

## 2 Setting the Scene

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The Government is committed to ensuring that the legal and regulatory framework within which business operates promotes enterprise, growth and the right conditions for investment and employment.

Our system of company law and corporate governance is a critical part of this framework. It sets out the legal basis on which companies are formed, operated and managed. It provides the corporate vehicle which enables people to collaborate in business, and the legal structure through which companies are financed, ultimately by millions of savers and pensioners. It sets the rules for company boards and shareholders and for the exercise of decisions on business growth and investment. And it is the means by which people are held to account for the exercise of corporate economic power.

For these reasons, an effective framework of company law and corporate governance is a key building block of a modern economy. A genuinely modern and effective framework can promote enterprise, enhance competitiveness and stimulate investment. Conversely, an ineffective or outmoded framework can inhibit productivity and growth and undermine investment confidence. The high profile corporate collapses of recent years – including Enron, Worldcom and Parmalat – have demonstrated the critical importance to the modern global economy of robust frameworks for corporate activity, and the far-reaching economic consequences when these fail.

### **Our objectives**

That is why we are committed to creating a modern, enabling and robust framework for our companies. We are determined to ensure that our system of company law and corporate governance is one which:

- facilitates enterprise by making it easy to set up and grow a business;
- encourages the efficient allocation of capital by giving confidence to investors;
- promotes long-term company performance through shareholder engagement and effective dialogue between business and investors; and
- maintains the UK's position as one of the most attractive places in the world to set up and run a business.

## Global challenge

This last point is critical. Our framework must reflect the challenges of modern capital markets in which business and investment decisions are increasingly determined by global conditions. More and more companies are operating internationally. Increasingly, businesses can make choices as to where to incorporate, and recent legal judgments are tending to make such cross-border incorporations easier. Similarly, investors can choose where to put their money – around a third of stock in listed UK companies is now held by overseas owners, more than twice the level in 1993.

This increasingly global marketplace is reflected in changes in regulatory conditions – for example the move towards global convergence of accounting standards, so that ultimately companies should be able to prepare their accounts on the same basis, wherever in the world they are listed. It is also reflected in developments at European level, where there is already a large body of European law and where the Commission's Company Law and Corporate Governance Action Plan is focused on fostering the global efficiency and competitiveness of EU businesses, strengthening shareholders' rights and third party protection and rebuilding the confidence of investors.

The Government supports the Action Plan as a platform for action to remove barriers to the efficient operation of markets, make it easier for companies to set up cross-border operations, extend investment opportunities for investors and improve access to, and the availability of, capital across Europe. As in the UK, it believes that EU action should be facilitative and enable enterprise and entrepreneurship to flourish. The aim must be to promote growth, competitiveness and jobs, not put new barriers in the way of economic activity.

The recent Sarbanes-Oxley legislation in the US, enacted in response to the Enron and Worldcom collapses, has also had important consequences for companies and investors around the world.

## UK response

In Britain, we have acted decisively to recognise and anticipate these challenges. In 1998, the Government commissioned the Company Law Review (CLR), an independent group of experts, practitioners and business people, to take a long-term and fundamental look at our underpinning system of company law, to see how it could be brought up to date. Many of the proposals for legislative change contained in this White Paper are a result of that Review.

The CLR is part of a wider programme of action to facilitate enterprise, encourage investment, promote long-term company performance and ensure that Britain remains one of the best places in the world to set up and run a business:

