

**TREASURY SHARES: SUMMARY OF RESPONSES TO CONSULTATIVE
DOCUMENT URN 01/500 OF SEPTEMBER 2001**

General

The Department received a total of forty responses to its consultative document on Treasury Shares. The responses came from a wide variety of interested parties including individuals, companies both small and large, accountancy and law firms, governmental bodies and organisations representative of these parties. The tone of the responses was generally supportive although many included reservations of one kind or another. The proposals were welcomed as an enhancement to the flexibility that companies would have in adjusting their capital structures; some respondents, however, were concerned that safeguards put in place to prevent abuse might not be adequate.

Q1 Have you any comments on the draft Regulatory Impact Assessment (RIA) at Annex E? In particular, what are your estimates of the savings or other benefits (or any costs) that would be expected to result from the proposed regulations? Paragraph 6 of the RIA sets out the comments that were previously received on savings. Comments are also sought on the regulatory impact of the proposed tax treatment. (Paragraph 1.7 of the consultative document.)

Seven respondents commented on the draft Regulatory Impact Assessment. The general consensus amongst these respondents was that the savings or other benefits of the regulations were difficult to estimate. Only one put forward a quantitative analysis of the savings or other benefits (or any costs) that would be expected to result from the proposed regulations. This respondent stated that if treasury shares could be used as an alternative to warehousing shares in a trust in connection with employee share schemes, typical savings on trustee fees would amount to approximately £10,000 per annum in the case of this particular company. One respondent stated that the benefits of the proposals as a cost effective tool for active capital management were expected to be considerable. Three respondents had misgivings about there being any savings arising from the use of treasury shares with two of these putting forward arguments for an increase in costs associated with the proposals; both reiterated that these costs were difficult to quantify. One of these respondents suggested that the fact that pre-emption rights would apply to treasury shares (unless disapplied by shareholders) would negate any savings that might otherwise be made. Another respondent suggested that the proposals would lead to greater flexibility, and in some instances, lower transaction costs only in respect of modest adjustments to a company's capital structure; it was stated, however, that the extent to which this was borne out in practice would, to a great extent, be determined by the precise manner in which companies were allowed to sell shares held in treasury. The impact of the proposals on facilitating more significant adjustments, this respondent considered, would be minimal.

Q2 Do you consider that there is likely to be any demand to finance the purchase of shares for holding in treasury from the proceeds of a fresh issue of shares and, if so, should this option be included in the regulations? If yes, what are your views on the treatment of the proceeds of a sale of any treasury shares financed from the proceeds of a fresh issue of shares and on the additional requirements identified in i) - iii) of paragraph 2.5. Under the draft regulations, a purchase of shares for holding in treasury could be financed only out of distributable profits. Shares which are purchased for immediate cancellation could continue to be financed out of the proceeds of a fresh issue of shares. (Paragraph 2.5.)

Twenty-three respondents addressed this question. Eight respondents considered that there was unlikely to be any demand to finance the purchase of shares for holding in treasury from the proceeds of a fresh issue of shares and the option should therefore not be included in the regulations. Of the remaining respondents, ten thought there would be a demand and the option should be included in the regulations, three did not foresee a demand but thought that the option should be included anyway, and two did have firm views one way or the other.

Amongst the majority who wanted the option included in the regulations it was generally considered that there could be cases where a company wished to restructure its capital base and finance the purchase of one class of treasury shares from the issue of another class of equity or non-equity share. It was suggested that the option should be included in the regulations as it would give additional flexibility consistent with treasury stock being a tool of regulating the cost of capital on a running basis. Few respondents went on to address the second part of this question. Of these, most suggested that the proceeds of a sale of treasury shares financed from the proceeds of a fresh issue of shares should be treated in the same way as the sale of treasury shares from distributable profits.

Q3 What are your views on the proposal that investment companies should be prevented from holding treasury shares? (Paragraph 2.7.)

