, to give all AIM companies (not just those subject to the Act) the ability to send annual reports and accounts and admission documents on a reverse takeover to shareholders using electronic communications, subject (in the case of UK companies) to compliance with the requirements of the Act as to the making of electronic communications and subject (for companies not subject to the Act), to compliance with the provisions of the note on AIM Rules 18 and 19. These changes take immediate effect.

Short selling: FSA publication of feedback on short selling discussion paper/CESR Model for Pan-European Short Selling Disclosure Regime

In October 2009 the FSA released a summary of the feedback received in response to its short selling discussion paper published in February 2009. Following a review of the responses received and in light of, among other matters, the consultation published by CESR, the feedback sets out the FSA's current policy with regard to short selling. The FSA concludes that, currently, there is no major aspect of the disclosure regime that should change but reconfirms its commitment to proceeding on as wide an international basis as possible and to achieving a harmonised regime within Europe. The FSA proposes to continue therefore, with the current interim measure (which requires disclosure of net short positions in respect of 0.25% or more of the issued share capital of UK financial services companies or companies carrying out a rights issue) pending its eventual replacement by a permanent regime that would ideally reflect an international consensus on this area.

On 2 March 2010, CESR published its proposals for a pan European short selling disclosure regime based on a two-tier model for disclosure of significant individual net short positions in all shares that are admitted to trading on an EEA regulated market or multilateral trading facility, except where the primary market for such shares is outside the EEA. CESR recommends that the new regime is introduced as soon as possible.

The regime is largely unchanged from that proposed in CESR's consultation (reported on in our Summer 2009 bulletin), except that the 0.1% threshold triggering private disclosure to a regulator has been raised to 0.2% as a result of feedback received to its proposals. Changes of 0.1% in a position trigger further disclosure obligations after the initial disclosure obligation has been incurred. Once a higher threshold of 0.5% has been reached, the short seller would be required to publicly disclose its position to the market as a whole as well as to the relevant regulator. Again, further notifications to the public and the regulator would be required as a result of any increase or decrease in the net short position of 0.1% or more. Disclosure reports, whether public or private, must be made on the trading day following the relevant threshold having been met. For disclosure purposes account must be taken of all positions which provide an economic exposure to particular shares including exchange-traded and OTC derivatives, as well as short positions in cash markets. Calculations and reports are to be made on a net basis, so that positions resulting in a long economic exposure to shares are subtracted from short positions with respect to the same shares.

Extension of application of UK Market Abuse super equivalent provisions

On 1 December 2009, the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2009 ("Market Abuse Regulations") were published, which extend the operation of the so-called sunset clauses in the Financial Services and Markets Act 2000 ("FSMA") to 31 December 2011.

The sunset clauses relate to sections 118(4) (misuse of information) and 118(8) (behaviour giving rise to a false or misleading impression or distortion of the market) of FSMA which are super-equivalent to the definitions of market abuse contained in the Market Abuse Directive ("MAD") reflecting the regime operated in the UK prior to MAD. Under the sunset provisions it was intended that such clauses would cease to apply on 31 December 2009, in anticipation of the outcome of the intended review of MAD. However, as the European Commission announced its call for evidence on the operation of MAD in April 2009 and has yet to publish its proposals to amend MAD, and in view of the UK government's belief that it is important for the UK to retain such super-equivalent provisions, the clauses will now continue to apply until 31 December 2011.

Insider Dealing: European Decision

The European Court of Justice has considered the expression "use of inside information" in Article 2(1) of MAD. In its decision in *Spector Photo Group & Van Raemdonck*, the Court held that, on a proper interpretation of Article 2(1), the fact that a primary insider who holds inside information trades on the market in financial instruments to which the information relates, implies that the person "used that information" within the meaning of the Article. Whether, in turn, that person has infringed the prohibition on insider dealing must be considered in the light of the purpose of the Directive, namely, to protect the integrity of the financial markets and enhance investor confidence. Amongst other things, that confidence is based on the assurance that investors will be placed on an equal footing and protected from the misuse of inside information. The implication that the person used the inside information is subject however, to the right to rebut the implication.