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- we have brought forward the **Companies (Audit, Investigations and Community Enterprise) Act 2004 (the C(AICE) Act)** to ensure better oversight and stronger regulation of the accounting and audit profession, to increase investor confidence in company reporting and enforcement, and to strengthen powers to investigate companies. The Act has been widely welcomed as a robust but measured response to recent corporate scandals which strikes the right balance between strengthening market confidence and avoiding unnecessarily prescriptive and burdensome regulation. In addition, it encourages the development of the social enterprise sector by making it possible to form a new type of company, the “community interest company”, whose profits and assets must be used for the benefit of the community;
- we have laid draft regulations which will require all quoted companies to produce an **Operating and Financial Review (OFR)**. The OFR is a new form of narrative report in which companies will need to describe future strategies, resources, risks and uncertainties, including policies in relation to employees and the environment where these are relevant to future strategy and performance. The requirement to produce an OFR represents a further major step forward in improving company reporting and transparency and in promoting effective dialogue on the key drivers of long-term company performance. It also recognises that in a modern economy, those who run successful companies need to develop relationships with employees, customers, suppliers and others which support long-term value creation;
- we have introduced the **Directors’ Remuneration Report Regulations 2002**, which require quoted companies to disclose and seek shareholder approval for their executive remuneration policies, and to disclose how remuneration relates to performance. Recently-published research by Deloitte has demonstrated that these Regulations have led to substantial and direct improvements in the transparency of executive remuneration. More fundamentally, the Regulations have acted as a catalyst for increasing company accountability and effective shareholder engagement; and
- we have raised the **audit thresholds** for turnover and balance sheet totals to £5.6m and £2.8m respectively, taking some 69,000 companies out of the requirement to have their accounts professionally audited.

The Government’s approach has not relied on legislation alone. One of the key strengths of our framework for corporate activity is that it has been developed in close partnership with market participants. This is reflected in the way we have worked alongside businesses, professionals and investors in driving reform and modernisation:

- the **Financial Reporting Council's** powers of oversight and enforcement have been substantially increased and extended by the C(AICE) Act. But it remains a light-touch, market-led regulator, which derives its funding equally from listed companies, the accountancy profession and Government and which, through its Council and Board, operates with the full cooperation and involvement of companies, investors and the profession;
- under the aegis of the Financial Reporting Council, a new **Combined Code on Corporate Governance** was published in July 2003 which incorporates many of the changes recommended in an independent review by Sir Derek Higgs, aimed at strengthening the independence and effectiveness of non-executive directors;
- to promote more active **shareholder engagement**, particularly where shareholders have concerns about management, strategy or performance, the Government welcomed the Institutional Shareholders' Committee principles in October 2002, and the commitment to reflect these principles in fund management contracts and insurance fund practice. The ISC is assessing the effectiveness of the principles in achieving change and the Government will take this into consideration when reviewing their impact on engagement;
- UK institutional investors manage almost half of UK equities, investing much of the long-term wealth of British savers and exercising indirect control and significant influence over much of British industry. This ownership is intermediated through an **investment chain** of relationships connecting ultimate owners with their investment in companies. Ensuring this chain works efficiently is of vital economic importance for productivity and long term growth, because the chain is a critical mechanism for ensuring that investment is efficiently allocated. The Government has systematically investigated how well the investment chain works, notably through the Myners, Sandler and Higgs reviews, and in the light of the analyses and recommendations of these reviews, has undertaken a comprehensive reform programme;
- a separate report by Paul Myners to the Shareholder Voting Working Group focused on the practical steps which market participants must take to improve the **effectiveness of the voting process** and has been well received. DTI has agreed to implement the report's legislative recommendations;

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- in order to ensure that company accounts are subjected to **high-quality and independent audit**, the new Combined Code also strengthens the role of the audit committee in the light of the report from Sir Robert Smith. Audit firms have introduced more frequent rotation of audit partners and longer cooling-off periods before an auditor can be recruited by a client; and
- we have worked alongside business to take forward the recommendations of Sir Derek Higgs and Laura Tyson aimed at extending the **diversity and effectiveness of company boards**. Proposals for further action are set out in “Better Boards”, published in December 2004.

### Further reform and the Company Law Review

All these developments have contributed to our objective of creating a modern, enabling framework which facilitates enterprise and market confidence. But the role played by the underlying law governing the day-to-day operation of companies remains critical to business competitiveness.

Our company law reform programme is focused on four key objectives:

- Enhancing shareholder engagement and a long-term investment culture
- Ensuring better regulation and a “Think Small First” approach
- Making it easier to set up and run a company
- Providing flexibility for the future.

