INVESTMENT COMPANIES

SHARE REPURCHASES USING

CAPITAL PROFITS

A CONSULTATIVE DOCUMENT

MARCH 1999

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CHAPTER 1: SUMMARY AND CONSULTATION PROCEDURE

Summary

1 This consultative document seeks comments on a proposed change to company law. At present, investment trust companies (ITCs), like other companies, may purchase their own shares. Such shares subsequently have to be cancelled. Unlike other companies, ITCs may not use "capital profits", ie profits derived from increases in the value of the securities in which they have invested, to repurchase their own shares (or make other types of distribution), if they wish to be treated as "investment companies" under the Companies Act 1985. However, ITCs may use "revenue profits", ie dividends and other income from their investments, to repurchase their own shares. This consultative document seeks views on the proposal that investment companies, within the meaning of the Companies Act 1985, should be allowed to use capital profits to repurchase their own shares.

2 This consultative document refers to "investment trust companies" or "ITCs" which is the term generally used in the industry. It also uses the term "investment companies" which is found in sections 265 and 266 of the Companies Act 1985. As a general rule, for company law purposes, ITCs seek to come within the definition of an "investment company" in the Act. In addition, for tax purposes, they generally seek to come within the definition of an "investment trust" contained in the Income and Corporation Taxes Act 1988 and this term is used when referring to the relevant provisions in the Taxes Act. It should also be noted that references to the use of capital profits by ITCs are references to the use of **realised capital profits** and references to unit trusts are to **authorised unit trusts**. Unit trusts subject to regulation by the Financial Services Authority (FSA) - and consequently authorised for sale to the general public - are authorised unit trusts; those not subject to regulation by the FSA and therefore not eligible for sale to the general public - but which may be marketed to institutional investors such as pension funds and charities - are unauthorised unit trusts.

3 The issuing of this consultative document does not form part of the ongoing substantive review of core company law which was announced in March 1998 with the publication of the consultation paper "Modern Company Law for a Competitive Economy".

Deadline for comments / additional copies of consultative document

4 Comments on any issue raised by this consultative document would be welcomed. Replies should be submitted by **14 May 1999** to:

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5 This document may be copied without seeking the permission of the Department. Alternatively, please telephone Robert Ellis (0171-215 0409) for additional copies. Please telephone Peter Brower (0171-215 0224) if you have any other queries. The document has also been placed on the DTI website - http://www.dti.gov.uk.

Costs, savings and benefits

6 Views would be welcomed on any costs (both recurring and non-recurring), savings or other benefits that would be expected to result from the proposals and the approximate value and source of those costs/savings/benefits. The information will help in assessing the value of implementing the proposals.

Open government

7 Under the Code of Practice on Access to Government Information comments may be made publicly available unless consultees specifically request otherwise. Consultees should indicate, therefore, if they wish their response to remain confidential. A summary of all the responses received will be prepared and circulated to all consultees who respond to this consultative document and to anyone else who requests it. The summary will not identify respondents.

CHAPTER 2: INTRODUCTION

Investment Trust Companies

8 Investment Trust Companies (ITCs) are public limited companies incorporated under the Companies Act. They are an established form of collective investment enabling private investors to invest in a wide range of shares and other securities, thereby spreading the risk which is associated with investment in such assets. They also enable private investors to benefit from the expertise of the professional investment managers responsible for the ITC's portfolio. In addition, they enable institutional investors, such as pension funds and insurance companies, to invest in overseas markets or industrial sectors in which they may not have in-house expertise.

9 There are other forms of collective investment products available to investors in the UK, the main ones being unit trusts and open-ended investment companies (OEICs). As with ITCs, unit trusts and OEICs pool the funds subscribed by investors to invest in a professionally managed portfolio of investments which, generally, are listed on the Stock Exchange. Unlike an ITC (where the amount of initial capital to be invested is fixed when it is set up), unit trusts and OEICs have an "open-ended" structure, meaning that the manager of the fund is required to issue and redeem units at the demand of the investor, with the size of the fund increasing or reducing depending on whether there are net purchases or sales by investors.

ITC share price discount

10 For some years a number of ITCs have seen their share price standing at a discount to their net asset value, that is the value of the securities in which they invest. There are a number of reasons for this, one of which is that the supply of shares in a particular ITC may be greater than the demand for those shares. ITCs are able to issue shares when share values are standing at a significant premium to their net asset values. However, they are less able to manage their capital structure to reduce the number of shares in the market when standing at a discount. The changes proposed in this consultative document would make it easier for ITC boards to manage their share structures in the interests of their shareholders.