Twenty-four respondents addressed this question and, of these, twenty-one considered (and many strongly so) that investment companies should not be prevented from holding treasury shares; two considered that investment companies should not be allowed to hold treasury shares and one reserved judgement. One respondent suggested that one of the possible reasons why a treasury share facility should not be extended to investment companies, was that it might blur the distinction between open-ended investment companies (oeics) and (closed-end) investment companies. However, other respondents considered that the distinction between oeics and investment companies had been clarified by the definitions in the Financial Services and Markets Act 2001. One respondent stated that the benefits for investment companies were the same as for other plcs, ie flexibility to adjust share capital and reduction of the cost of capital, and that the risks were the same as for other plcs or possibly lower.

Q4 What are your views on including a requirement in the regulations that treasury shares may not be included as an asset in the balance sheet? (Paragraph 2.23.)

Twenty respondents commented on this question. Opinion was divided with some respondents favouring an outright prohibition on treasury shares being shown as an asset; others saying that treasury shares should not be shown as an asset but that the accounting treatment of such shares should be left to the Accounting Standards Board to decide; and others stating simply that this was a matter for the Accounting Standards Board. Some respondents pointed out that the International Accounting Standards Board (IASB) Standards Interpretations Committee (SIC) interpretation number 16 stated that treasury shares may not be included as an asset in the balance sheet.

Q5 The draft regulations provide that the consideration received on a sale of treasury shares shall be treated as a profit (although the regulations do not specify whether such profit would be realised or unrealised or a combination of both). What are your views on the regulations providing instead that only the proceeds from a sale of treasury shares up to the amount charged on purchase would be realised, with any excess (profit) being unrealised? Should any unrealised profit be required to be transferred to a designated reserve such as the Share Premium Account? (Paragraph 3.1.)

Half of all respondents addressed this question. The majority view of respondents was that only the proceeds from a sale up to the amount charged on purchase should be realised and any excess profit should be unrealised, and that unrealised profit should be required to be transferred to a designated reserve. However, other respondents made out the case for all proceeds from a sale of treasury shares to be treated as profits (and for those profits either to be treated as realised or to be subject to guidance from the professional bodies). Some respondents made the point that, whatever the outcome of the consultation, the law needed to be clear on what was capital and what was profit - this was not a matter that should be left to professional guidance.

Q6 What are your views on the proposed requirements concerning the recording of treasury shares in companies' own registers? (Paragraph 3.2.)

Twenty respondents answered this question. Nineteen of these registered agreement, principally for reasons of transparency, although four of these respondents had some reservations. The principal comment of these respondents was that shares recorded in the register of members as being held by the company should be specifically recorded as treasury shares. Two respondents stated that if the regulations allowed treasury shares to be held by nominees then the register should also identify the fact that these shares were treasury shares.

Q7 What are your views on the proposed modifications to section 169 notices for companies notifying Companies House of purchases of their own shares, the holding of such shares in treasury and their subsequent sale or cancellation? (Paragraphs 3.3 - 3.6.)

All eighteen respondents who commented on this question agreed, more or less, with the proposals. However, nearly half commented on the notification process, primarily to suggest that this was an opportunity to simplify the process either by reducing the number of different forms used and/or combining the existing 169, proposed 169(1B) and proposed 169A(2) notices.

Q8 Do you have any comments on the proposed treatment of bonus shares? (Paragraphs 3.7 - 3.9.)

Seventeen respondents commented on this question; the majority agreed with the proposals, although some had comments of detail (such as how the proposals would impact on B share schemes). Generally, it was agreed that treasury shares should attract any fully paid bonus shares which a company issued; and that these bonus shares should also be classed as treasury shares and entered in the register of members and notified to Companies House.

Q9 What are your views on the proposed changes to the compulsory purchase provisions in Part XIII A of the 1985 Act in respect of takeovers? (Paragraphs 3.10 - 3.11.)