In the UK, in section 118(2) of FSMA, (market abuse), insider dealing is defined as occurring where an insider deals, or attempts to deal, "on the basis of" inside information. So it would seem that the related provisions of the Code of Market Conduct will need to be amended to remove the requirement for it to be proven that the trading was informed by the inside information. HM Treasury and the FSA are understood to be considering the implications of the judgment.

ABI amended guidelines on allotment of shares, disapplication of pre-emption rights and own share purchases

The Association of British Insurers ("ABI") has published amended guidance on directors' powers to allot shares, the disapplication of pre-emption rights and the purchase of own shares. The guidelines relating to the allotment of shares and disapplication of pre-emption rights were last revised in December 2008. The guidelines relating to own share purchases were last updated in June 1999. There are no substantive amendments to the guidance and the majority of the revisions have been made to reflect changes resulting from the introduction of the Act.

Accordingly, in relation to own share purchases, the ABI continues to recommend the annual renewal of such authority (despite the Act providing for a maximum period for authorities taken by public limited companies of five years) and for such authority to be conferred by way of special resolution rather than the ordinary resolution prescribed by the Act. In addition, in relation to a market purchase of shares the limits of 5% and 10% have been retained although in practice authorities of up to 10% are typical for companies admitted to the Official List and the ABI is likely to accept authorities of up to 15% where justified.

ABI additional guidance on articles of association

The ABI has updated its guidance on articles of association, which was last revised in December 2008. The changes to the 2008 guidance include an acknowledgment that following the clarification of the position of corporate representatives as a result of the implementation of the Companies (Shareholders' Rights) Regulations 2009, the designated corporate representative procedure will no longer be required in the majority of cases (with the exception of certain jurisdictions, for example, Jersey). Other changes include a requirement that the articles contain a cap on non-executive directors' fees and finally a statement that companies seeking to impose penalties upon shareholders for failure to comply with notices served under section 793 of the Act should comply with LR 9.3.9 (where applicable) and DTR 5 of the DTRs.

UKLA: List! Issue 23 and Issue 24

On 30 December 2009, the FSA in its capacity as the UK Listing Authority, published issue 23 of its List! newsletter. Among various topics, the FSA considered certain circumstances in which a prospectus may be required in connection with the issue of new securities in relation to a scheme of arrangement. In this regard, the FSA restated its view that a new issue of securities under a scheme of arrangement pursuant to section 425 of the Companies Act 1985 should not require the publication of a prospectus as no individual shareholder is invited to make an investment decision because shares will be allotted automatically upon the scheme becoming effective. However, in relation to a mix and match facility offered in connection with a takeover by way of scheme of arrangement, as the shareholder can elect to take a preferred combination of shares and cash and thereby exercise an investment decision, it is the FSA's view that a prospectus would need to be published (subject to the availability of any relevant exemptions) in such circumstances.

Issue 24 of List! was published on 2 March 2010 and contains guidance on the interrelationship of the working capital statement and risk factor sections of certain prospectuses and circulars as a result of recent experience and feedback and a clarification of the FSA's approach when applying the CESR recommendations for the consistent implementation of the Prospectus Directive Regulation. The FSA, when determining whether an issuer has complied with its obligations with respect to a prospectus, will take into account compliance with the CESR recommendations. The working capital and risk factor sections are two of the most important disclosure sections in a document and, as also acknowledged by the CESR recommendations, the FSA notes that there is scope for overlap and inconsistency between them in particular, the potential for the disclosure of assumptions and caveats in the risk factors section to detract from what is otherwise a "clean" working capital statement, that is, the company has sufficient working capital for present requirements (namely 12 months from the issue date). If a clean working capital statement cannot be given, an explanation will be required of how additional working capital may need to be provided. Issue 24 sets out various principles to which the FSA will have regard when applying the CESR recommendations to the sections of the document containing the risk factors and working capital statement, which include:

- types of risk factor which are fundamentally inconsistent with a clean working capital statement, for example, a factor which states that the issuer may not be able to meet a significant repayment obligation if the business is not sufficiently cash generative;
- not all risk factors relating to funding or finance are incompatible with a clean working capital statement;
- risk factors should be particular to the issuer and should detail a specific risk;
- the document as a whole should be consistent;
- the document belongs to the issuer and the responsibility for the accuracy of the document lies with the issuer and its advisers. The role of the FSA is to challenge an inconsistency but not to redraft or delete risk factors;
- risks should only be expressed to operate in the longer term if this is genuinely the case and the FSA will question risk factors drafted in this way so as to ensure that they are not being used in an attempt to avoid an overlap with the working capital statement by taking the risk factor outside the 12 month period; and
- the use of preambles or disclaimers in the risk factors cannot be used to make them consistent with a clean working capital statement.

CESR: September 2009/January 2010 FAQs updates re Prospectuses

CESR updated its Frequently Asked Questions (FAQs) regarding prospectuses: common positions agreed by CESR members, in both September 2009 and January 2010. The topics covered by the updates include commentary on: withdrawal rights; profit forecasts or estimates; valuations or statements produced by an expert; meaning of offer to the public; and free offers.

With respect to withdrawal rights following publication of a supplementary prospectus, it has been confirmed that such rights fall away following the admission of the securities to trading.

With respect to debt and derivative securities with a denomination per unit of at least €50,000, the disclosure obligations relating to profit forecasts set out in Item 8.3 of Annex IX of the Prospectus Directive Regulation ("PR") have been confirmed to apply equally to "profit estimates" notwithstanding the unintentional omission of "profit estimates" from such paragraph.

It has also been confirmed that the qualification "prepared by an expert at the issuer's request" set out in Item 24(b) of Annex I of the PR, (dealing with those documents that must be on display), applies only to valuations and statements and not to any other report, letter, document or historical financial information included or referred to in the registration document. All reports, letters and other documents referred to in a prospectus are therefore expected to be put on display, whether or not they are prepared by an expert at the issuer's request. The FSA in List! Issue 23 (see above) confirms that in its view Item 24 should be interpreted as requiring all documents, letters and reports referred to or included in the registration document to be put on display. However, valuations and statements are only required to be put on display where these have been prepared by an expert at the request of the issuer.

With respect to the the definition of public offer, it has been confirmed that in the absence of other circumstances, which might together amount to an offer to the public, the indication of secondary market prices should not amount to an offer to the public. For example, a company with a dual listing would be able to publish secondary market prices on its Web site alongside information about its business and security identification numbers without having to publish a prospectus.

The January 2010 update of the FAQs includes clarificatory wording in FAQ 6 with respect to "Free offers". The existing FAQ 6 confirmed, broadly, that no prospectus is required in connection with an offer of securities, which are offered free of charge or for which there is no element of choice on the part of the recipient. This is firstly, because there is deemed to be no offer to the public within Article 2.1(d) of the Prospectus Directive ("PD") and secondly, because such an offer falls within the exemption to publish a prospectus under Article 3.2(e) of the PD, as the value of the offer is less than €100,000.

The update also clarifies the obligation under Articles 4.1(d) and (e) of the PD to publish a document setting out the number and nature of securities and the reasons for and details of the offer, by confirming that it will only apply in relation to a free offer or offer of securities to group employees if such an offer is (i) an offer to the public within Article 2.1(d) of the PD and (ii) is an offer that either (a) does not benefit from the exemption under Article 3.2(e) of the PD referred to above, or (b) the total consideration of which exceeds €2,500,000 calculated over a 12-month period.

TAKEOVERS AND MERGERS

Extension of Disclosure Regime and Code Amendments

On 16 December 2009, the Code Committee published its response statement to its consultation paper issued in May 2009 which proposed the extension of its disclosure regime (as reported on in our Summer 2009 bulletin). In light of the responses received the Panel has largely adopted the proposals made in the consultation paper and the consequent amendments to the Code will take effect on 19 April 2010.