Share repurchases

11 Under the Companies Act, a company may repurchase its own shares in the circumstances and subject to the conditions set out in Part V, Chapter VII of the Act. By enabling an ITC to contract its capital when supply exceeds demand, share repurchases may - in some circumstances - prove to be a key tool in reducing the share price discount.

12 There are special provisions in the Companies Act concerning "investment companies" which have the effect of restricting share repurchases by ITCs (since, as a general rule, ITCs seek to come within the definition of an "investment company" in the Act). Specifically, investment companies may not use "capital profits", that is profits derived from increases in the value of the securities in which they have invested, to make distributions (which would include share repurchases). Investment

companies are not prevented by the Companies Act from using other means to repurchase their shares, for example they could use “revenue profits”, that is dividends and other income from the companies in which they have invested. However, in many cases there are drawbacks in using these other means which either render them impracticable or restrict the amount of funds available for a repurchase; these drawbacks are set out more fully in Chapter 4.

13 The subject of this consultative document is whether the provisions in the Companies Act which have the effect of restricting share repurchases by investment companies using capital profits should be relaxed.

Outline of the consultative document

14 The next chapter explains the present legislation (company, tax and financial services) and other rules that apply to ITCs and to other forms of collective investment products. Chapter 4 considers the arguments for and against a relaxation of the provisions in the Companies Act which restrict share repurchases by investment companies. Chapter 5 sets out the amendments which the Department proposes to make, and identifies a number of key issues to be considered.

15 A summary of the questions on which consultees’ views are sought is at Annex A. Annex B comprises a questionnaire on the procedures used in this consultation and which consultees may wish to complete and return with their responses to the document. A copy of a draft statutory instrument which could be used to amend the Companies Act is set out at Annex C.

CHAPTER 3: PRESENT LEGISLATION AND RULES

Rules applying to Investment Trust Companies

The Companies Act 1985

16 Part VIII of the Companies Act contains rules limiting the distribution by a company of its profits and assets. These rules are intended primarily to protect the interests of creditors of the company but also to protect shareholders against actions by the company which might unfairly or covertly diminish the value of their shares.

17 Section 263 of the Act establishes the general rule that distributions may only be made out of profits available for the purpose. For the purposes of Part VIII of the Act, the term "distribution" is defined widely to cover every description of distribution of a company's assets to its members, except those specified in section 263(2). It would include, for example, dividend distributions or a distribution by way of a repurchase of shares (unless the repurchase was made out of unrealised profits or out of capital, for which there are rules elsewhere in the Act). Profits available for the purpose of distributions are defined in section 263(3) as net, accumulated, realised profits. This means that any accumulated, realised losses must be deducted when calculating distributable profits (though this is subject to additional special rules for "investment companies" in certain circumstances - see paragraph 19 below).

18 Section 264 contains an additional restriction on distributions by public companies. This prevents a public company making a distribution when the value of its net assets is below, or would fall below, the aggregate of its called-up share capital and undistributable reserves. For these purposes a company's undistributable reserves include any reserve which the company is prohibited from distributing by its memorandum or articles (section 264(3)(d)). There are alternative requirements in the case of investment companies wishing to make distributions under section 265 - see paragraph 19 below.

19 As noted in paragraph 17 above, there is an exception to the rule in section 263(3) that any accumulated, realised losses must be deducted when calculating distributable profits. This is found in section 265 which allows "investment companies", in addition to the distributions permitted to public companies generally, to make distributions out of accumulated, realised revenue profits minus accumulated revenue losses (realised or unrealised), subject to certain provisos, and in doing so to ignore any capital losses they may have made. This provision can be important for ITCs which have sustained capital losses as a result of falls in the value of securities they hold since it allows them to make dividend distributions to their shareholders (assuming they have sufficient revenue profits available for the purpose) which is the main function of some investment companies. Furthermore, if an investment company retains more than a certain amount of its eligible investment income, it would lose the tax privilege provided by the Income and Corporation Taxes Act 1988. Consequently, most ITCs have notified the registrar of companies of their intention to carry on business as an investment company within the meaning of the Companies Act.

20 One of the provisos referred to in the previous paragraph is that an investment company may only make a distribution under section 265 of the Companies Act if, at that time, the amount of its assets is not less than, or would not become less than, one and a half times the aggregate of its liabilities. Another proviso is that the investment company has not distributed any of its capital profits in the accounting reference period before the distribution.