Of the twenty-one respondents who answered this question, seventeen agreed with the proposals, ie that in determining the 90% threshold at which the compulsory purchase provisions applied, treasury shares should not be included; and that once the 90% threshold had been reached and the company had been notified of that fact by the offeror, that no further sales of shares from treasury other than to the offeror should be allowed. The remaining four respondents either raised points of detail or commented that the provision did not go far enough and that the regulations should provide, in addition, that all sales of treasury shares by the offeree should be prohibited once a takeover bid had been tabled. One respondent made the same point but considered that such a prohibition should be included in the Takeover Panel's City Code. Another respondent suggested that the City Code should be amended so that the same restrictions that applied to the issue of new shares during the course of an offer should also apply to the sale of shares from treasury. That is, during the course of an offer, a company could only sell shares that were held in treasury with the specific approval of shareholders at a general meeting.

Two respondents raised the issue of treasury shares used for employee shares schemes and considered that some exemption should be provided to allow for their sale during an offer period.

Q10 Do you have any comments on whether or not it should be permitted for companies' treasury shares to be held by nominees? (Paragraphs 4.1 - 4.2.)

Of the twenty-three respondents who commented on this question, fourteen did not agree that it should be permitted for companies' treasury shares to be held by nominees. Six saw no reason not to permit treasury shares to be held by nominees, although most had reservations, chiefly in relation to transparency. Some, however, considered that the proposed disclosure requirements, for both purchases into, and sales from, treasury, were adequate to ensure transparency.

Those who were not in favour of treasury shares being held by nominees tended to agree with the points mentioned in the consultative document regarding the possible difficulties of ensuring compliance with the regulations, transparency, and the identification of treasury shares where they were held by a nominee.

Some respondents suggested that the use of nominee holdings might have to be permitted as sales and purchases of shares in listed shares were now largely conducted through CREST, which apparently relied on the use of nominee accounts. However, one respondent disagreed and stated that an alternative would be for the company to become a sponsored member of CREST and settle/hold stock in its own name.

Q11 Do you have any comments on the fact that, because a company holding treasury shares will be regarded as a member of itself, the regulations include no references to the transfer of title to treasury shares? (Paragraphs 4.3 - 4.5.)

Of the eleven respondents who commented on this question, nine agreed with the proposal for the regulations not to include any references to the transfer of title to treasury shares. One respondent suggested that the regulations should include some provision and another questioned the status of treasury shares.

Q12 What are your views on including a provision prohibiting treasury shares being sold at a discount to their nominal, or par, value? (Paragraph 4.6.)

Twenty respondents commented on this question and nearly all did not see the need for a provision in the regulations prohibiting treasury shares being sold at a discount to their nominal, or par, value. However, some respondents qualified their comments by saying that a prohibition was unnecessary if treasury shares were to be funded only from distributable profits. One respondent, whilst supporting there being no prohibition on selling treasury shares at less than par, nevertheless considered that it might be appropriate to introduce anti-abuse provisions prohibiting new shares being issued, repurchased and resold so as to avoid the prohibition in section 100 of the Companies Act 1985 on new shares being allotted at a discount to their par value. Another respondent suggested that there should be a prohibition on selling treasury shares at a discount to par value without the prior consent of shareholders. Another respondent agreed that this ought to be a matter for the shareholders of the company concerned and

suggested that the shareholders should have to approve a special resolution. Some respondents questioned whether section 151 of the Companies Act 1985 - which provides that companies may not provide financial assistance for the acquisition of their own shares - might apply where treasury shares were being sold at a discount to their nominal, or par, value.

Three respondents commented in relation to employee share schemes. They mentioned that they would not be in favour of a prohibition on selling treasury shares at a discount to par value because share schemes often involved distribution of shares to employees for no payment. Such a prohibition would make it more difficult for treasury shares to be used in conjunction with such a scheme. One of these respondents explained that the provision in the regulations to sell treasury shares [in section 162D(1)] would also require that treasury shares be transferred for some consideration. This respondent therefore recommended that the regulations should make it clear that a sale of treasury shares could include a sale for no consideration, at least in respect of treasury shares held for the purposes of employee share schemes.

