



The Secretary to the Code Committee
The Takeover Panel
10 Paternoster Square
London
EC4M 7DY

23 July 2010

Review of certain aspects of the regulation of takeover bids

Dear Sir / Madam,

Thank you for giving the Institute of Directors (IoD) the opportunity to comment on your consultation paper, published on 1 June 2010. Issues surrounding corporate governance are of considerable interest to the IoD and its membership. We are therefore pleased to present our views on your review of the regulation of takeover bids.

About the IoD

Founded in 1903, and granted a Royal charter in 1906, the IoD is an independent, non-party political organisation of 45,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies. The IoD is a founder member of the European Confederation of Directors' associations (ecoDa).

The IoD's overall perspective on takeover policy

The IoD believes that a market for corporate control is a valid component of an effective corporate governance system. The threat of hostile takeover can provide a source of discipline for severely underperforming companies and their management.

However, takeovers are difficult to implement successfully. Many takeovers do not result in a combined enterprise that is stronger than the sum of its parts. A number of academic studies have shown that contested takeovers, on average, destroy value for the shareholders of the acquiring firm¹. Widespread use of takeovers may also encourage a short-termist management approach, both amongst acquisitive companies and companies under threat of takeover.

As a result, we view hostile takeovers as a governance mechanism of last resort. The presence of an effective board (containing a high proportion of independent, knowledgeable and challenging non-

¹ The following articles provide a review of the available academic evidence: Andy Cosh and Alan Hughes. June 2008. *Takeovers after Takeovers*. Centre for Business Research, University of Cambridge; Marina Martynovaa, and Luc Renneboog. October 2008. *A century of corporate takeovers: What have we learned and where do we stand?* Journal of Banking and Finance; Christian Tuch and Noel O'Sullivan. 2007. *The impact of acquisitions on firm performance: A review of the evidence*. International Journal of Management Reviews.

executive directors) and an ongoing process of engagement between boards and shareholders should be regarded as the main means of ensuring the success of the company over the longer term.

When significant takeover bids do occur, the final say on the commercial viability of the transaction should be a matter for shareholders. Furthermore, for such an important (and potentially risky) corporate event, it is important to ensure that the shareholders on both sides of the transaction are fully supportive of such a step.

The Takeover Code provides a fair and transparent mechanism through which to solicit the support of offeree (i.e. target company) shareholders during a hostile takeover bid. However, there is currently no guarantee that a takeover transaction has the support of the offeror (acquiring company) shareholders.

The UK model of corporate governance is based on the principle of shareholder monitoring and oversight of corporate activity. **In our view, it is consistent with this approach to require that all bids for major UK listed companies should be conditional on achieving the support of the shareholders of the acquiring company².**

Government should not seek to play a significant role in the approval of takeovers except in exceptional cases of national security, or where there are implications for the competitiveness of markets (i.e. anti-trust concerns).

The IoD does not believe that takeover policy should discriminate against foreign buyers. We are committed to sustaining the UK as a leading destination for foreign investment and as a leading location for corporate HQs and operations.

Furthermore, it would be undesirable for takeover policy to be perceived as a pretext for protectionism, as part of an industrial strategy, or as the outcome of a political lobbying process. For these reasons, we are opposed to the concept of a new public interest test for takeovers.

Answers to specific consultation questions

In this section, responses are provided to some of the specific questions that are posed in the consultation paper.

We reserve our comments for issues which are of particular concern to the IoD and its members. Some questions are answered with “no response”. These are issues on which the IoD prefers not to express a public opinion at the current time.

Q1. What are your views on raising the minimum acceptance condition threshold for voluntary offers above the current level of “50% plus one” of the voting rights of the offeree company?

We have sympathy with the idea that longer-term engaged shareholders should play a significant role in determining the outcome of takeovers. Many holders of UK equity securities - including many mainstream institutional investors - are relatively disengaged from a governance perspective. It is important for the future of UK corporate governance that a higher proportion of shareholders are encouraged to adopt more of a stewardship orientation vis-à-vis their investee companies, including with respect to takeovers.

In the wake of the Kraft/Cadbury takeover, it was helpful for Sir Roger Carr and others to broach the idea of a higher acceptance threshold as a means of achieving this objective³. However, on balance, we have reached the conclusion that this particular reform would not be the best way to tackle the issue of investor passivity in the case of takeovers. Our concerns relate to its implications for the wider framework of UK company law.

² Further details regarding this proposal are provided in the answers to questions 18 and 19 below.

³ In our statement of 22 April 2010, the IoD also argued that this proposal was worthy of detailed consideration.