21 The term "investment company" is defined in section 266. In order to come within the terms of the definition, a company must give notice in the prescribed form to the registrar of companies of its intention to carry on business as an investment company, and must meet the following requirements:-

- the business of the company must consist of investing its funds mainly in securities, with the aim of spreading investment risk and giving its members the benefit of the results of the management of its funds;
- none of the company's holdings in companies other than investments companies must represent more than 15% of its investments;
- its memorandum or articles of association must prohibit the distribution of the company's capital profits; and
- the company must not have retained more than 15% of its investment income in any financial year.

22 Like other companies, ITCs are subject to Chapter VII of Part V of the Companies Act which allows companies to purchase their own shares subject to a number of restrictions and requirements, including that the purchase must be financed out of "distributable profits" ie those profits out of which lawful distributions can be made (sections 160, 162 and 181). A further requirement is that any repurchased shares are cancelled and the amount of the company's issued share capital reduced accordingly. In May 1998 the Department published a consultative document, *Share Buybacks*, which proposed allowing companies to purchase and hold in treasury for subsequent resale up to a total of 10% of their issued share capital. If DTI Ministers agree, in the light of that consultation, that there should be a change to the law, the Department plans to issue a follow-up document which would include draft amending legislation. It is anticipated that such a document would also address the issue of share repurchases by investment trust companies. However, for the purposes of this consultative document, it remains the position that shares repurchased by ITCs must be cancelled.

The Second Company Law Directive

23 The special rules in the Companies Act for investment companies reflect provisions of the Second Company Law Directive (Council Directive 77/91/EEC of 13 December 1976). Article 15.1 of the Directive lays down certain restrictions and requirements in respect of distributions by public companies. Article 15.1(a) prohibits distributions when net assets are, or would become, lower than the subscribed capital plus undistributable reserves. This corresponds with section 264(1) of the Companies Act. Article 15.4 allows Member States to derogate from Article 15.1(a) in the case of investment companies with fixed capital. This derogation corresponds with section 265(1) of the Companies Act. The Directive imposes a number of requirements

where this derogation power is used - the expression "investment company" must be included in all of the company's business letters and order forms (implemented by section 351(1)(c) of the Companies Act), the company's assets must be at least one and a half times its liabilities (implemented by section 265(1)), and distributions contrary to Article 15.1(a) must be disclosed in the company's annual accounts (implemented by Part V of Schedule 4 to the Act). The Directive does not prevent investment companies making distributions from capital profits.

The Income and Corporation Taxes Act 1988

24 The provisions in the Companies Act concerning investment companies are closely related to provisions in the Income and Corporation Taxes Act 1988 ("the Taxes Act"). Under the Taxes Act, if a company is approved by the Inland Revenue as an "investment trust" in respect of an accounting period, capital gains made by the company during that accounting period will not be chargeable gains.

25 The expression "investment trust" is defined in section 842 of the Taxes Act. The definition is similar in many respects to the definition of an "investment company" in the Companies Act. For example, throughout an accounting period the investment trust's holdings in a company may not exceed 15% by value of its overall investments (except where the holding is in another investment trust or in a company that would qualify as an investment trust if all the shares making up its ordinary share capital were listed on the Stock Exchange) In addition, it may not retain more than 15% of its eligible investment income (that is income it derives from shares or securities and certain types of rental income). A further element of the definition in the Taxes Act is that the distribution as dividend of surpluses arising from the realisation of investments must be prohibited by the company's memorandum or articles of association. This is very similar to one limb of the definition of an investment company in the Companies Act except that the Companies Act definition is more restrictive because it requires the memorandum or articles to prohibit **any** type of distribution, not just distributions as dividend.

London Stock Exchange Listing Rules

26 ITCs are subject to the Listing Rules of the London Stock Exchange. It is one of the conditions for approval as an investment trust under section 842 of the Taxes Act that all the shares making up the company's ordinary share capital are listed on the Stock Exchange. Under section 265(4)(a) of the Companies Act an investment company wishing to make distributions under section 265(1) must have its shares listed on a recognised investment exchange other than an overseas investment exchange within the meaning of the Financial Services Act 1986. ITCs are subject to the Exchange's Listing Rules which deal with the establishment of an orderly market, the disclosure of price-sensitive information, the conduct of a company's directors and officers and to Chapter 15 which deals with purchases of own securities. They are also subject to special rules set out in Chapter 21 that apply to investment entities. These cover, for example, the experience of the company's directors and investment managers, the spread of investment risk and the independence of the directors from the investment managers. In addition, an ITC must comply with the requirements laid down for approval by the Inland Revenue as an investment trust under the Taxes Act.