Q13 Do you have any comments on the proposal that sales of treasury shares should not be restricted to sales for cash? (Paragraph 4.7.)

Of the twenty-one respondents who addressed this question, only two disagreed with the proposal although others had reservations. Most thought that, in order for companies to be able to benefit fully from the potential flexibility afforded by the introduction of treasury shares, it was important that treasury shares could be sold for non-cash consideration. However, some suggested that there was a need for an equivalent of a section 103/108 [of the Companies Act 1985] report - which was required where new shares were offered other than for cash - in order to prevent abuse. One respondent considered that there was justification for a cash restriction if treasury shares acquired from the proceeds of a fresh issue of shares were to be permitted.

Both of the respondents who disagreed with the proposal also cited the need for a section 103/108 report or its equivalent. One of these respondents gave the example of where a company issued shares for cash – possibly under a disapplication of pre-emption rights – bought them back for cash and then resold them for non-cash consideration, all of which was substantially in contemplation at the time of the original share issue.

Q14 Do you have any comments on whether it should be prohibited to hold redeemable shares in treasury? It would not be permitted to hold redeemable shares in treasury past their date of redemption. (Paragraph 4.8.)

Of the twenty respondents who answered this question, nineteen agreed with the proposal. Some commented that the regulations should include as broad a range of shares as possible, including redeemable shares; one considered that, in practice, less use would be made of redeemable shares.

Q15 Do you consider that companies should be entitled to grant a charge, either fixed or floating, over treasury shares or should this be prohibited? Alternatively, in the absence of a prohibition, should a requirement be introduced for a company to offer to sell its treasury shares to shareholders before a charge could be granted? (Paragraphs 4.9 - 4.11.)

Ten of the twenty respondents who commented on this question thought that there should be a prohibition on a charge being granted over treasury shares. Two respondents mentioned that this would be consistent with treasury shares not being treated as an asset. Another said that knowledgeable creditors would not be keen to accept a charge over company shares held in treasury and that charges would normally only be exercised if a company was in financial difficulties, at which time the value of the company's shares would have dropped. Another respondent pointed out that any proposal to allow companies to grant a charge over treasury shares could be defeated by the shares ceasing to be qualifying shares, an event that could be controlled by the company.

Eight respondents did not see it necessary for the regulations to prohibit a charge being granted over treasury shares and most of these stated that they did not think a requirement should be introduced for a company to offer to sell its treasury shares to shareholders before a charge could be granted.

Some respondents differentiated between floating and fixed charges. One respondent, for example, saw no problem with a floating charge being granted over treasury shares but envisaged difficulties with a fixed charge where the charge holder would normally expect to be registered as the holder of the shares.

Q16 Do you agree with the Department's analysis that no amendments to Part VI of the 1985 Act dealing with disclosure of interest in shares need to be made? (Paragraph 4.12.)

Eighteen respondents commented on this question, the majority of whom agreed with the Department's analysis that no amendments to Part VI of the Companies Act 1985 dealing with disclosure of interest in shares needed to be made. However, other respondents argued that treasury shares should be disregarded for the purposes of investors calculating whether or not they had an interest in shares. Some of these respondents suggested there was an inconsistency in treating treasury shares as part of the company's issued share capital for the purposes of disclosure of interest in shares, but not, for example, for the purpose of determining the 90% threshold for the compulsory purchase provisions in Part XIII A of the 1985 Act in respect of takeovers.

Q17 Do you agree with the Department's analysis that no amendments to Part XIII of the 1985 Act dealing with arrangements and reconstructions need to be made? (Paragraphs 4.13 - 4.15.)

Of the seventeen respondents who answered this question, twelve agreed that no amendments to Part XIII of the Companies Act 1985 dealing with arrangements and reconstructions needed to be made. One of these suggested that the matter be kept under review to ensure that the analysis remained valid.

