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FSMA secondary legislation consultation
responses
Financial Stability and Regulatory Policy
Team
Room 4/23
HM Treasury
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27 May 2004

Dear Madam

FSMA Two Year review – changes to secondary legislation

We are please to provide comments on the consultation document relating to proposed changes to secondary legislation under the FSMA.

We restrict our comments in the main to chapter 6 of the consultation document “Sale of a Body Corporate”, and deal with this matter in appendix to this letter, but we would also, in response to question 20, urge consideration to changes to Article 49 of the Financial Promotion Order “High net worth companies, unincorporated associations etc”.

Article 49 provides an exemption inter alia for financial promotions made to ‘high net worth companies’. In order to qualify for the exemption, such companies need to have (or another company in the company’s group needs to have) net assets or share capital of £5 million, or £500,000 if the company has more than 20 members. This exemption has been carried forward largely unaltered from Article 11 of the Financial Service Act 1986 (Investment Advertisements) (Exemptions) Order 1996, which covered ‘persons sufficiently expert to understand the risks involved’. We consider that there is a case for reconsidering whether companies falling below the size thresholds set out in Article 49 are inherently any less sophisticated than companies which exceed the thresholds and what investor protection objective is being served by prohibiting financial promotions to companies which fall below the threshold.

In practice, a figure of £5 million for share capital or net assets appears to be an arbitrarily high figure (compounded by the fact that the test has to be passed on a company by company basis – such that a group of companies with consolidated net assets of say £20 million may fall outside the exemption because no company within the group individually has assets of £5 million or more). This also contrasts with the fact that under the FSMA regime, individuals with net assets of £250,000 are subject to an exemption. The related exemption – for companies with assets of

£500,000, provided that they have at least 20 members – typically provides little assistance, since it is not common for small private companies (or even small groups) to have as many as 20 members. At the same time, the logic underpinning the proposition that numbers of members has a bearing on investment expertise is not readily apparent.

In our view, there is not now, nor was there under the Financial Services Act regime, an excessively strong case for an extensive investor protection regime for corporate bodies. Those charged with running corporate bodies do not, it appears to us, represent the same order of investor as private individuals investing in a personal capacity, irrespective of the size of the body corporate. The nature of the directors' fiduciary duties, the collective role of members of the board and the greater custom and practice of seeking legal and other professional advice means that there is at least a case for permitting financial promotions to be made to all corporate bodies, without regard to any size criteria. If, notwithstanding these considerations, it is believed that protections should be afforded to corporate bodies, we nevertheless feel that a considerable reduction in the size threshold can be justified, and that consolidated positions can be taken into account. We believe that this could contribute to the availability of start up and seed capital, recognising the fact that business angels who have not chosen to obtain certificates of high net worth or as sophisticated investors may be willing to receive approaches via corporate investment vehicles which they control.

If you would like to discuss further any aspect of this response, please contact David Cattermole on 020 7311 8346.

Yours faithfully

KPMG LLP

Q24: Do you agree that the exclusion in the Regulated Activities Order should be narrowed so that the "may reasonably be regarded" test will apply only in relation to a party who is acquiring or disposing of the day to day control of that body corporate and hence not to advice given to a party whose object is not acquisition or disposal of day to day control?

Although we have some doubts about the distinction drawn between holding investments for commercial purposes and holding investments for investment purposes (as opposed to the proposition that a shareholder or group of shareholders which has, or is proposing to take, control of a company is likely to be well-informed (and hence 'expert') in relation to the relevant investment), we do not disagree with the conclusion that the effect of the Regulated Activities Order exemption may be too wide in enabling advice to be given to shareholders who individually or as a group do not have or do not intend to take control.

We would therefore support clarification that it is services performed for the shareholder (or group of shareholders) proposing to acquire or dispose of control which are exempt regulated activities, and not those services which are provided to other persons who may be involved in such a transaction but who do not form part of the controlling group.

Q25: Do you agree that the exclusion in the Regulated Activities Order should be narrowed so that the "may reasonably be regarded" test will apply only in relation to takeovers of small companies?

Having regard to our response to question 24, we do not agree that the size of the company should be a relevant factor when determining whether the regulated activities undertaken should be treated as exempt. Whilst we accept that it may be desirable that financial advisers involved in providing advice in connection with takeovers subject to the City Code should be authorised by the FSA, we do not agree that the logic of the RAO should be compromised in order to achieve this end. In terms of the need for investor protection, an 'investor' proposing to bid for a large company is no different in essence from an investor proposing to take over a small company. Services provided to such parties by financial advisers should logically be exempt regulated activities in both cases. However, regulated activities, such as investment advice, provided to a minority shareholder in the target company should not be subject to the exemption (a position which could be achieved without the need for a large company/small company distinction).

As noted above, if it is believed to be desirable that all advisers who give advice (to any party) in connection with a City Code transaction should be authorised by the FSA (and hence subject to FSA oversight) this can be dealt with separately by making it, for example, an obligation of the City Code that offerors and offerees should appoint such advisers. Such an objective should not, however, be confused with the question of whether the activity is or is not regulated.

Q26: Which option do you prefer as the definition of "small" company in respect of which the "may reasonably be regarded" test should apply? Do you have any other suggestions?