### Enhancing shareholder engagement and a long-term investment culture

Companies work best where there is a good understanding and effective engagement between those who own companies, and those who run them on their behalf. In order to achieve this, roles and responsibilities need to be clearly defined, and there needs to be efficient and transparent mechanisms for ensuring that views are heard and decisions taken. Measures in the Bill will provide better guidance for directors on their responsibilities and duties, ensure more effective and efficient communication with shareholders, and make it easier for shareholders, including indirect investors, to exercise their rights of ownership. These changes are aimed at ensuring that directors and shareholders can work together in a way which promotes long-term company performance and value creation.

### **Ensuring better regulation and a “Think Small First” approach**

Our company law was originally designed for large companies with numerous public investors. The current companies legislation generally works by offering smaller private companies exemptions from a fundamental framework which was designed for larger companies. But today the vast majority of companies are smaller – often owner-managed – and have different needs, with over 90% of companies having five shareholders or fewer.

For these companies, laws designed to regulate larger companies with a publicly-traded share ownership are burdensome and impose unnecessary costs. Wherever possible, the Government wants the new law to recognise smaller private companies not as the exception, but as the rule. We will therefore remove unnecessary burdens on small firms and present the provisions they use most often in a more accessible way. We will also ensure that small companies and their advisors can readily access guidance on what they need to know about the law.

### **Making it easier to set up and run a company**

Compared with many other countries, it is relatively easy and cheap to set up a company here. The Government believes this is an important benefit to Britain – start-ups are one of the crucial motors of our economic growth, and more and more companies from overseas are seeking to incorporate here. But there are still some procedural requirements that can complicate both the setting up of a company, and its initial operation – for example, the default requirement for all companies, even the smallest, to hold an Annual General Meeting, and the requirement to appoint a company secretary. Where these obstacles can sensibly be removed, the Bill will remove them.

### **Providing flexibility for the future**

The measures in this Bill demonstrate that law which was appropriate at one time may become an obstacle when times change. The Government believes it is crucial that there should be some measure of flexibility built into the company law framework to ensure that it can be kept up-to-date in future, subject to appropriate processes of public consultation and Parliamentary scrutiny. The Bill will provide this.

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### **The way ahead**

The CLR consulted widely with legal experts, business and practitioners in drawing up its recommendations. As a result the work of the CLR has been universally recognised as providing an authoritative assessment of the changes needed to ensure that our framework of company law remains at the forefront of international competitiveness. For this reason, the CLR's principles (and the vast majority of its specific recommendations) are firmly reflected in the Government's reform proposals.

In addition the Government has continued to take account of market developments and to discuss both the general approach to reform, and where appropriate specific proposals, with the business and legal communities and wider stakeholder interests. We intend to continue to work in partnership with these interests in keeping our law responsive and flexible. In particular, we have consulted extensively on ideas for deregulatory change, with a view to ensuring that unnecessary burdens are removed wherever practicable. Our assessment suggests that the proposals for reform set out in this White Paper will produce savings for business of around £250m a year. We would welcome any responses to this document which suggest additional areas for removing unnecessary burdens.

### **Approach to legislation**

The Company Law Reform Bill will include amended and restated provisions of particular importance to small companies in their day-to-day operations. The Bill will set out the revised provisions in a new, more logical and easily accessible way. These areas will include such core policy areas as formation, and meetings and resolutions. It is also intended that the provisions on reports and accounts should be restated in a more accessible way. Some clauses which show the approach proposed for the content of small company reports and accounts are included in this document.

The Bill will also include new provisions setting out the duties of directors.

In other areas, the new Bill will introduce specific amendments to the Companies Act 1985. However, the scale of these changes and the nature of the provisions being amended will mean that it will not be necessary or appropriate always to restate entire areas of that Act in a new form. These are largely the more technical areas, of greater interest to larger companies, and the effect of the provisions will be to amend the 1985 Act.

This document provides a description of the policy so that all those with an interest in the area can understand what is intended. For many areas, draft clauses are included. (The draft clauses will not necessarily appear in the Bill in the order given here). In some areas, detailed clauses are still being worked on and drafts are not included. Some draft regulations which will be brought forward in parallel are also included. The DTI website provides a more detailed commentary on the key clauses ([www.dti.gov.uk/cld/review.htm](http://www.dti.gov.uk/cld/review.htm)).

The Government welcomes all comments on what is proposed.