In the normal course of a company's activities, "50% plus one" (i.e. a simple majority) is the level of shareholder support that is required in order to control a company by means of ordinary resolutions at General Meetings. Ordinary resolutions can be used to dismiss and reappoint the entire board of directors or to make key decisions for the company.

In our view, it would create an anomaly within company law if a simple majority of shareholder votes were sufficient to dismiss the board and direct the company, but insufficient to decide the outcome of a takeover. It would place takeover procedures at variance with the rest of UK company law.

Furthermore, an acceptance threshold above 50% could lead to a difficult situation in the aftermath of a failed takeover bid. Shareholders controlling more than 50% of voting shares – who had previously accepted the failed takeover offer - could be minded to replace the board, and take over the company's decision-making process. This would be highly disruptive, and not in the company's long-term interests.

It is possible to argue that any disparity between a higher acceptance threshold for takeovers and other forms of company decision making could be eliminated by increasing the general threshold for ordinary resolutions. However, this would represent a profound change to UK company law, with implications for numerous areas of company decision-making. We would not view this as a proportionate solution to the problem.

The acceptance of a bid by more than 50% shareholders could anyway represent a *de facto* vote of no confidence in the management of the target company. It is questionable whether the incumbent management and board could retain the necessary legitimacy to continue in such circumstances.

Q2 What are your views on raising the acceptance condition threshold for mandatory offers above the current level of "50% plus one" of the voting rights of the offeree company?

See answer to question 1.

Q3 If you believe that an increase in the acceptance condition thresholds for voluntary and/or mandatory offers would be desirable, at what level do you believe they should be set and why?

We do not believe that it would be desirable (see above).

Q4 What are your views on the consequences of raising the acceptance condition thresholds?

See answer to question 1.

Q5 What are your views on the suggestion that shares acquired during the course of an offer period should be "disenfranchised"?

We do not support this suggestion. There is no merit, *per se*, in being a long-term holder of a company's shares. Long-term investors – such as passive index funds – may devote minimal resources to company engagement. In contrast, short-term investors can, in certain cases, exert a beneficial effect on a company's governance through an active and constructive process of company dialogue. It would be inappropriate for the latter group to be disenfranchised (or otherwise disadvantaged) during a takeover situation.

We adhere to the basic principle – as defined in the Takeover Code and the EU Directive on Takeovers - that holders of the same class of shares should have equal voting rights. Any attempt to establish differential voting rights should be undertaken in the context of different classes of share.

Q6 If you are in favour of “disenfranchisement”, what are your views on how such a proposal should be implemented? In particular, what are your views on the various consequential issues identified in section 3 of the PCP?

We are not in favour. However, even if such a change were desirable, there would be significant difficulties involved in its practical implementation. Although we do not regard it as good practice, current market practices permit Investors to separate their economic and legal interests through arrangements with market counterparties. This would make it difficult to ensure that voting rights remain under the control of so-called “long-term” investors in the company.

Q7 What are your views on the suggestion that shares in a company should not qualify for voting rights until they have been held by a shareholder for a defined period of time and regardless of whether the company is in an offer period?

We disagree with this suggestion for the reasons given in the answer to question 5.

Q8 What are your views on the suggestion that the threshold trigger at which independent market participants become subject to the Code’s disclosure regime, currently 1%, might be lowered to 0.5%?

Although we are in favour of transparency with respect to the ownership of shareholdings, we feel that this proposed change would exert a minimal impact on the outcome of takeovers. The 1% disclosure threshold is already low by international standards. We are not convinced that the benefits of this change would exceed the costs.

Q9 What are your views on the suggestion that there should be additional transparency in relation offer acceptance decisions and of voting decisions in relation to schemes of arrangement? If you are in favour of this suggestion, please explain your reasons and how you think such additional transparency should be achieved?

We agree with the concept that institutional investors should periodically disclose their voting decisions on takeovers and other governance issues (e.g. on an annual basis), and be held accountable for them. We do not see this as necessarily being an issue for the Takeover Code. However, it is an issue for the Stewardship Code and company law.

Q10 What are your views on the suggestion that the application of the Code’s disclosure regime to situations where the rights attaching to shares have been “split up” might be clarified?

We believe that investors should disclose any splitting of dealing, voting and offer acceptance decision-making. We regard such splitting as potentially detrimental to the ability of investors to implement an engaged approach to company ownership. Where such splitting occurs, it should be disclosed and justified, and investors should be held accountable by beneficial owners.