Generally, those who did not agree with the Department's analysis thought that it was wrong in principle for a company seeking a section 425 compromise or arrangement with its members to be able to vote on the proposals and that treasury shares should be excluded in the calculation of the 75% majority.

One respondent said that it was not clear that the company would be able to vote at the court meetings. Moreover, as the consent of the company was required to a scheme under section 425 in any event, this seemed an additional complicating factor which would make it more difficult for holders objecting to a scheme to be able to prevent it, if the treasury shares were counted in favour. It was also possible that the court would treat the treasury shares as a separate class. Another respondent believed that it should be made clear in the legislation that treasury shares were to be treated as a separate class of shares for the purposes of section 425. On this basis the company could presumably bind them to the scheme without the need for a separate class meeting.

Q18 Do you have any comments on treasury shares being used for employee share schemes or being held in order to satisfy share options or share awards? In particular, do you consider that any provisions need to be introduced or restrictions lifted to facilitate the use of treasury shares in this way? (Paragraphs 4.16 - 4.17.)

Twenty-four respondents commented on this question and virtually all welcomed the use of treasury shares for employee share schemes including share options and awards. Some considered that the holding of treasury shares in connection with employee share schemes was potentially the most useful implication of the proposals and that a company could reduce its costs by holding in treasury, rather than in an external trust, shares purchased on the market to satisfy future delivery of shares under such schemes. They thought that there was a need for maximum flexibility to facilitate the use of treasury shares in this way.

Nine respondents commented on the issue of whether shares held in treasury for employee share schemes should be ring-fenced in order to ensure that the company did not sell shares from treasury which were being held on behalf of employees. Two respondents saw a need for ring fencing, one of whom mentioned that ring fencing might enhance confidence amongst potential employee-investors in that security, and that independence would be maintained on their behalf. Five respondents did not see a need for ring fencing. Some of these pointed out that a company would be under a contractual obligation to its employees in respect of shares held in such schemes. If sufficient shares were not available because they had been sold from treasury, the company would have to buy back some from the market or issue new ones.

Q19 Do you agree with the Department's analysis that no amendments to section 364A of the 1985 Act dealing with the annual return filed at Companies House need to be made? (Paragraph 4.18.)

Eighteen respondents answered this question; five did not agree with the Department's analysis. Those who disagreed considered that there should be provision for a separate disclosure in a company's annual return of the number of shares of each class held in treasury. Two respondents went further by proposing that not only should the number of treasury shares held by the company be indicated but also the number held by nominees (if the holding of treasury shares by nominees were to be permitted).

Q20 Do you have any comments on any of the minor proposed consequential changes to company law dealing with:-

- i) alteration of a company's objects (paragraph 5.1);**
- ii) minimum membership for carrying on business (paragraph 5.2);**
- iii) variation of class rights (paragraphs 5.3 - 5.6);**
- iv) merger relief and merger accounting (paragraphs 5.7 - 5.8);**
- v) capital redemption reserve (paragraph 5.9);**
- vi) definition of connected persons etc (paragraph 5.10);**
- vii) investigation of a company (paragraph 5.11);**
- viii) index of defined expressions (paragraph 5.12);**
- ix) form and content of company accounts (paragraph 5.13);**
- x) form and content of group accounts (paragraph 5.14).**

A few respondents made some minor comments on the proposed consequential changes, all of which will be considered by the Department. The principal comment was that Schedules 9 and 9A to the Companies Act 1985 needed to be amended along similar lines to the proposed amendments to Schedules 4 and 4A set out in paragraphs 16 and 17 of the Schedule to the draft regulations. Schedules 9 and 9A deal with accounting rules for banking companies/groups and insurance companies/groups respectively. Schedules 4 and 4A deal with the form and content of company accounts and group accounts respectively.

Q21 Do you have any comments on any other company law issue raised in the consultative document? Do you have any comments on any company law issue not covered in the consultative document? Do you have any comments on the draft regulations?