On the same date, the Code Committee also published its response to its consultation paper issued in July 2009 which proposed miscellaneous Code amendments. The amendments introduced to the Code as a result of this response statement took effect on 25 January 2010, and included:

- clarification of the circumstances in which the chain principle provisions will be applied in a mandatory bid context (Note 8, Rule 9.1);
- clarification of the application of the Code to management incentivisation schemes (new Rule 16.2 and notes thereto);
- provision for the Panel to require offeree directors to state their intentions with regard to alternative offers (Rule 25.3(a)(v));
- clarification of the period of time for which an offeror who decides not to pursue a competition clearance or who is prohibited from making an offer following a competition reference will be prevented from making a new offer (Rule 12.2); and
- confirmation that an offeror will only be relieved of its obligation to extend the offer if the acceptance condition has not been satisfied at the relevant closing date.

Consultation on aspects of the Code

On 5 March 2010, the Code Committee published a consultation paper seeking views on proposed changes to the Code requirements for an independent report to be produced in relation to certain financial information in the form of a quantified statement of effects, for example, a profits forecast, when published before or during the course of an offer together with other miscellaneous proposed Code amendments. The proposals include:

- the relaxation, in certain circumstances and subject to provisos, of the reporting requirements for statements that would otherwise constitute profit forecasts or an asset valuation, where these constitute "normal course" forecasts;
- extending the exemption from the reporting requirements under Rule 28.6(c) for interim and preliminary statements of companies admitted to the Official List, to those traded on the AIM and PLUS markets;
- extending the reporting requirement so that a report will be required in connection with profit forecasts made in respect of a part of a business; and
- extending the merger benefit statement requirements (set out in Note 8 to Rule 19.1) to other quantified statements of the potential financial effects of a course of action during an offer.

The final date for submission of responses to the consultation paper is 21 May 2010. It is intended that any consequent changes to the Code would take effect later in 2010.

CORPORATE GOVERNANCE

ABI Position Paper: Executive Remuneration

On 15 December 2009, the ABI published a position paper on executive remuneration. The ABI's Executive Remuneration Guidelines ("ABI Guidelines") set out criteria by which shareholders will judge remuneration policy as it applies to the directors of the companies in which they invest. It falls to the Remuneration Committees of those companies to decide how to apply the ABI Guidelines in the current economic climate. The ABI is keen for shareholders to have a high quality dialogue with members of the Remuneration Committees in order to minimise the risk of misunderstanding and possible confrontation.

The ABI's position paper is designed to help Remuneration Committees understand how shareholders expect the ABI Guidelines to be implemented. It does not however, replace the ABI Guidelines (which were themselves updated in December 2009, principally, to acknowledge the importance of risk management as one of the considerations relevant to executive remuneration and incentives).

The main conclusions of the paper are that Remuneration Committees should be accountable to shareholders for their decisions, especially where this involves the use of discretion, whilst shareholders should seek an open and constructive approach to communication rather than a purely compliance-based approach to remuneration guidelines based on the advice of consultants. Specific points made include the following:

- remuneration structures that seek to increase tax efficiency should not result in additional costs to the company or an increase in its own tax bill;
- awards should be scaled back where there would be a risk of excessive windfall gains if the level of share or option grants expressed as a multiple of salary was to be maintained at existing levels, despite a substantial fall in the share price;
- the payment of annual bonuses to directors should be discouraged if the business has suffered an exceptional negative event. In such circumstances, shareholders should be consulted on bonus policy and any proposed payments should be carefully justified;
- where there are elements of remuneration that are unusual or complex, the company should seek to highlight and explain them;
- salary decisions should not be taken on the basis of simple benchmarking against peer companies. If benchmarking is used, the aim should be to provide a point of reference for determining the appropriate salary for the specific job and not simply to apply the median;
- a change in market capitalisation alone is not justification for a salary increase as responsibilities may not have increased;
- the payment of annual bonuses to executive directors is discouraged if the business has suffered an exceptional negative event, even if some specific targets have been met. In such circumstances shareholders should be consulted on bonus policy and any proposed payments should be carefully justified;
- special or one-off awards are also discouraged. A need for special grants, particularly for continuing management,

suggests poor remuneration planning by the Remuneration Committee and may be a reward for failure. However, such awards may be justified by the Remuneration Committee when, for example, hiring a new management team to turn around an unsuccessful company; and

- retention awards for main board directors are rarely considered to work. Retention concerns on their own should not be sufficient grounds for remuneration to be increased.