As noted above, we do not support the proposal to determine whether an activity is or is not an exempt regulated activity on the basis of size of company.

Q27: Do you agree that the exemption for promotions in respect of takeovers should be subject to the same conditions as those which apply under the revised RAO?

We agree with the general principle that persons to whom regulated activities may be provided on an exempt basis should also be capable of being recipients of financial promotions which do not need approval by an authorised person. However, care is needed in applying the principle, as the circumstance of an unauthorised person issuing a financial promotion is different from that of a party requesting a financial adviser to perform regulated activities.

The proposed financial promotion exemption which is drafted on the basis of the proposed RAO exemption appears to have the very narrow result of permitting unapproved financial promotions to be issued to bidders seeking to take-over, or a group of seller seeking to sell a controlling stake in, a small company. It would appear that the issuer of the financial promotion would need to *know* that the relevant party “S” or “T” was proposing to enter into a transaction before communicating with “S” or “T” about the transaction. If the issuer of the financial promotion already knows that “S” or “T” is proposing to bid, it is likely that “S” or “T” has already entered into a dialogue with the issuer of the financial promotion. In such circumstances, it is not clear that a response by the issuer to “S” or “T” would in any event constitute a financial promotion.

In our view, the wording of the exemption should reflect the position that when issuing the financial promotion the issuer will not necessarily know that the party being communicated with is proposing to enter into a transaction (because the party has not, at that stage, been made aware of the possibility of the transaction). For example, the wording might be expressed in terms of a communication issued to persons reasonably believed by the issuer to be persons who might enter into a transaction satisfying the conditions set out in paragraph 2 or 3 of proposed article 69. We believe that it should also be made clear that in order to communicate with “T”, it is not necessary to communicate with the entire group of persons acting together, but the communication can be made to any person whom the issuer of the financial promotion reasonably believes may be or may become a member of group of persons acting together for the specified purpose.

As noted in relation to the RAO exemption, we believe that the exemption should not be restricted by reference to the size of the company, and that party “T” should be considered expert enough to receive communications relating to a transaction satisfying the conditions involving “BC” and not just “BD”.

Paragraph 6.22 discusses briefly the effect of the change to the sale of body corporate exemption on communications with target shareholders. The communication of advice by a target board to shareholders is one part of this matter, and the impact of the change may be mitigated in the manner debated in paragraph 6.22. It is however by no means the most important part of the takeover process. The critical communications which made during takeovers are offer

documents and announcements sent by the offeror to target shareholders, which are prepared so as to comply with detailed requirements contained in the City Code. We consider that financial promotions to target shareholders in the context of takeovers subject to the City Code are already well controlled by the operation of the City Code, and where relevant the market abuse rules and the law on misleading statements. The removal of an exemption so as to bring such communications additionally within the financial promotion regime appears to create potentially increased costs for companies, with no ostensible incremental benefits in investor protection terms. We would suggest that an exemption be drafted exempting from the financial promotion regulations financial promotions which are subject to the City Code or the SARs.

We comment on the proposals relating to Articles 63 to 66 below.

Q28: Do you agree that it is desirable to have some form of regulation or conditions on unauthorised persons who are carrying out telephone campaigns?

Yes.

Q29: Do you agree that broadly speaking we should regulate to the same extent as under previous legislation?

Yes.

Q30: Which of the three options above do you prefer and why?

We would support option (i), provided that there is official confirmation that it is possible for an authorised person to approve the content of a telephone campaign (this position does not appear to conform entirely with the guidance issued by the FSA (FSA Handbook, AUTH App 1 10.4).

Q31: Do you agree that under the proposed regulatory framework the provisions in the Financial Promotion Order providing exemptions for takeovers of relevant unlisted companies (i.e. Articles 63-66) are no longer necessary?

Although the proposed framework may provide the ability to issue exempt financial promotions to “significant shareholders”, as stated in paragraph 6.39, Articles 63 to 66 represent the only mechanism for an offeror to communicate to minority shareholders without the need for approval. The proposals do not make Articles 63 to 66 unnecessary, nor should simplifying the FPO by removing parts of it be regarded as an objective in itself.

We do agree, however, that Articles 63 to 66 are not much used. The reason for this, though, in our view, is that the conditions attached to Articles 63 to 66 are so restrictive that parties who might otherwise wish to use the exemption find themselves unable to use it, or find compliance so onerous that seeking approval for the financial promotion is an easier option (there are 49 separate conditions set out in Schedule 4 to the FPO which need to be satisfied). Some of the more crucial elements which militate against the use of the exemption are:

- the exemption is only available to a party making an offer for a relevant company if the target board is prepared to recommend the terms of the offer;
- a requirement for the target company to have obtained advice in relation to the offer from an independent competent person;
- timetable issues;
- general level of detail which may be appropriate for offerors offering securities but may not be needed in the event of a wholly cash offer eg 2 years material contracts information for the offeror.

We believe that an exemption which did not require an offer to be recommended, but prescribed information which an offeror was required to include in any offer document sent to target shareholders would enable the exemption to be employed much more widely than at present.

Our position on this point mirrors our comments in relation to offers subject to the City Code, that is, that it should be possible for issuers of financial promotions to issue them with out the need for approval where the contents comply with a prescribed list of contents.