3 Enhancing Shareholder Engagement and a Long-Term Investment Culture

The Government believes that companies work best where the respective roles and responsibilities of directors and members or shareholders are clearly understood, where there is effective communication and engagement between directors and shareholders, and where there are efficient mechanisms for taking decisions critical to the running of the company.

The Government's proposals in this area, which are based upon the CLR's analysis, therefore aim to ensure greater transparency and accountability within the company's operations, and greater opportunity for all shareholders to play an informed part in company business.

As part of this, the Bill will provide greater clarity on what is expected of directors, making it easier for all to understand what those duties are. In particular the Bill will make clear that, while directors must promote the success of the company for the benefit of its members, this can only be achieved by taking due account of longer term performance and wider interests, such as the interest of its employees and the impact of the company's operations on the community and on the environment.

3.1 Improving shareholder dialogue

Shareholders have a key role to play in driving long-term company performance and economic prosperity. Informed, engaged shareholders – or those acting on their behalf – are the means by which the directors are held to account for business strategy and performance and by which investment decisions are taken which reflect the most efficient allocation of capital. However the investment chain has become increasingly complex, with the result that communication up and down the chain and the exercise of ownership rights and responsibilities have become more difficult.

For this reason, the Government has already taken a number of steps to increase effective shareholder engagement and the efficient working of the investment chain, including action to require all quoted companies to seek shareholder approval for the directors' remuneration report and to produce an Operating and Financial Review, as well as action in response to the Myners,

Sandler and Higgs reviews. We intend to build on these reforms by introducing a number of measures in this Bill aimed at improving communication with shareholders and indirect investors and encouraging the exercise of ownership rights.

Access to timely, transparent company information

It is important that shareholders have access to clear and meaningful information to enable them to have a constructive dialogue and increase their engagement with the company in which they hold shares. The Bill will introduce a number of measures to enhance the timeliness and transparency of company information and proceedings:

- The holding of the Annual General Meeting (AGM) will be linked to the reporting cycle to ensure shareholders have a timely opportunity to hold the directors to account. The current law requires companies to hold an AGM once a year and there can be as long a gap as 15 months between AGMs. The Bill will require public companies to hold their AGM within 6 months of the end of the financial year.

- Quoted companies will be required to put on their website the preliminary announcements of their annual results and their full accounts and reports. This information must be made available to all members of the public and not just to members.

- Shareholders of quoted companies will have a right within a 15-day holding period after the accounts become available to propose a resolution to be moved at the general meeting where the accounts are laid (usually the AGM). Such resolutions would be circulated at the company's expense.

- Quoted companies will also be required to disclose on their websites the results of polls at general meetings. This will ensure increased transparency for shareholders, whether as registered members of the company or as indirect investors, of decisions taken at general meetings.

- Shareholders of quoted companies will also have a new right, if a certain specified minority so request, to require an independent scrutiny of any polled vote. The Bill will also provide that the scrutiny report of any poll must be disclosed on the company's website.

The Government believes that there is a good case for improving voting disclosure and wants to see effective accountability by institutional investors. This will improve transparency and lead to better engagement with companies by institutional investors. In line with this approach, the Government will continue to explore the proposal that institutional investors should be required to disclose how their voting rights have been exercised. The practicalities of this approach need to be examined against alternatives such as operating through a statement of principles, such as those issued by the Institutional Shareholder Committee.

Facilitating e-communications

The use of new information and communications technologies has grown rapidly over recent years, which presents great opportunities to reduce costs and enhance the immediacy and transparency of dialogue between companies and shareholders. These developments were not anticipated at the time that the majority of the provisions in existing company law were first put in place decades ago. Existing provisions of company law impose a number of requirements about the use of paper communications, which can prevent both companies and shareholders from enjoying all the cost-savings and other benefits that sensible use of new communications technology can bring. For example, at present the Companies Act requires companies to send every shareholder the full annual report and accounts or a summary version. Unless the shareholder positively opts for electronic communication this must be in paper. In practice, while many shareholders do not need or want to receive a paper copy, very few have taken up the electronic option. The resulting costs of printing and sending paper copies of the annual report can be considerable, particularly for a large quoted company with tens of thousands or even a million or more shareholders.

The Government therefore intends to allow all companies, subject to shareholder approval, to be able to use electronic communications with shareholders as the default position, permitting (but not requiring) companies to use websites and e-mail to communicate with their registered members. Of course, electronic communication will not suit everyone. Individuals will be able to request continued communication on paper if they wish. Nonetheless, the overall reduction in paper circulation expected could produce very significant cost savings, particularly for companies with large numbers of registered members.