National Association of Pension Funds: Governance Policy

The National Association of Pension Funds ("NAPF") has approved a number of additions to its corporate governance policy that are intended to apply in the 2010 AGM voting season, including the following:

- the additional flexibility under the Shareholder Rights Directive to hold a general meeting of members on 14 days' notice, should apply only in those limited cases where it is clearly to the advantage of shareholders as a whole;

- the independence of a director who has been nominated by a dissenting shareholder, but who is not associated with that shareholder should be judged by the same independence criteria as applies to all directors as set out in the NAPF policy;

- boards and shareholders should consider the history of a director when contemplating support for his/her re-election. Particular care is required where a director has had significant involvement in material failures of governance, stewardship or fiduciary responsibilities at the company; and

- following the adoption with the ABI of a joint policy on executive contracts and severance, companies are encouraged to take steps to limit contractual payments to base pay and benefits, and to explain more fully any reasons for payments in excess of that amount, including what steps have been taken to mitigate the cost to the company.

FRC Stewardship Code for Institutional Investors

The FRC has issued a consultation document on a stewardship code ("Stewardship Code"), which will be designed to promote the adherence by institutional investors with best practice in the stewardship of UK-listed companies and will set out good practice for institutional investors when engaging with UK-listed companies. It is intended that the Code on the Responsibilities of Institutional Investors published by the Institutional Shareholders' Committee in November 2009 ("ISC Code") be used as a basis for the Stewardship Code and the FRC is seeking views on whether the ISC Code is suitable in its current form or whether changes need to be made. It is also consulting on which institutional investors and agents should be encouraged to apply the Stewardship Code on a "comply or explain" basis, what information they should be asked to disclose and to whom, and what arrangements should be put in place to monitor compliance. In that connection, the FSA has stated that on conclusion of the FRC's consultation on the Stewardship Code, it will consult upon a rule introducing a "comply or explain requirement" for relevant investment management firms. This is likely therefore to result in new mandatory requirements being imposed on investment managers regulated under FSMA.

The FRC is inviting the views of companies as well as institutional investors as part of its consultation on the proposed Stewardship Code.

Review of the Combined Code: FRC Final Report

On 1 December 2009, the FRC published its final report on the effectiveness of the Combined Code. In light of the review, the FRC is now consulting on a number of changes to the Combined Code and other actions. It has also published a consultation document, which includes a revised draft Combined Code.

The FRC has concluded that, while the Combined Code and its related guidance required some updating, it remains broadly fit for purpose. In particular, the flexibility it allows is felt to be preferable to a more prescriptive framework for corporate governance.

The FRC proposes to adopt those recommendations made by Sir David Walker in his review of corporate governance in UK banks and other financial institutions ("Walker Review") that it considers are appropriate to all listed companies. The FRC does not, however, intend to extend its formal activities in monitoring or enforcing reporting against the Combined Code, but will continue informally to monitor standards of disclosure.

The key proposed changes to the Combined Code and relevant follow up actions are as follows:

- the title of the Combined Code will be changed to the "UK Corporate Governance Code". The FRC believes that this will make the Combined Code's status as the UK's recognised corporate governance standard clearer to foreign investors and foreign companies listed in the UK;

- the revised Combined Code is to apply to accounting periods beginning on or after 29 June 2010;

- the inclusion in the Combined Code of a revised introductory section and proposed revisions to its structure to encourage a greater focus on board behaviours;

- the introduction of new Combined Code principles concerning: the roles of the chairman and non-executive directors; the need for the board to have an appropriate mix of skills, experience and independence; the commitment levels expected of directors; and the board's responsibility for defining the company's risk appetite and tolerance;

- consultation on whether to include a "comply or explain" provision that either the chairman or all members of the board should stand for annual re-election;

- the introduction of new "comply or explain" provisions including: new board evaluation reviews to be externally facilitated at least every three years; the chairman to hold regular development reviews with all directors; and companies to report on their business model and overall financial strategy;

- in the section of the Combined Code dealing with remuneration, the inclusion of wording to emphasise the need for performance related pay to be aligned with the long-term interests of the company and to the company's risk policies and systems, and to enable variable components to be reclaimed in certain circumstances. Wording is also to be included to the effect that all forms of performance-related remuneration, not just share options, are discouraged for non-executive directors; and

- consultation on whether to allow companies the choice of meeting the disclosure requirements of the Code either in the annual report or on the company's Web site.

