SUMMARY OF RESPONSES TO THE CONSULTATIVE DOCUMENT - INVESTMENT COMPANIES: SHARE REPURCHASES USING CAPITAL PROFITS

The Department received a total of 42 responses to its consultative document on investment companies: share repurchases using capital profits. Of these, 35 supported a change to the law so as to allow investment companies to repurchase shares using capital profits, 2 were opposed to a change, and 5 offered no comments. Most consultees responded to the consultative document by giving answers to the summary of questions set out in Annex A, sometimes with accompanying comments. These questions and a summary of the answers and accompanying comments are set out below along with a summary of the comments which related to costs. Several consultees - particularly those in favour of the proposals - commented on the arguments put forward in the consultative document for and, more usually, against a change to the law. These comments (which typically included comments on moving in and out of investment company status and on the alleged blurring of the distinction between OEICs and ITCs that the Statutory Instrument might bring about) have not been reproduced in this summary.

It should be noted that those organisations which commented, either in favour of, or opposition to, the proposals have been included in the numbers responding to question 1. However, only those organisations which specifically responded to the questions in Annex A - either in full or in part - have been included in the numbers responding to questions 2, 3 and 4.

PRINCIPAL QUESTIONS RAISED IN THE CONSULTATIVE DOCUMENT

1 Should company law be relaxed so that investment companies be allowed to use capital profits (in addition to revenue profits which they may presently use) to repurchase (or redeem) their own shares? ITCs would still be able to make distributions under section 265(1) of the Companies Act 1985.

In response to this question, 35 consultees favoured a relaxation of the law so that investment companies be allowed to use capital profits to repurchase (or redeem) their own shares and 2 consultees were opposed to such a relaxation.

2 If the answer to question 1 is yes, should the relaxation go further so that investment companies be allowed to use capital profits to make any distributions with the exception of dividends? Such distributions would include, for example, certain permitted forms of financial assistance.

In response to this question, 7 consultees favoured further relaxation so that investment companies be allowed to use capital profits to make any distributions -

including, for example, certain permitted forms of financial assistance - with the exception of dividends. However, 22 consultees were opposed to further relaxation. The principal comments in response to question 2 were as follows:-

- further relaxation should be permitted. Investment trusts are unique in that they exist to give a collective service (collective investment) but the method of obtaining that service is buying their shares. Whilst legal advice on financial assistance is variable, the cautious view is that ITCs should not advertise for new shareholders. This is severely limiting for them because effectively they are precluded from advertising for new customers. No such limitation is placed on OEICs or commercial companies. The law in this area should be amended to permit ITCs to advertise; the content of such advertisements would be covered by existing regulation but certain limits would have to be placed on the scope of any advertising, such limits being designed to protect existing investors.

  Note: this comment concerns provisions in the Financial Services Act and has therefore been passed to the Treasury which has responsibility for that Act;

- the role of ITCs in savings and retirement planning is well known and there may be opportunities in the future where capital profits could be distributed other than by way of dividend to improve the attractions of ITCs in the retail savings market. An ITC should be positioned to benefit from such opportunities provided the interests of existing shareholders are protected;

- too wide a relaxation might encourage companies to circumvent the prohibition against the use of capital profits for the payment of a dividend;

- it is sufficient that the relaxation be limited to a distribution by way of the repurchase or redemption of shares since the giving of the permitted forms of financial assistance described in section 153(4) of the Companies Act 1985 (loans and employee share schemes) has little or no relevance to ITCs.

3 If investment companies are to be allowed to use capital profits to repurchase their own shares, should there be any restrictions such as a limit on the frequency that shares may be repurchased or on the value of the shares that may be repurchased as a proportion of share capital? If so, why?

In response to this question, 3 consultees were in favour of restrictions such as a limit on the frequency that shares may be repurchased or on the value of the shares that may be repurchased as a proportion of share capital and 28 consultees were opposed to such a restriction. The principal comments in response to question 3 were as follows:-

- authority should be set out in the memorandum and articles of association possibly setting a particular percentage of share capital per year. For amounts over this percentage, authority should be required from shareholders;

- limits set by shareholders at annual general meetings could be a useful feature. They would increase the transparency of the share purchase process by giving shareholders an indication of the activity proposed;

- such a restriction would fetter the directors' discretion and limit the effectiveness of the facility;

- restrictions on the number of shares which may be repurchased are already adequately dealt with by the Listing Rules;

- present restrictions, coupled with section 75 of the Financial Services Act, are sufficient. It is section 75 which prevents investment companies becoming so open-ended (eg by allowing redemption on demand) as to become collective investment schemes.