3.2 Enfranchising indirect investors

When investors – whether major institutional investors or retail investors – buy shares in a listed company, they are increasingly likely to hold their shares through an intermediary or a chain of intermediaries.

The use of intermediaries makes electronic trading of shares easier and cheaper, but it can also be a regulatory requirement for example in relation to shares held as part of ISAs. However, as it is the intermediary's name that appears on the company's register of members, indirect investors risk losing their governance rights. There is no automatic basis in company law for a direct relationship between a company and these indirect investors. Instead the indirect investors may have to rely on contractual arrangements with the intermediaries to pass on at least some basic information and dividends from the company and to act on their instructions.

The Bill will therefore enhance the ability of indirect investors – those not holding legal title to the shares of the company in which they invest – to play a fuller role in company proceedings.

- *Exercising rights through proxy*. The Bill will ensure that the registered shareholder can nominate a proxy or proxies who can, on their behalf, attend and speak at meetings, demand a poll, and vote on a show of hands or on a poll. This will enable those indirect investors acting as proxies to the registered shareholder to exercise all the participation rights which would otherwise rest with the registered shareholder alone.

- *Exercise of governance rights*. The Bill will make it easier for indirect investors to exercise governance rights. Some companies already make their own provisions through their articles to recognise and enfranchise their indirect investors, but the present best practice can involve considerable detailed bespoke legal advice and drafting to set out complex provisions in a company's articles. This is expensive and time consuming. In future where a company makes provisions in its articles to enfranchise indirect investors, then to the extent provided in the company articles, reference to registered members and their rights in primary legislation should be extended to include those designated by the registered member. The end result will be greater parity of treatment in law for registered members and indirect investors for the exercise of governance rights as specified in the company's articles.

- *Right to information power*. In addition, the Bill will include a reserve power for the Secretary of State to compel some or all public companies to provide information – electronically – to persons having an interest in shares if the registered member requests. At present the intermediary, as the registered member, is only entitled to one set of information and, if this is all it receives, it cannot currently pass this on to all the indirect investors. Some companies are happy to provide more copies, but others have been reluctant because of the cost involved. Some intermediaries also have not

wanted to incur the costs involved in mailing the information out to the indirect investors. However, it is now increasingly reasonable to assume that indirect shareholders will have access to the internet. Electronic delivery avoids most of the costs of paper, is much quicker and more practical particularly when forwarding through a chain of intermediaries. It is anticipated that the Secretary of State's power will only be exercised if the market does not develop appropriate solutions to ensure that indirect investors have access to information they require to engage in the governance of the companies in which they invest.

3.3 Directors

Directors' duties

The general duties which directors owe to the company are at the moment found in case law – i.e. decisions in individual court cases over the years – rather than in the Companies Act. As a result, those who become company directors may do so without understanding their obligations under the law. Those obligations may also not be understood by the members of the companies, in whose interests the directors should be acting. Both the CLR and the Law Commissions believed that there was a need to make the law in this area more consistent, certain, accessible and comprehensible, and recommended that there should be a statutory statement of directors' general duties. The Government agrees that directors' duties are fundamental to company law, and that it is very important that the duties are widely known and understood. The Bill will therefore introduce a statutory statement of directors' general duties.

- The statutory statement of duties will replace existing common law and equitable rules. The duties will be owed to the company, and – as now – only the company will be able to enforce them. (In certain circumstances, the shareholders may be able to bring a derivative action, albeit essentially for the company's benefit.)

- The statement of duties will be drafted in a way which reflects modern business needs and wider expectations of responsible business behaviour. The CLR proposed that the basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and suppliers, and in the community more widely. The Government strongly agrees that this approach, which the CLR called "enlightened shareholder value", is most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare

for all. It will therefore be reflected in the statement of directors' duties, and in new reporting arrangements for quoted companies under the Operating and Financial Review Regulations.

- The statement will address circumstances where there is a conflict between a director's duties to the company and his or her personal interests or duties to others. It is important however that the duties do not impose impractical and onerous requirements which stifle entrepreneurial activity. The CLR recognised that this might happen in circumstances where a director wished to exploit a business opportunity which might also be exploited by the company. Normally at the moment directors have to obtain the members' agreement, even if the company does not wish to exploit the opportunity or has already decided to abandon the opportunity. The statutory statement will implement the CLR's recommendation that the company's rights might be waived by the board, acting independently of any conflicted director.