The IoD has already argued that the Stewardship Code should define best practice with respect to stock lending⁴. In our view, such best practice should state the following⁵.

- Institutional shareholders should have a clear and disclosed policy with respect to the lending of shareholdings;
- Lending policy should be mandated by the ultimate beneficial owners of the shares;

⁴ As part of our consultation response on the Stewardship Code, 16 April 2010.

⁵ These principles are based on the International Corporate Governance Network’s Securities Lending Code of Best Practice (2007).

- Where lending activity may alter the risk characteristics of a portfolio, the investor's investment policy should state the extent to which this is permitted;
- The returns from lending should be disclosed separately from other investment returns when reporting to clients or beneficiaries;
- It is bad practice to borrow shares for the purpose of shareholder voting.

Q11 What are your views on the suggestion that the same requirements as to the disclosure of financial information on an offeror, the financing of the offer, and information on quantified effects statements should apply regardless of whether:

(a) the consideration being offered is cash or securities;

(b) the offer could result in minority shareholders remaining in the offeree company; or

(c) the offer is hostile or recommended, or whether a competitive situation has arisen?

This is an aspect of the takeover process that is excessively focused on the interests of offeree shareholders. In our view, financial information and a discussion of the implications of a takeover are of interest to a wide range of parties, including the shareholders of the acquiring company (who will have to live with the long-term consequences of the takeover). As a result, disclosure should not only be based around the informational requirements of offeree shareholders.

Q12 What are your views on:

(a) disclosures made by offerors of their intentions in relation to the offeree companies under Rule 24.1; and

(b) the views of the boards of offeree companies on offerors' intentions given under Rule 25.1?

If you consider that greater detail is required, how do you consider that this would be best achieved?

We support the idea that offeror companies should make meaningful disclosures regarding their intentions for the merged entity, and that the board of the offeree should publish their assessment of this blueprint.

However, we doubt that the meaningfulness of current disclosures will be significantly improved by more detailed or stringent rules in the Takeover Code. Rather, we support the idea that the Takeover Executive should stimulate best practice by the issuance of a Practice Statement on the implementation of Rules 24.1 and 25.1.

It may also be helpful for the Takeover Panel to periodically publish a commentary on the standard of current disclosure practices. This role would be analogous to the monitoring role of the FRC in respect of disclosures with respect to the UK Corporate Governance Code.

Q13 What are your views on the matters to which the board of the offeree company should have regard in deciding whether or not to recommend acceptance of an offer?

The main principles that should guide the board's behaviour during a takeover are the directors' duties defined in section 172 of the Companies Act 2006.

Of particular importance is the duty, in subsection 1(a), to take account of the longer-term implications of decisions for the success of the company. As a result, the board's perspective should extend beyond short-term fluctuations in the share price. The board should not shrink from opposing a bid if it believes, in good faith, that it can justify a strategy and vision for the company that will be more successful in the longer-term.

Q14 What are your views on the suggestion that there should be a requirement for independent advice on an offer to be given to offeree company shareholders separately from the advice required to be given to the board of the offeree company?

We do not support this proposal. Rule 25.1(a) already provides that the board of the offeree company must obtain independent advice on the offer, and make the substance of this advice known to shareholders. It would be excessive to require that the target company should finance the undertaking of another independent appraisal of the bid for shareholders.

The decision-making process in respect of a bid is ultimately the responsibility of shareholders. They have a fiduciary obligation to ensure that sufficient resources are devoted to their investment decision-making process. This may involve commissioning independent research on a takeover bid. However, this is a matter for shareholders, not the company.

Q15 What are your views on the suggestion that the board of any offeree company should be restricted from entering into fee arrangements with advisers which are dependent on the successful completion of the offer?

As a general principle, we do not believe that financial advisers on either side of the transaction should make their fees conditional on the success or failure of particular transactions. This creates conflicts of interest, and brings into question the objectivity and independence of their advice.

We would not necessarily insist that fee arrangements should be restricted by regulation. However, best practice should strongly favour non-transactional fee relationships with financial advisers. Furthermore, fee arrangements with advisers should be disclosed, and companies should be held accountable by shareholders for the integrity of such arrangements.

Q16 What are your views on the suggestion that the fees incurred in relation to an offer should be required to be publicly disclosed?

We agree with this suggestion. Such a step would bring greater transparency to the takeover process, and increase the accountability of both companies and advisory firms.

Q17 If you are in favour of the disclosure of fees, how do you think that any provision should operate? For example:

(a) to which fees (and other costs) should any provision apply and on what basis?

(b) at what point(s) of the transaction should any disclosure be made?