The consultation on the revised Combined Code ends on 5 March 2010. It is intended that the revised Combined Code will be published in April or May 2010.

Guidelines Monitoring Group's second report on compliance with Walker Guidelines

On 15 December 2009, the Guidelines Monitoring Group ("Monitoring Group") published its second annual report on the private equity industry's compliance with the requirements and recommendations of the Walker Guidelines on disclosure and transparency in private equity ("Walker Guidelines"), introduced in November 2007.

After publication of the Monitoring Group's first full report in January 2009, an update report, issued in April 2009, recommended that the criteria for defining portfolio companies required to comply with the Walker Guidelines should be expanded so as to apply to UK companies acquired by one or more private equity firms where the enterprise value at acquisition is greater than £500 million (or where the market capitalisation together with the premium for the acquisition of control was in excess of £300 million in a public to private transaction) and more than 50% of revenues were generated in the UK or UK employees totalled more than 1,000 full-time equivalents. This recommendation was accepted by the BVCA and implemented with immediate effect.

A total of 60 portfolio companies were covered by the Walker Guidelines during 2009, of which 15 complied on a voluntary basis. In addition, a total of 34 private equity firms were also covered.

Overall, the sample of 32 portfolio companies taken for review purposes were found by the Monitoring Group to have met the enhanced disclosure requirements. By way of general observation, the disclosure requirements relating to financial position, financial risks and principal risks and uncertainties were generally well met. However, the standard of disclosure in respect of social and community issues, environmental matters and essential contractual arrangements was mixed.

The Monitoring Group also found that all private equity firms covered by the Walker Guidelines, both required and voluntary, met all the requirements without exception. This compares with the previous year when around 50% of private equity firms met all the requirements without exception.

Following the expansion of the qualifying criteria, which took place in April 2009, the Monitoring Group and BVCA are continuing their consultation to decide whether the enterprise value threshold should be lowered to £350 million (£210 million for public to private transactions). The results of that consultation are expected to be announced shortly.

UK COMPANY LAW

Meaning of "subsidiary": *Enviroco Ltd v Farstad Supply A/S* [2009] EWCA Civ 1399

In the Enviroco case (above), the Court of Appeal had to decide whether on the proper construction of sections 736 and 736A, Companies Act 1985, (as amended by the Companies Act 1989) ("CA 85"), the test of subsidiary status under section 736(1)(c) was satisfied in relation to Enviroco Limited, where the shares in that company previously held by ASCO plc had been charged to the Bank of Scotland under a Deed of Pledge (governed by Scottish law) and as required by the Deed of Pledge, the shares had been registered in the name of the bank or its nominee.

The decision of the Court of Appeal, which overturned the High Court's decision, turned on the construction of section 736(1)(c), CA 85, to the effect that a company is a "subsidiary" of another company, its "holding company", if that other company "is a member of it and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in it".

As to the statutory definition of the term "member," section 22, CA 85 provides that:

"(1) The subscribers of a company's memorandum are deemed to have agreed to become members of the company, and on its registration shall be entered as such in its register of members.

(2) Every other person who agrees to become a member of a company and whose name is entered in the register of members, is a member of the company."

In the absence therefore in section 736, CA 85, of a deeming provision as to membership of a company of the kind found in section 258(3), CA 85 (meaning of "subsidiary undertaking"), it was not open to the Court to imply such a provision and so the test of "subsidiary" status was not met on the particular facts of the case.

This raises a number of potential issues in relation not only to certain provisions of the Act (which replicate the relevant provisions of sections 736 and 736A, CA 85), but also in relation to the proper construction of finance and other contracts which use the term "subsidiary."