- At present, there are a number of remedies for breaches of the duties, including the payment of damages by way of compensation where the director's action is considered negligent and the restoration of company property where assets have been misappropriated. The statement of duties will not change this.

- The statutory duties will apply to all persons acting as director. They will also apply to shadow directors, although there will be aspects of the duties that must apply differently to shadow directors.

- It is important that the statement of duties enables the law to respond to changing business circumstances and needs. It will therefore leave scope for the courts to interpret and develop its provisions in a way that reflects the nature and effect of the principles they reflect.

- The statement of duties should be widely accessible and understood. The Government will therefore publish plain language guidance explaining the statutory duties.

Regulating directors' conflicts of interest

Part 10 of the Companies Act 1985 contains a variety of provisions designed to deal with situations in which a director has a conflict of interest. The provisions are intended to clarify the director's general duties to the company in areas where conflicts of interest commonly arise, such as the making of loans by a company to a director.

The present mixture of regulation in Part 10 has grown up piecemeal, without any attempt to look at directors' transactions with their company in the round. As a result, the provisions of Part 10 are widely regarded as excessively complex and fragmented. The Government does not favour repeal of these provisions: as respondents to the CLR and the Law Commissions made clear, codification of the general duties will not in itself prevent the abuses which caused these provisions to be enacted. We have also been mindful of the argument that directors may find better guidance in clear statutory rules than in general principles. At the same time, it is clear that Part 10 is in need of major reform, and the Bill will restate, as well as amend, the current requirements. We have had five main aims in our reform of Part 10:

- the Bill will simplify the overall structure, so that the provisions are more accessible to directors and other users. In particular, types of transaction requiring shareholder approval – including property transactions; loans, quasi-loans and credit transactions; and *ex gratia* payments for loss of office – have been brought together; and, where appropriate, the clauses have been drafted so as to facilitate comparison between the requirements in these areas;

- the Bill will deregulate where the existing provisions are unnecessary or excessive. In particular, companies will be able to make loans to directors with the consent of shareholders. This is a significant reform which will provide a simple and, in many cases, readily applicable method of ensuring compliance;

- the Bill will remove existing loopholes e.g. by requiring directors to disclose the interests of connected persons if they would have to be disclosed if they were the director's interests, and by broadening the definition of a director's service contract in relation to the requirement that they be open to inspection by shareholders;

- the Bill will reflect modern business behaviour e.g. by requiring disclosure of interests to other directors as soon as is reasonably practicable, and by giving shareholders the right to receive copies of directors' service contracts on payment of a fee; and

- the Bill will clarify the law where the existing provisions are unclear or incomplete e.g. by making it clear that the rules relating to *ex gratia* payments for loss of office do not extend to payments that a company is bound to pay to a director on his retirement or other loss of office because it has a legally binding obligation to do so.

Disclosure requirements can play an important role in the regulation of directors' conflicts of interest, but it is important that such requirements are proportionate and not excessively complex. Parts 2 and 3 of Schedule 6 to the Companies Act 1985 currently set out the information about loans and other dealings in favour of directors which must be provided in the notes to a company's annual accounts. The information required is extensive and the provisions not properly understood by many directors and users of accounts. The Government is therefore considering whether the requirements relating to disclosure of transactions in which directors are interested might be simplified without any loss of necessary protection to shareholders.

Directors' liability

The law on directors' liability needs to strike a careful balance: on the one hand, the law must be firm and robust to deal fairly with cases where something has gone wrong, as a result of either negligence or of dishonesty; on the other, Britain needs a diverse pool of high-quality individuals willing to assume the role of company director, and a willingness by directors to take informed and rational risks.

The Government consulted on these issues in December 2003. In the light of the responses, it introduced two important reforms through the C(AICE) Act 2004. These are the most significant changes to the law on directors' liability for nearly 80 years. As a result from 6 April 2005 companies may:

- indemnify directors against most liabilities to third parties; and
- pay directors' legal costs upfront, provided that the director repays if he or she is convicted in any criminal proceedings or judgement is given against him or her in any civil proceedings brought by the company or an associated company.

The response to these reforms has been very positive, and we believe that they address the most important issues raised by respondents to the consultation.