The required level of granularity of fee disclosure is a matter for debate. However, shareholders should be able to form a clear view from disclosures of the overall costs of takeover activity (particularly in respect of different categories of advisory fee), and the structure of fee arrangements. This information should be published on a periodic basis, as part of the regular reporting process.

Q18 What are your views on the suggestion that shareholders in offeror companies should be afforded similar protections to those afforded by the Code to offeree company shareholders?

We believe that the shareholders of the acquiring company should play a significant role in the takeover decision-making process.

The UK system of corporate governance is based on the principle of shareholder monitoring and oversight of listed companies. The UK Corporate Governance Code, for example, is underpinned by the idea that shareholders should engage with companies in respect of their strategy, risk, and corporate governance arrangements, and hold them accountable.

Consistent with this approach, we also believe that shareholders are the best placed actors to provide oversight in respect of the commercial merits of significant takeover transactions. However, it is important that such shareholder involvement should take place on both sides of the proposed takeover transaction, i.e. in respect of the shareholders of both the target and the acquiring company.

From a corporate governance perspective, it is puzzling that decision-making in respect of a takeover has historically focused on the shareholders of the target company. The acquiring company's shareholders are actually more exposed to the longer-term consequences of the takeover than those of the target company (who may not remain as shareholders in the combined entity).

Significant takeovers are distinct from many other types of corporate activity in their capacity to transform the prospects of the acquiring company in a relatively short period of time. The stakes are particularly high for offeror shareholders - a significant amount of academic research suggests that many takeovers have negative implications in terms of value creation for the shareholders of acquiring companies⁶.

At such a crucial moment, it is important to ensure that the interests of management and shareholders are properly aligned, i.e. that shareholders fully buy into the logic of the takeover. In our view, this is best achieved by making all significant takeover transactions conditional on securing the approval of shareholders. This condition would apply equally to acquiring companies from both the UK and overseas.

As well as ensuring an alignment with shareholder interests⁷, such a "say on takeovers" would also provide wider society with greater assurance that the potential risks and negative externalities of a hostile takeover are justified by the benefits in terms of longer-term value creation. As a result, the legitimacy of takeover activity in the eyes of employees and other stakeholders would be increased.

It has been argued that it is not feasible to demand shareholder approval from the shareholders of a non-UK company. Such companies lie outside of the UK's jurisdiction. This may affect the ability of the UK to make demands concerning their internal governance or decision-making mechanisms.

We are not convinced by these arguments. It is legitimate for the UK to be able to define the "rules of the game" that apply in respect of a takeover of a UK company. Compared to most other major economies (including the United States), the UK has a remarkably open and unrestrictive takeover regime. In relation to the obstacles that can be placed in the way of takeover bids in other jurisdictions, e.g. poison pills and various forms of government interference, the requirement of shareholder approval would represent a modest constraint on the freedom of action of the acquiring firm.

It has also been argued that the requirement of a shareholder vote would be a mere formality for a company controlled by a blockholder (i.e. a shareholder with a large controlling stake). This would in some way reduce its value. Blockholder controlled companies are common outside of the Anglo-American corporate sectors, and amongst unlisted companies. In contrast, UK and American listed companies tend to have a diffuse ownership structure.

However, this criticism misses the point of what shareholder approval is trying to achieve. A shareholder vote is aimed at ensuring that there is an alignment between the interests of shareholders and management. In other words, it indicates that the suppliers of risk capital are satisfied that the proposed takeover represents a productive use of their resources. Although it may be easier for blockholder controlled companies to gain shareholder approval, this does not change the meaning of such an assurance.

Q19 If you consider that offeror company shareholders should be afforded protections: (a) to which offeror companies should such protections apply and in what circumstances?

⁶ See footnote 1 for a list of academic references which examine the effect of takeovers on corporate performance.

⁷ In the terminology of modern corporate governance, such a vote would minimise the agency costs arising from the takeover, i.e. costs incurred as a result of divergences in the interests of the acquiring company's principals (i.e. the shareholders) and agents (i.e. the management).

(b) what form should such protections take?

(c) by whom should such protections be afforded (for example, the Panel, the FSA, the Government or another regulatory body)?

At the current time, UK companies with a premium listing on the London Stock Exchange are subject to the significant transactions rules of Chapter 10 of the FSA's listing rules. These may require shareholder approval of proposed takeover transactions that exceed a specified relative size threshold⁸. However, the rules do not apply to acquiring companies without a premium listing, e.g. non-UK listed companies or UK companies without a premium listing.