Financial regulation

27 ITCs themselves are not required to be authorised under the Financial Services Act 1986 (FSA) but where an ITC employs an outside management company to manage its investments, which is generally the case, that management company would have to be authorised under the FSA. Most management companies with ITC clients have joined the Investment Management Regulatory Organisation (IMRO) which imposes requirements on its members designed to protect investors. In recent years ITCs have introduced Investment Trust Savings and Investment Schemes (ITSSs), Personal Equity Plans (IT PEPs) and personal pension schemes in order to promote investment in ITC shares by personal investors. The operators of these schemes are regulated under the FSA's framework of investor protection. In addition, the Personal Investment Authority has introduced a disclosure regime that applies to ITSSs, IT PEPs and IT personal pension schemes designed to help potential investors compare the aims, risks and costs associated with different types of investment. In common with all plcs, ITCs may market new shares (but not existing shares) to the public directly; the ITC manager may also market ITSSs, IT PEPs and IT personal pension schemes.

Rules applying to unit trusts and OEICs

28 There are a number of differences in the regulatory rules that apply to open-ended funds such as unit trusts and OEICs and those that apply to ITCs. Whereas ITCs are set up under the Companies Act, unit trusts are established by trust deed, and OEICs are companies set up under the Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulations 1996. Unlike ITCs, unit trusts and OEICs are hardly ever listed on the Stock Exchange. Both unit trusts and OEICs are directly regulated under the Financial Services Act 1986 as collective investment schemes. OEICs and unit trusts are subject to the special rules that apply to investment entities in Chapter 21 of the Stock Exchange's Listing Rules. However, OEICs are not subject to Chapter 15 which deals with purchases of own securities.

29 Both unit trusts and OEICs are subject to detailed product regulation by the Financial Services Authority (FSA). FSA rules place restrictions on how the manager may invest their funds and place limits on their ability to borrow. There are also specific rules for determining the value of their investments, and the price of their shares or units reflects the net value of their assets. Furthermore, the assets of a unit trust or OEIC are not held on the balance sheet of the manager, but by an independent trustee or, in the case of an OEIC, depository. As unit trusts and OEICs are subject to this detailed product regulation they are able to market their shares or units directly to the public under the supervision of the Personal Investment Authority. Investments in OEICs and unit trusts are covered by the investors compensation scheme.

30 ITCs, by contrast, are not subject to detailed product regulation. There are no comparable limits on how their assets may be invested, and they have extensive powers to borrow (subject to the requirement in the Companies Act mentioned in paragraph 20 above that to make distributions under section 265 their assets must be at least equal to one and a half times the aggregate of their liabilities). The value of an ITC's investments is determined according to the accounting provisions of the

Companies Act, and the price of their shares is a reflection of market sentiment. Unlike OEICs and unit trusts, investments in ITCs are not covered by the investors compensation scheme.

CHAPTER 4: ARGUMENTS FOR AND AGAINST A CHANGE TO THE CURRENT LAW

31 ITCs, like any other company, are already able to repurchase their own shares, subject to the provisions in the Companies Act. The issue considered in this consultative document concerns the profits from which an ITC (which also qualifies as an investment company) may make repurchases, and consequently the scale on which repurchases could be carried out.

32 Subject to the provisions of the Companies Act, an ITC can use any distributable revenue profits it may have to effect a repurchase of its own shares. However, in order to be approved as an "investment trust" under section 842 of the Taxes Act, an ITC may not retain in respect of any accounting period more than 15% of its eligible investment income. This rule means that ITCs typically have relatively minor revenue profits available for distribution from which they could repurchase their own shares. Moreover, some ITCs aim exclusively for capital growth, and many of these may have no revenue profits at all.

33 An alternative is for an ITC to relinquish its status as an "investment company" under the Companies Act, alter its memorandum or articles of association, and then repurchase shares using any net, accumulated, realised profits (including any realised capital profits) it may have, in the same way as other companies. However, if it did this it would not be able to make distributions under section 265(1) of the Act. It has been suggested to the Department that moving in and out of investment company status, even for a limited period only, is confusing for investors as it complicates the presentation of accounts.

Proposed change to the Companies Act 1985

34 In view of the limitations and disadvantages associated with possible alternative actions, the Department is proposing a change to the Companies Act so that the restrictions on investment companies making distributions using capital profits is brought into line with the similar restriction in the Taxes Act and they would only be prevented from making distributions **by way of dividends**. This would have the effect of enabling ITCs to repurchase their shares using capital profits, whilst at the same time retaining their status as investment companies under the Companies Act and therefore also able to make distributions under section 265(1).