The issues on which substantive comments were received are set out below.

Qualifying shares: eleven respondents commented on this issue. These comments centred on why the ability to hold treasury shares was to be restricted to companies whose shares were listed or traded within the EEA and why other countries/markets were not included. The United States, Australia, Canada and Japan were specifically mentioned as was NASDAQ. Some respondents suggested that the ability to hold treasury shares be extended either to all public companies or to all public and private companies.

Ten percent limit: one respondent considered that the proposed limit of 10% was acceptable but suggested that the Secretary of State should have the power to set (by statutory instrument) a different limit (including a lower limit) if experience showed that a different limit would be desirable. [Note by DTI: the Second Company Law Directive 77/91/EEC provides that the maximum number of shares that a company may hold in treasury is 10%. There is no lower limit.]

Sale of treasury shares and shareholders' consent: two respondents questioned whether a company's directors should have unfettered discretion to sell treasury shares at prices other than that which would maximise the proceeds for the company. They considered that the law should require directors to receive prior approval from shareholders to use treasury shares for specific purposes where the sale proceeds would be substantially less than the prevailing market price, for example, to use the shares to satisfy employee share option schemes. One considered that such consent would serve to minimise the risks of treasury shares being used as a "poison pill" or other device that was inconsistent with the interests of the majority of the company's shareholders.

Q22 Do you have any comments on whether the current tax treatment of share repurchases should be extended to purchases without cancellation or on any practical issues which need to be considered? (Paragraphs 7 - 9 of Annex D.)

Effect of proposal: the effect would be that, in principle, where a shareholder sold directly back to the company, the difference between the sum received and the issue price of the shares would be taxed as income. In practice, however, a market-maker generally acts as an intermediary between the company and the shareholder, and the shareholder's gains are liable to tax as capital gains in the same way as on a sale to a third party.

Where an opinion was expressed, respondents were in accord with the proposals. In many cases, the sentiment was expressed that the proposed treatment was the only realistic option. No comments were made on practical difficulties with the scheme.

Q23 Do you have any views on the proposal that treasury shares should be excluded from issued share capital for tax purposes, and should also be disregarded when applying tests based on a percentage of issued share capital? (Paragraphs 10 - 11 of Annex D.)

Where a response was made, respondents were generally in agreement. Some respondents felt that there should be an explicit, blanket rule stating that shares held in Treasury were deemed 'not to exist' for tax purposes. One respondent pointed out that a general rule would not work in all circumstances.

Q24 Do you have any views on the proposed tax treatment of shares sold from treasury under which a sale of shares held in treasury after a purchase would not give rise to a capital gain or loss in the hands of the company selling the shares, and a sale of shares by a company from treasury would be regarded as an issue of shares for the purposes of reliefs such as capital gains rollover relief on a takeover? (Paragraphs 12 - 15 of Annex D.)

There were no significant responses to this question. However, the view was expressed by some respondents that, for all purposes (including for certain investment incentive schemes), sale by a company of shares held in treasury should be regarded as being issued.

Q25 Do you have any comments on the proposed Stamp Duty treatment under which a purchase of shares without cancellation would be treated in the same way as a purchase followed by cancellation, and a sale from treasury would be treated like a new issue? (Paragraphs 16 - 17 of Annex D.)

Effect of proposal: under current law, a company that purchases its own shares and then cancels them is subject to 0.5% ad valorem stamp duty. A new issue of shares is generally free of stamp duty. It is proposed to replicate this treatment for treasury shares. So, a company that purchases its own shares and holds them in treasury would be subject to 0.5% stamp duty. The subsequent transfer of those shares from treasury would be free of stamp duty.

Some respondents used the consultation as an opportunity to call for the abolition of stamp duty on shares. Otherwise, responses supported the proposal that there should be similarity of treatment for shares that are cancelled and subsequently reissued, and shares that enter and are then transferred out of treasury.

Department of Trade and Industry
31 May 2002