In our view, all bids for large UK listed companies (e.g. those within the FTSE 350 or with a premium listing on the LSE) should be conditional on the approval of the acquiring company's shareholders. Such large listed companies are in some sense, public interest entities; i.e. they have systemic importance for the UK economy, regardless of their size relative to the acquiring company. Consequently, hostile bids for such entities should always be subject to the scrutiny of shareholders.

For smaller UK listed companies (e.g. those outside of the FTSE 350, or with a standard listing on the LSE, or a listing on AIM or PLUS), there is a stronger case for arguing that the need for a shareholder vote should depend on the relative significance of the transaction for the acquiring company. In such circumstances, the FSA significant transactions criteria (or something similar) could be used in order to determine the threshold for a shareholder vote.

We would expect that our proposal for a "say on takeovers" would need to be implemented by means of changes to company law rather than through changes to the Takeover Code.

Q20 What are your views on the suggested amendments to the "put up or shut up" regime? In particular:

(a) what are your views on the suggestions that "put up or shut up" deadlines might be standardised, applied automatically and/or shortened?

(b) what are your views on the suggestion that a "private" "put up or shut up" regime might be introduced?

We think that it is important for the Takeover Panel to retain some flexibility to define the takeover timetable according to the circumstances of each bid (albeit within broad parameters).

Q21

What are your views on possible offer announcements that include the possible terms on which an offer might be made and/or that include pre-conditions to the making of an offer?

No response.

Q22 What are your views on the deadline for the publication of the offer document and the suggestion that the current 28 day period between the announcement of a firm intention to make an offer and the publication of the offer document might be reduced?

No response.

Q23 What are your views on the suggestion that the Panel should have the ability unilaterally to foreshorten the timetable for subsequent competing offers?

No response.

⁸ This occurs when the takeover qualifies as a "class 1 transaction". This would typically occur if the target company represented more than 25% of the acquiring company in terms of metrics such as gross assets, profits, market value, or gross capital.

Q24

What are your views on the Panel's approach to inducement fees? In particular:

(a) do you consider that inducement fees should be prohibited?

(b) if you consider that inducement fees should continue to be permitted:

(i) do you regard the de minimis nature of inducement fees (and the Panel's approach to what is de minimis) as a sufficient safeguard?

(ii) do you consider that any further restrictions should be imposed on inducement fees by the Panel (for example, in relation to the timing of payment or the triggers for payment)?

(iii) what are your views on the suggestion that the Panel should cease to require confirmations from the offeree company board and its financial adviser that they each believe the inducement fee to be in the best interests of shareholders?

No response

Q25 What approach should the Panel take to deal protection measures? In particular, do you consider that any specific deal protection measures should be either prohibited or otherwise restricted? Please explain the reasons for your views.

No response.

Q26 What are your views on the suggestion that implementation agreements and other agreements containing deal protection measures should be required to be put on display earlier than at present?

No response.

Q27

What are your views on "fiduciary outs" in the context of inducement fee arrangements?

No response.

Q28 What are your views on the ability of deal protection measures to frustrate a possible competing offer and on whether linking deal protection measures to the payment of an inducement fee may cure any such potential frustration?

No response.

Q29 What are your views on the suggestion that provisions similar to those previously set out in the Rules Governing Substantial Acquisitions of Shares should be re-introduced?

We have sympathy with the proposal to re-introduce rules governing substantial acquisition of shares (SARs).

These rules (which existed between 1980 and 2005) regulated stake building in companies between the 15% and 30% level (i.e. up to the level at which "control" is deemed to pass according to the Takeover Code).

Subject to certain exceptions, the SARs prohibited the acquisition of shares, or rights over shares, of 10% or more of the voting shares in any seven day period, if the resulting holding would represent between 15% and 30% of the voting rights. If a purchaser wished to acquire shares more speedily, it was obliged to make a tender offer.

The SARs, in effect, provided a bridge between the strict mandatory offers regime which is applicable (and continues to apply) at the 30% shareholding threshold and the buying freedom that exists at lower levels of shareholding.

The benefit of SARs was to provide the board with time to react to the building up of a potential stake, and give them the opportunity to make a reasoned case on their business strategy to shareholders. They also had the effect of discouraging market raids from short-term traders.

Such a measure would be consistent with the view that takeovers should not be opportunistic transactions arising from short-term fluctuations in share prices, but rather the end point of a considered process that focuses on the long-term interests of the company.

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

A handwritten signature in black ink that reads "R. Barker". The signature is written in a cursive style and is underlined with a single horizontal line.

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