35 The arguments for and against such a change are set out below.

Arguments for a change in the current law

36 A number of arguments have been put to the Department in support of a change to the Companies Act to make it easier for ITCs to use capital profits to repurchase their own shares. Proponents of such a change consider it to be a technical one which would enable them to repurchase shares as easily as other plcs. The change would not be a quantum leap. ITCs can, of course, already repurchase their own shares without losing investment company status by using revenue profits. They can also repurchase their own shares out of capital profits by giving up investment

company status. The change would simplify the process for ITCs by not requiring them to relinquish investment company status if they wanted to use capital profits to repurchase their own shares. The change would benefit ITCs since the repurchase of shares is one of a number of measures that ITC boards may use to help to address the problem of share discount. It would also give ITC boards greater flexibility to manage their capital structure and maximise shareholder value.

37 As noted earlier, the Taxes Act is less restrictive than the Companies Act with regard to ITCs' use of capital profits. The Taxes Act states that, in order to qualify as an "investment trust", the company's memorandum or articles of association must prohibit the distribution **as dividend** of surpluses arising from the realisation of investments. The Companies Act states that, in order to qualify as an "investment company", the memorandum or articles of association must prohibit the distribution (in any form) of the company's capital profits. It is not clear why the two definitions differ in this respect, although the fact that companies were not permitted to repurchase their own shares at all when the provisions in the Taxes Act were first drawn up in 1965 might be a relevant factor. It has been put to the Department that the requested change in the Companies Act would bring that Act more in line with the corresponding provisions in the Taxes Act.

38 Any concerns about the interests of creditors when an ITC conducted a share buyback, it is argued, are relatively small because ITCs, by their nature, are asset rich. ITCs have few creditors, other than debenture holders whose interests are likely to be protected. In addition, ITCs are subject to the requirement in section 265(1) of the Companies Act that their assets must not be less than one and a half times the aggregate of their liabilities if they wish to make a distribution under that section.

39 Although there are other possible solutions to the problem of the share price discount, share repurchases are considered by ITCs to be an essential tool available to boards. The winding up of an ITC could involve significant costs. Alternatively, if an ITC was acquired by another company while its shares stood at a discount to the asset value it is probable that the investors would not receive what they considered to be an acceptable proportion of the underlying asset value. In addition, investors might be left with tax liabilities that they had not anticipated. Another possible solution - conversion of the ITC into a unit trust or an OEIC - might be viable but, it is argued, this is a matter for shareholders to decide.

Arguments against a change in the current law

40 The main concern expressed to the Department about changing the Companies Act in the way described is that by doing so there would be a blurring of the distinction between ITCs and open-ended investment funds such as unit trusts and OEICs. ITCs are "closed-ended funds" which means that the amount of initial capital to be invested is fixed when they are set up. Investors wishing to acquire or dispose of their shares do so through the stock market in the same way as with shares in other companies, or by means of an ITC Savings Scheme, PEP or other scheme through which the shares may be held. Unit trusts and OEICs, on the other hand, are "open-ended funds" - investors wishing to acquire or dispose of units or shares buy them from, or sell them back to, the unit trust or OEIC at a price calculated by reference to

the underlying asset value. Unless a unit trust or OEIC resells the units or shares to another investor, they are cancelled and the fund is reduced in size accordingly. Thus, the size of an open-ended fund increases or decreases depending on the demand from investors.

41 OEICs and unit trusts are subject to the regulatory framework established by the Financial Services Act 1986 as well as the rules of the Financial Services Authority and other financial regulators such as IMRO and PIA. This framework, and the associated rules, are primarily intended to protect investors and potential investors. There are rules on the types of investment that may be made by collective investment funds, and the extent of borrowing that is permitted. The price of units and shares in unit trusts and OEICs is determined by regulation, on the basis of the underlying net asset value. Managers and trustees or depositories (in the case of OEICs) must be authorised by IMRO, and the unit trust or OEIC must be authorised by the Financial Services Authority, with the marketing of the schemes subject to PIA rules. As noted earlier, ITCs themselves are not subject to these rules (although the sale of some of their products, and any outside managers they may choose to employ, are subject to them - see paragraph 27 above).