4 If investment companies are to be allowed to use capital profits to repurchase their own shares, would this give rise to any concerns about creditor protection, bearing in mind the points made in paragraph 54 of this document?

In response to this question, 1 consultee considered that allowing investment companies to use capital profits to repurchase their own shares could give rise to creditor protection concerns. However, 27 consultees did not consider this to be the case. The principal comments in response to question 4 were as follows:-

- there are two key differences in the treatment of investment companies compared to other companies, ie the prohibition on distribution of capital profits and the rule by which revenue account income can be distributed to shareholders as dividends, notwithstanding the existence of capital losses, though subject to the rule that total assets must equal 1.5 times liabilities. These provisions reflect the special characteristics of ITCs and in many ways have to be seen as a *quid pro quo* for each other. If the prohibition on distribution of capital profits were relaxed, and to the extent this was actually made use of by trusts, there is a case for considering amending section 265(1) in respect of subsequent dividend distributions;

- Consideration should be given as to whether consent ought not to be required to be obtained from creditors by investment trust companies wishing to repurchase the shares. The relatively limited number of creditors in such companies should not create undue or insurmountable difficulties;

- there are few creditors other than debenture holders in an ITC. However, it is extremely easy to calculate quickly and accurately the value of the assets of an investment trust: this in itself allows creditors to make better informed judgements. In addition, the majority of assets of most ITCs are traded securities which could be sold quickly for cash;

- there is additional protection for those creditors of an ITC where the proposed repurchase requires the cancellation of the share premium account. In this case, the consent of the Court is required and the Court must satisfy itself before approving the cancellation that the ITC's creditors are properly protected. In certain cases, the Court will require the sanction of the ITC's creditors before approving the cancellation;

- where an ITC makes a reduction of share premium account or share capital in order to create sufficient distributable profits with which to fund the redemption or purchase of own shares, the protection of creditors is one issue which is considered by the court when granting approval for reduction. This is normally achieved by undertakings given to the court, obtaining the consent of the (usually very few) creditors and/or providing a bank guarantee.

COSTS

Several consultees made the point that ITCs without substantial capital profits (in their normal sense) have been looking at the viability of applying to the courts to convert their share premium account into a distributable reserve. The question then arose as to whether this way of funding a share repurchase entailed the loss of investment company status, which in turn revolved around the question of whether this reserve was, technically, a capital profit for Companies Act purposes. The legal advice sought on this one issue alone has, it is estimated, costs the companies concerned hundreds of thousands of pounds. Moreover, as a number of these opinions were conflicting, the issue has never been satisfactorily resolved and further opinions, at further expense, were likely to be taken by ITCs.

One consultee stated that it was difficult to estimate the total of other costs that would be incurred if future repurchases were unable to benefit from the proposed change to the legislation. However, various aspects of share repurchases without the change would involve additional costs. The loss of investment company status, for example, meant that companies would have to amend their articles, amend the presentation of their accounts, comply with the additional disclosure requirements and also consider the impact of the change on their ability to pay dividends. In addition, ITCs would need to communicate with their shareholders to ensure that they were fully aware of the implications of the loss of investment company status (and also did not confuse this with loss of investment trust status). The proposed company law changes would either remove the need to go through many of these hoops or drastically simplify them. The incremental cost of this activity (ie on top of the normal expenses that would be incurred in a repurchase even if the company law changes were made) could be around £10,000 for each transaction (this might vary by £5,000 on the up or downside). As 100 companies had sought shareholders' authority to make share repurchases to date, this implied an additional cost of around £1 million.

Only one other consultee gave an estimate of actual savings which would result from the proposed legislation. The costs - including the legal and accounting advice - incurred by two ITCs in changing their status from an investment company (as defined by the Companies Act 1985) to an ordinary plc and back to an investment company were estimated to be £50,000 and £100,000 respectively. (In the case of the latter,

the ITC also converted share premium, with court consent, to create distributable reserves.) This consultee estimated that allowing ITCs the power to buy back shares from capital profits would reduce one-off costs by at least £50,000 per ITC and reduce ongoing monitoring costs by a few thousand pounds each year.

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