

Financial Services Authority



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Dear Keith,

Shareholder engagement and the current regulatory regime

As you will have seen, Sir David Walker's review of corporate governance in UK banks and other financial industry entities was published for consultation on 16 July. This includes recommendations designed to strengthen shareholder engagement with the boards of investee companies, with the aim of promoting good corporate governance.

This is a proposition that the FSA strongly supports. However, we are aware that concerns have been raised over the extent to which more active shareholder engagement would be consistent with certain elements of our existing regulatory regime for market abuse, disclosure of substantial shareholdings and changes in control. Having considered this issue, I thought it would be helpful to share our thinking with the Institutional Shareholders' Committee.

We are satisfied that there is no fundamental inconsistency. In the three areas mentioned above, we do not believe that our regulatory requirements prevent collective engagement by institutional shareholders designed to raise legitimate concerns on particular corporate issues, events or matters of governance with the management of investee companies. Ad hoc discussions or understandings of this nature would not, in our view, trigger the restrictions or disclosures imposed by our rules. Our thinking is set out in more detail in the Annex to this letter.

I hope this clarifies our position, but please let me know if the ISC thinks there are any further issues that we should address.

Yours sincerely,

Sally Dewar

Market abuse

We have met with representatives of a number of investment management firms to discuss their approach to shareholder engagement and, without exception, the firms we have met do not consider that the market abuse regime is an impediment to their activist strategies. Those we spoke to said that their channels for bilateral and if necessary collective dialogue, both among themselves and with issuers, worked appropriately while acknowledging the need to maintain proper standards of market conduct.

In an article in Market Watch 20 (published in May 2007) we reiterated the basic principle that a firm would not be committing market abuse by carrying out trading on the basis of its own intentions or knowledge of its own strategy. We also pointed out that we might come to a different conclusion if a party dealt on the basis of their knowledge of another party's intentions and strategy, or if several parties acted together with a view to avoiding market disclosures which would otherwise be necessary were the shares to be acquired by a single entity. However, our survey of market participants suggests that investment managers are able to maintain effective engagement with investees without contravening these restrictions. And, as discussed below, we would not see collective engagement by shareholders with an issuer's management as requiring a major shareholding disclosure unless other conditions were met.

Disclosure of Major Shareholdings

The FSA maintains rules which implement the requirements in European law for the public disclosure of significant shareholdings in publicly quoted companies. While the regime does require holdings of shares to be aggregated for the purpose of establishing whether a threshold has been reached or exceeded, this does not in practice appear to be problematic. This is because under the disclosure requirements the aggregation of voting power is only necessary where there is an agreement between two or more persons which obliges them to adopt a lasting common policy towards the management of the issuer through the exercise of their voting rights. This is unlikely to include the kind of ad hoc discussions and understandings which might be reached between institutional shareholders in relation to particular issues or corporate events.

Change in control (CIC)

The Financial Services and Markets Act 2000 (FSMA) implements European requirements obliging potential controllers to seek pre-approval from the FSA for acquisitions of controlling levels of shareholdings and voting rights in authorised financial institutions. These requirements are intended to prevent control of such institutions falling into unsuitable hands. Before March this year, the CIC regime in FSMA required aggregation of shares and voting rights where people had an agreement or arrangement under which they undertook to act together in exercising their voting rights.

The CIC regime in FSMA was changed in March this year in order to implement the EU Acquisitions Directive (the Directive). For the purposes of calculations relating to a decision

to acquire or increase control, holdings of shares or voting power are now aggregated where, among other things:

- (as for disclosure of major shareholdings) there is an agreement between two or more persons which obliges them to adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the institution; or
- people are “acting in concert”.

We believe the first type of aggregation would be unlikely to arise from the kind of ad hoc discussions and understandings described above.

The phrase ‘acting in concert’ is not defined in FSMA, or in the Directive, and although the European Level 3 committees produced some guidance on the Directive, this is quite wide in scope.

However it is not intended that the phrase ‘acting in concert’ – either in the Directive, FSMA or the Level 3 guidance - should capture ad hoc discussions and understandings in good faith solely aimed at exerting influence intended to promote generally accepted principles of good corporate governance. The FSA will apply this approach to changes in control.

We shall keep this approach under review, and are ready to discuss the issue further with industry if the need arises.