42 It has been argued that, by giving ITCs greater freedom to repurchase their shares, they would come to look and behave much more like open-ended investment funds. In addition, the Financial Services Authority has recently consulted on the possibility of allowing limited issue, and possibly limited redemption, unit trusts and OEICs (Consultation Paper II: Limited Issue and Limited Redemption Funds). It is argued that such funds would thereby become more like closed-ended funds, and that the combination of these proposals is tending towards the emergence of a spectrum of collective investment products from fully open-ended to closed-ended, similar to that seen in other countries. The question arises therefore why all the different types of product across this spectrum should not be subject to the same degree of financial regulation.

43 It is further argued that, if the Department were to allow companies to retain repurchased shares in treasury, rather than requiring them to cancel them, and this freedom were extended to ITCs, then they would be even more like open-ended funds.

CHAPTER 5: PROPOSALS FOR CHANGE AND ISSUES TO BE CONSIDERED

Changes to the Companies Act 1985

44 The amendments to the Companies Act that the Department is considering making are set out below (a draft statutory instrument is at Annex C).

(i) Amend section 265(4)(b)(i) so that a company could, during the relevant period, repurchase its own shares (or redeem redeemable shares since this amounts to the same thing) using capital profits, but still make a distribution under section 265(1). This could be done either by allowing any type of distribution other than by way of dividend, or by prohibiting any distribution other than by way of redemption or purchase of the company's own shares. The former would adopt the same wording as that used in the Taxes Act. However, the word "dividend" is not used elsewhere in these provisions in the Companies Act, and so its use here could give rise to uncertainty and it would further widen the concession to permit other forms of distribution out of capital profits, eg certain permitted forms of financial assistance. The Department therefore proposes the alternative wording, so that section 265(4)(b)(i) would read as follows:

> "*(4) An investment company may not make a distribution by virtue of subsection (1) unless ... (b) during the relevant period it has not (i) distributed any of its capital profits other than by way of the redemption or purchase of any of the company's own shares in accordance with Chapter VII of Part V, or...*".

(ii) Change the definition of "investment company" in section 266(2)(c) so that the company's memorandum or articles of association are required to prohibit only distributions of capital profits other than by way of the redemption or purchase of the company's own shares. As with the previous amendment, the Department prefers this approach rather than allowing any distribution other than by way of dividend for the reasons given in (i) above. Thus, section 266(2)(c) would read as follows:

> "*(2) Those requirements are ... (c) that distribution of the company's capital profits other than by way of the redemption or purchase of any of the company's own shares in accordance with Chapter VII of Part V is prohibited by its memorandum or articles of association...*".

(iii) Amend section 264 to make clear that it does not prevent distributions of capital profits by an investment company by way of the purchase or redemption of its own shares. Section 264(3)(d) defines a company's undistributable reserves as including "any other reserve which the company is prohibited from distributing by any enactment ... or by its memorandum or articles". The amendments proposed above would mean that an investment company was still prohibited from using capital profits to make certain (though not all) types of distribution, so if section 264 were left as it is, it

could cast doubt on whether investment companies could in fact distribute such profits. To remove any ambiguity, it is proposed to add the following new subsection after section 264(3):

> "*(3A) Nothing in paragraph (d) of subsection (3) shall prevent the distribution by an investment company of capital profits by way of the redemption or purchase of any of the company's own shares in accordance with Chapter VII of Part V.*"

45 If the above amendments were to be made, the Department proposes that they would have immediate effect on the coming into force of the amending regulations. The Department is aware that some companies have purchased their own shares out of capital profits by relinquishing their status as investment companies under the Companies Act. In order to prevent such companies benefiting retrospectively from the proposed changes, and seeking to "re-instate" their investment company status for the accounting reference period in question, the Department proposes to insert a transitional provision (draft regulation 5) in the statutory instrument. This would provide that an investment company could not apply the changes retrospectively where they come into force in the middle of its accounting reference period for the purpose of section 265. The Department does not consider that any amendment is needed to the special accounting rules for investment companies in Part V of Schedule 4 to the Act, given the way in which the term "investment company" is defined in paragraph 73 of that Part, and given the effect of the proposed transitional provision.

Issues to be considered

46 ITCs, like other companies, are already able to purchase their own shares. However, if they wish to qualify as investment companies under the Companies Act they may not, at present, use capital profits for this purpose. Changing the Act in the way described above would therefore increase the **scale** on which some ITCs could repurchase their own shares by making available for the purpose additional profits.

Investor protection

47 One of the main issues that needs to be considered is whether such a change in the scale on which ITCs could repurchase their own shares, particularly if it were combined with the ability to retain repurchased shares "in treasury" then resell them, would blur the distinction between, on the one hand, ITCs and, on the other, unit trusts and OEICs. The Department wishes to ensure that this does not give rise to concerns about investor protection.