Some consultees also favoured further reform of the law to permit companies to limit directors' liability to the company for breach of the duty of care, skill and diligence. The Government explained in Parliament that this would need to be considered alongside the statement of directors' duties now set out in draft in this White Paper. It would for example be possible to permit shareholders if they wished to agree some limit on directors' liability for negligence without permitting them to limit the liability of any directors who

put personal interests before their duty to the company. The Government will continue to consider whether concerns about potential liability for negligence are affecting director recruitment and behaviour, and, if so, whether such concerns justify a further change in the law.

Who can be a director?

One of the flexibilities of British company law is that it allows all legal persons (for example, other companies) to be company directors in the same way as if they were individuals. This flexibility can sometimes be abused by those who wish to conceal who is controlling a company (for example those intending to commit fraud may use a company with corporate directors to help obscure the identity of the individuals involved), and the Government considered the option of banning corporate directors. Equally however, an outright ban might harm those companies who make use of the current flexibilities for entirely legitimate reasons.

We therefore propose that the Bill should include a requirement that at least one director be a natural person. This provision is intended to ensure that every company will have at least one individual who can, if necessary, be held to account for the company's actions. It is also consistent with the increased thrust being placed in the Bill on the importance of directors understanding their statutory duties.

Each company can set its own rules for who appoints its directors. It is for the company to ensure that it appoints persons who not only understand their duties but also take full responsibility for their actions and omissions. The Bill will therefore remove the restrictions on directors over 70 years old, at the same time as providing that 16 will be the minimum age for a director. This prohibition of child directors will need transitional provisions. In particular, any child under 16 appointed after publication of this White Paper will not be entitled to financial compensation in respect of early termination from office resulting from the introduction of the prohibition.

3.4 Minority shareholder rights

Derivative actions are the route by which shareholders, usually minority shareholders, are able to enforce the company's rights where directors have breached their duties, (since in these circumstances it is unlikely that the directors, who usually act on behalf of the company, will want to take action). They are therefore an important mechanism by which shareholders can hold directors to account for the proper exercise of their duties in pursuit of their company's short and long-term interests. Derivative actions are currently available to shareholders in certain circumstances as a matter of common law, not statute.

The Bill will therefore put derivative actions on a statutory footing. This proposal has been recommended by the Law Commission and endorsed by the CLR. The Bill will also clarify the complex provisions on alteration of class rights, and extend them to companies without share capital.

3.5 Auditor liability and audit quality

The Government is keen to encourage confidence in the statutory audit and to ensure a strong, competitive and high quality audit market. To help in this, over the course of the past two years the Government has promoted debate to identify further ways by which these goals can be achieved.

In the aftermath of a company failure, those who have suffered losses may look to the auditors as having the "deepest pockets" of all of those they can pursue for compensation. Consequently, the auditor may bear 100% of the compensation even though the auditors' "share" of the blame (when compared to other culpable parties) may be less. Theoretically, this makes audit firms vulnerable to very large claims where they are held to have been negligent in their conduct of an audit. In practice, however, most claims are settled out of court.

In December 2003, the Government launched a public consultation on director and auditor liability. This showed clear support for changes to the law on directors' liability, and appropriate provisions were included in the Companies (Audit Investigations and Community Enterprise) Act 2004. These come into force next month. The responses on auditor liability were more mixed and the Government concluded that it would be inappropriate to permit the capping of auditors' liability to a predetermined amount. However, it invited auditors, their clients and investors to work together to consider other approaches by which liability might be limited, and in parallel to identify ways to improve audit quality and enhance competition. The Government is grateful for the helpful and constructive approach adopted by all contributors.

In the light of that work, the Government is now persuaded of the benefits of change. The reforms will have three key parts – firstly, legislating to allow shareholders to agree limitations to the liability of auditors; secondly, some specific improvements to the quality of the audit process; and, thirdly, the establishment of an on-going process by which further enhancements to quality and competition can be identified and then implemented. The Government sees these three parts making up a balanced package of measures to improve the audit market, and believes it is important that all of these go forward together.

The Government believes that it would be inappropriate to change the law on who can sue the auditors in the civil courts. However, given the wider importance of audited financial statements, the Government proposes to make it a criminal offence knowingly or recklessly to give an incorrect audit opinion.

Proportionate liability by contract

The Government proposes that shareholders should be able to agree a limit to the auditor's liability for damage incurred by a company, to such an amount that is determined by the Courts to be just and equitable, having regard to the relative extent of responsibility of the auditor for the damage incurred.