It is understood that Enviroco Ltd has since applied for leave to appeal the Court of Appeal's decision.

Statements of Capital under Companies Act 2006

One of the new requirements introduced by the Act is the obligation for a company to produce a statement of capital at various stages during its life cycle, including each year in its annual return. There are 24 separate sections in the Act which require a statement of capital to be filed.

Generally, the following information is required to be included in a statement of capital:

- the total number of shares of the company;
- the aggregate nominal value of those shares;
- for each class of shares: prescribed particulars of the rights attaching to such shares; the number of shares within that class; and the aggregate nominal value of that class; and
- the amount paid up and the amount if any unpaid on each share whether on account of nominal value or by way of premium.

The requirements set out in the last bullet point are potentially problematic and onerous for companies that have a complex share capital history. For companies that have raised capital at different times, and/or that allot shares frequently, for example, pursuant to employee share schemes, the obligation to specify the amount paid per share may entail a large number of entries having to be made. Furthermore, for companies that have bought back or redeemed shares, or have consolidated or sub-divided their capital, or used share premium account as part of a capital reduction, the correct allocation of the share premium per share may be impossible to determine.

In light of this, the Department for Business Innovation and Skills ("BIS") issued a consultation paper in November 2009 for which the closing date for responses was 11 January 2010. The consultation sets out its proposals for amending the capital statement requirements having taken into consideration the value to the reader of the information, the ease with which such information can be provided and the requirements of the Second Company Law Directive. In particular, BIS is seeking comments on the following proposals as to what will constitute the requisite information for inclusion in a statement of capital, which if adopted, it believes will resolve the problems identified above:

- the total number of issued shares and the total number of issued shares within each class;
- the total nominal value paid up on issued shares on formation for both public and private companies and possibly for other statements of capital;
- the amounts unpaid on shares in each class for all companies;
- the total nominal value of issued shares (including paid and unpaid) for public companies in aggregate and by class and possibly for private companies too if feedback suggests that this is desirable; and
- the aggregate value of the share premium account.

Pending the outcome of the consultation, BIS in its FAQ published in September 2009, encourages companies to do what they can to provide numbers in their statements of capital and provide a pragmatic allocation of their share premium reserve between shares and/or classes of shares as per the guidance on this topic issued by the Institute of Chartered Secretaries and Administrators ("ICSA") in September 2009. It is emphasised that each part of the statement of capital form must be completed otherwise it will be rejected by Companies House.

The ICSA guidance provides that where it is not possible to allocate the share premium reserve to each share or class of share, it may be appropriate for the company to divide the total share premium by the number of shares in issue and allocate the premium on this basis, or where there are different classes of shares in issue, to allocate the premium between such classes based on the percentage of the total issued share capital represented by each class unless the company believes that there is a better method for allocating the share premium between the relevant classes.

There have also been separate concerns about what information should be included in the statement of capital with respect to rights attaching to the shares and in November 2009 Companies House updated its FAQs to address this.

The requirements differ depending upon whether the statement of capital is being submitted with the annual return, in which case only a description of the voting rights is required, or at other times, for example, on incorporation or following an allotment of shares, where the prescribed particulars as set out in the Companies (Shares and Share Capital) Order 2009 must be included. These are:

- particulars of any voting rights attached to shares, including any that arise only in certain circumstances;
- particulars of any rights attached to shares in respect of dividends and/or participation in a distribution;
- rights with respect to capital and/or participation in a distribution, including a winding-up; and
- redemption rights if any, including whether at the option of the company or shareholder.

The Companies House guidance makes clear that it is not possible to cross refer to the company's articles of association or other document setting out the relevant rights and provides examples of entries that will be rejected. It also provides limited guidance on what would constitute acceptable wording based on the simplest case of a private company having adopted model articles. When completing a statement of capital, the safest course is therefore to set out the information in full as this appears in the company's articles of association or other document containing the relevant rights.