48 Chapter 3 above outlines the rules that apply to unit trusts and OEICs and those that apply to ITCs. From this it can be seen that, broadly speaking, unit trusts and OEICs are subject to specific rules designed primarily to protect investors, whilst ITCs are subject to the general legislation and rules that apply to listed public companies and also some provisions specific to ITCs. As noted in paragraph 27 above, ITCs are subject to investor protection measures: the fact that any outside management company employed to manage investments must be authorised under the FSA, and will generally be subject to IMRO rules; that operators of ITSSs, IT PEPs

and IT personal pension schemes are regulated under the FSA; and that these schemes are subject to the PIA disclosure regime. Moreover, ITCs are governed through independent boards. However, the sale and purchase of ITC shares is not otherwise subject to specific investor protection rules beyond the requirements in the Companies Act and the Stock Exchange Listing Rules.

49 Allowing use of capital profits to repurchase shares without thereby losing investment company status would give ITCs an additional degree of flexibility with respect to the size of their issued share capital. However, there would still remain a number of differences between, on the one hand, ITCs and, on the other, OEICs and unit trusts . The key difference is that, in the case of ITCs, share repurchases are at the discretion of the company's directors: shareholders must approve any repurchases but no individual investor has the right to demand repurchase of his own shares. In the case of unit trusts and OEICs, investors have the right to redeem their units or shares on demand.

50 The issue therefore is whether, notwithstanding these differences the additional scope that would be given to ITCs to repurchase their shares would give rise to investor protection concerns.

51 Share repurchases are governed by the provisions in Part V, Chapter VII of the Companies Act which are, at least in part, intended to help ensure that shareholders' interests are protected. A purchase can only take place where it is authorised by a company's articles. A "market" purchase must be authorised by shareholders voting on an ordinary resolution and, in the case of an "off-market" purchase, the proposed contract must be authorised by shareholders voting on a special resolution. (In general, if the Stock Exchange has listed the shares or afforded facilities for dealing in them to be undertaken, eg on AIM, the purchase is a market purchase; otherwise it is not.) The shares must be fully paid up and, after the purchase, the shares must be cancelled and the issued share capital reduced accordingly. In addition, shareholders' authorisation for a "market" purchase may be subject to certain conditions. It must specify the maximum number of shares authorised to be acquired, determine both the maximum and minimum prices which may be paid for the shares and specify a date on which the authorisation is to expire (which may not be later than 18 months after that on which the resolution is passed). In the case of "off-market" purchases, a resolution authorising a repurchase of shares is not effective unless a copy of the proposed contract or, if it is not a written contract, a written memorandum of its terms, is available for inspection by shareholders in the company. As with market purchases, the shareholder authorisation must specify a date on which it is to expire which may not be later than 18 months after that on which the resolution is passed.

52 Share repurchases by listed companies are subject to specific provisions in the Listing Rules of the London Stock Exchange. As with the Companies Act provisions, the requirements in the Listing Rules are designed with investor protection in mind. For example, there are detailed requirements concerning the information to be provided to shareholders and concerning the implementation of the offer, where authorisation is sought which would result in 15% or more of the issued share capital being repurchased. In addition, a company may not purchase its own shares when,

under the Model Code (set out in Chapter 16 of the Listing Rules), a director would be prohibited from dealing in its securities.

53 In view of these various investor protection measures contained in both the Companies Act and the Listing Rules, the Department does not believe that further restrictions - such as a limit on the frequency with which share repurchases could be conducted or on their size as a proportion of share capital - need be imposed on ITCs if they were able to use capital profits for this purpose. **The Department invites views on this conclusion.**

Creditor protection

54 A further issue of potential concern is creditor protection. If ITCs were allowed to use capital profits to repurchase or redeem shares, this could mean that there were fewer real assets to meet creditors' claims. Section 265(1) of the Companies Act provides that an investment company may only make a distribution under that sub-section if at the time the amount of its assets is not less than, or would not become less than, one and a half times the aggregate of its liabilities. This asset/liability cover helps to ensure a minimum standard of protection for creditors. In addition, the Department understands that ITCs in general tend to have fewer creditors than other types of listed company, that they are by the nature of their activities asset rich, and that loan creditors tend to have a charge against assets. Accordingly, the Department does not believe that the proposed amendment to the Companies Act would give rise to creditor protection concerns. **Consultees' views are invited on this issue.**

Types of distribution to be permitted

55 Changing the Companies Act in the way described above would allow ITCs to purchase (or redeem) their own shares using capital profits, whilst still qualifying as investment companies able to make distributions under section 265(1) of the Act. However, ITCs would continue to be prevented from using capital profits to make other forms of distribution. **The Department invites views on whether this apparently more limited relaxation of the distribution rules for investment companies would be preferable to allowing any form of non-dividend distribution from capital profits.**

Implementation of the proposed amendments

56 Subject to the outcome of this consultation exercise, the Department considers that the proposed amendments to the Companies Act could be made by means of secondary legislation adopted under section 2(2) of the European Communities Act 1972.