Specifically, the Government proposes that:

- such a limitation would apply in situations where damage to the company has been caused through the (mis)conduct of an audit, to the extent the Court considers just and equitable in the circumstances of the case;
- the company would be left to recover, as part of a separate action, the loss suffered for which some other defendant (e.g. another professional advisor) was responsible;
- the auditor would continue to be fully liable for any fraud to which he or she was party;
- the company could not agree in advance a monetary limit to the auditor's liability. This means there would be no scope for maxima set as cash sums, or expressed in accordance with a quantifiable formula (for example, as a multiple of the audit fee); and
- only those causes of action arising after the commencement of the legislation would be subject to the proposed provisions.

In practical terms this would mean that, as now, with the authority of the shareholders, the directors of the company would negotiate the scope, terms and cost of the audit contract. The directors would decide how much weight should be given to factors which might influence the terms of the audit, such as the cost and availability of insurance, the attitudes to risk of the directors, shareholders and auditors and the directors' perception of the level of competition between audit firms. In addition, if the shareholders had given explicit agreement, the contract with the auditors could include a limitation of the auditor liability as set out above. The Government proposes that shareholder agreement to such limitation should be required each year and in advance of each year's audit.

The Government also proposes that the existence of any limitation of liability would be shown in the company's annual financial statements. The auditor should also provide a list of all companies with which it has agreed a limitation of liability in its own annual financial statements.

Improvements in audit quality and value

The Government welcomes the four specific proposals from auditors, their clients and investors for improvements in audit transparency and to support shareholder involvement in the audit process.

These initiatives are:

- *Publication of audit engagement letters:* there is widespread support for publicly disclosing the content of audit engagement letters. This will increase transparency and enable third parties to understand better the scope of the audit and the terms on which it has been undertaken.

- *Shareholders rights to question auditors:* it has been proposed that shareholders be able to question auditors about the audit. The Government is considering proposals that, building on recent changes in Australia, might involve enabling shareholders to question the auditor in advance of AGMs, or by writing to the auditor, via the company, with reasonable questions. All queries must relate to the auditors' report or to the conduct of the audit.

- *Publication of auditor resignation statements:* there is widespread support for fuller disclosure of information in auditors' resignation letters, to enable investors to understand the reasons for the resignation. The law currently requires an auditor either to state that there are no circumstances connected with his or her resignation that need be brought to the attention of members or creditors of the company, or else to set out the circumstances for the company to circulate. Experience suggests that the risks of legal action may be inhibiting the frankness of such statements, and all concerned are keen to improve transparency.

- *Audit lead partner's signature on audit reports:* finally, it has been recommended that the lead audit partner on an audit should be required to sign and print his or her own name on the audit report, in addition to the name of the audit company undertaking the audit. It is expected that this will serve to improve audit standards by encouraging further personal responsibility for the actions taken by the audit team.

The Government welcomes in principle these initiatives and the Financial Reporting Council and the Department of Trade and Industry are taking them forward. It is intended that any necessary changes to the law will be included in the Bill, alongside the provisions on auditor liability.

Longer-term reform

The Government is grateful to the Institute of Chartered Accountants in England & Wales (ICAEW) for helping establish a "quality forum". The Government believes that this advisory body, made up of representatives of auditors, investors, business and regulatory bodies, is playing a valuable role in facilitating communication between business, auditors and investors, and generating practical ideas to improve audit quality.

The Government and the Financial Reporting Council will be working with stakeholders to continue to identify further ways in which quality and competition in the audit market can be enhanced.

3.6 Company Takeovers

The Takeovers Directive – which completed the European legislative process in April 2004 – lays down minimum standards for takeover regulation across the Community, and applies many of the core values of the UK system at the EU level. It will also reduce barriers to takeovers in the Community through improved shareholder protection and access to capital markets.

Takeover regulation in the UK has been overseen by the Takeover Panel, essentially on a non-statutory basis, for the past 36 years. Implementation of the Takeovers Directive requires the introduction of a statutory framework but the intention is to preserve the independence and authority of the Takeover Panel and its capacity to make and enforce rules regulating takeover activity. The Department published a consultative document – available at www.dti.gov.uk/cld/current.htm – on 20 January 2005, setting out proposals for implementing the Directive. The consultation period is open until 15 April 2005.

The Bill will include provisions to implement the Takeovers Directive and place the Takeover Panel on a statutory footing. The precise nature of these provisions will be determined in the light of the responses to consultation.