Reductions of Capital: CLLS memorandum re solvency statement

Since October 2008, it has been possible for a private company to reduce its capital without having to go to court under the new fast track procedure set out in the Act. This requires, among other things, a solvency statement to be made by the company's directors in which they each confirm:

- that they have formed the opinion by reference to the company's situation at the date of the statement that there is no ground on which the company could then be found to be unable to pay or otherwise discharge its debts; and
- that they have formed the opinion: (i) if it is intended to wind up the company within 12 months of the date of the statement, that the company will be able to pay or otherwise discharge its debts within twelve months of the commencement of the winding-up; or (ii) in any other case, that the company will be able to pay or discharge its debts as they fall due one year after the date of the statement.

An offence is committed under section 643(4) of the Act if the directors make a solvency statement without having reasonable grounds for the opinions expressed in it and then file it with the Registrar of Companies. The City of London Law Society ("CLLS") has published a memorandum containing consensus views of members of the Company Law Committee of the CLLS as to practical steps that directors can take to reduce the risk of committing an offence under section 643(4) of the Act. This includes recording all information relied upon in forming the opinions, consideration of whether reports from third parties, for example, auditors, should be obtained in support thereof and, in all cases, consideration of the particular issues that are relevant to the company at the particular time.

Guidance on determination of realised profits

The Institute of Chartered Accountants in England and Wales ("ICAEW") and the Institute of Chartered Accountants in Scotland ("ICAS") have published draft additional guidance on the determination of realised profits and losses in the context of distributions under the Act. The deadline by which comments in respect of the draft guidance must be received is 19 March 2010.

UK COMPANY TAX

Supreme Court landmark ruling on valuation of shares in private companies in buy-out scenarios and capital v. income treatment of sale consideration

The judgment in *Grays Timber Products Ltd v HMRC (Scotland) [2010] UKSC 4* provides a novel approach on how "market value" should be interpreted in the context of personal rights relating to shares. The result will affect the structuring of share incentives in private companies, including private equity companies.

On 3 February 2010, the Supreme Court published its judgment in Grays Timber Products Limited. Under the terms of a subscription and shareholders' agreement entered into by the managing director at the time he acquired his shares, the director was entitled to a 25% share of the consideration on a sale of the company, even though he only held around 6% of the shares. The Supreme Court confirmed the decision of the Court of Session that the consideration that the director received in excess of his *pro rata* share holding was paid to him in recognition of his services and therefore taxable as income from employment (with PAYE and NIC obligation on the company).

The case was the first occasion on which the UK courts have ruled on the highly complex "employment-related securities" legislation within Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"). Under Chapter 3D of Part 7 ITEPA where employment-related securities are disposed of for more than market value, the disposal proceeds in excess of market value are taxable as employment income.

In deciding whether Chapter 3D applied, the court had to determine what the "market value" of the director's shares was, and specifically, how the special compensation rights were to be analysed. Broadly, tax legislation defines market value as the price that a hypothetical purchaser might reasonably pay for an asset in a sale on the open market. The following two key issues arose.

- Firstly, should the shares be valued on the basis simply of their rights set out in the articles (which did not make reference to additional consideration), or should the right to additional consideration in the subscription and shareholders' agreement be taken into account?
- Secondly, even if the rights in the subscription and shareholders' agreement were treated as if set out in the articles, should they nevertheless be disregarded in the valuation as exclusively personal to the director in question and worthless to a purchaser?

The Supreme Court upheld the decision of the lower courts that the rights were personal to the director and therefore to be disregarded: the subscription and shareholders' agreement explicitly stated that the entitlement to additional consideration was in recognition of the personal services of the managing director.

On the facts, the decision was therefore the correct result, but the significance of the judgment lies in the court's analysis as to which factors are to be taken into account in determining market value (and, therefore, the proportion of the consideration that attracts the more favourable capital treatment).

Crucially, the court held that the rights were personal, did not transmit to the purchaser and were not therefore rights to be taken into account in ascertaining the market value of the shares, commenting that this would be the result whether or not the rights were attached to the shares.

It was commonly thought that, so long as rights were contained in the articles, they would be taken into account in determining market value of the shares as "intrinsic" to the shares. The judgment casts some doubt that this is always the case.

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