Annex A

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. [Note: capital and revenue profits are defined in paragraph 12. Distributions that investment companies are permitted to make under section 265(1) are outlined in paragraphs 19 and 20.]

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.

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?

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?

Annex B

URN 99/557 - QUESTIONNAIRE ON CONSULTATION PROCEDURES

We are keen to improve our consultation procedures. Please tick the correct box where appropriate.

1. Mailing

1a Was this consultation document sent to the right person and properly addressed? If **No**, please give the correct person/address. YES ☐ NO ☐

1b Are you on DTI Company Law Directorate's standard mailing list? YES ☐ NO ☐

If **No**, would you like to be? If so, please give your details below. YES ☐ NO ☐

If **Yes**, do you wish to have the mailing stopped or redirected? If so, please give your details below. YES ☐ NO ☐

2. Presentation of information

2a Was the document clear and easily understood? YES ☐ NO ☐

2b Was the document
too long ☐ too short ☐ about right ☐

2c Was the background information sufficient? YES ☐ NO ☐

2d Were the key issues correctly identified? If **No**, please comment below. YES ☐ NO ☐

2e Were the policy options offered clearly set out? If **No**, please comment below. YES ☐ NO ☐

2f Was the layout helpful ☐ confusing ☐ neither ☐

2g Could this consultation document have been made clearer? If **Yes,** please comment below. YES ☐ NO ☐

3. Responses from consultees

Was the period of time allowed for the return of responses to the document

too long ☐ too short ☐ about right ☐

4. Responsiveness of Company Law Directorate and Companies House

4a Have you been in touch with Company Law Directorate or Companies House about this consultation?	YES	☐	NO	☐
If **Yes**, was the response prompt	YES	☐	NO	☐
If **Yes**, was the response helpful	YES	☐	NO	☐
4b Following the analysis of replies, it is proposed to let those consultees who responded know the outcome and the next steps. Would this be helpful?	YES	☐	NO	☐

Thank you for taking the time to complete this questionnaire. Any additional comments or suggestions on the consultation procedure would be welcomed.

Annex C

DRAFT STATUTORY INSTRUMENT

STATUTORY INSTRUMENTS

1999 No.

COMPANIES

The Companies (Investment Companies) (Distribution of Profits) Regulations 1999

Made.........................	*1999*
Laid before Parliament	*1999*
Coming into force........	*1999*

The Secretary of State, being a Minister designated for the purposes of section 2(2) of the European Communities Act 1972, in exercise of the powers conferred on him by section 2(2) of that Act and of all other powers enabling him in that behalf, hereby makes the following Regulations:

Citation, commencement and interpretation

1.-(1) These Regulations may be cited as the Companies (Investment Companies) (Distribution of Profits) Regulations 1999 and shall come into force on 1999.

(2) In these Regulations, "the 1985 Act" means the Companies Act 1985.

Amendment of section 264

2. In section 264 of the 1985 Act (restriction on distribution of assets) the following subsection shall be inserted after subsection (3) -

> "(3A) Nothing in paragraph (d) of subsection (3) shall prevent the distribution by an investment company of capital profits by way of the redemption or purchase of any of the company's own shares in accordance with Chapter VII of Part V."

Amendment of section 265

3. In section 265 of the 1985 Act (other distributions by investment companies), in subsection (4)(b)(i) after the words "capital profits" there shall be inserted the words "other than by way of the redemption or purchase of any of the company's own shares in accordance with Chapter VII of Part V".

Amendment of section 266

4. In section 266 of the 1985 Act (meaning of "investment company") in subsection (2)(c) after the words "capital profits" there shall be inserted the words "other than by way of the redemption or purchase of any of the company's own shares in accordance with Chapter VII of Part V".

Transitional provision

5. Section 265(4) of the 1985 Act shall apply in relation to any part of a relevant period (as defined in section 265(5)) which falls before the date of coming into force of these Regulations as if the amendment to that section effected by regulation 3 above had not been made.

Minister of State,
Department of Trade and Industry.