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WHOSE COMPANY IS IT ANYWAY?

The benefits of unprotected capitalism and unruly shareholders

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Summary

- Free-market capitalism requires creative destruction. It is important that poorly performing companies are allowed to go out of business or allowed to be taken over, and it is equally important that new companies are able to replace them.
- If company management is not maximising shareholder value, then the shareholders should be entitled to act. Government regulations should not protect a company's management, executive board or supervisory board from shareholder disquiet.
- The UK remains Europe's best protector of shareholder rights. Its governance and pro-shareholder approach is based on clear principles, unlike other major EU economies where regulation protects local companies and management from shareholder disquiet. The UK's acceptance of hostile takeovers is a key discipline underpinning an approach to corporate governance which promotes the efficient deployment of capital.
- The UK should not protect so called 'national corporate champions' - to do so would require the government to pick winners by trying to decide which businesses should be protected. Instead, the government should let market forces decide.
- When governments support failing sectors or companies, they are also harming competitor companies, entrepreneurs and innovators, as well as the taxpayers and consumers who end up covering the additional costs of government protection.
- Participants in UK capital markets generally accept that there is a trade-off between the benefits of access to public capital through listed markets and the requirements of meeting the performance expectations of investors. Management has less incentive to maximise

shareholder value when governments impose corporate structures that protect company executives from activist shareholders or takeovers. Companies should consider the negative implications of incorporating in countries where management is protected at the expense of the rights of shareholders.

- Increasing government subsidies in order to prop up failing companies or industries that are being superseded by innovation is never successful in the long run. Government subsidies, or regulatory protection, cannot stop the inevitable demise of a badly run company or an out-of-date industry. Equally, government regulations should not attempt to stop innovation that would make established companies obsolete.
- There are unintended consequences of government protection for inefficient management. When a government 'protects' companies for fear of short-term job losses, it typically hurts the wider economy, including poorer households which end up with a higher cost of living and/or an additional tax burden.

Introduction

Charles Darwin described natural selection as ‘One general law, leading to advancement of all organic beings, namely, multiply, vary, let the strongest live and the weakest die’. This law also applies to companies and economies.

The process of ‘financial natural selection’ allows the economic cycle to function efficiently. As Joseph Schumpeter wrote over 70 years ago:

> [T]he opening up of new markets, foreign or domestic, the organisational development from the craft shop to the factory, illustrate the process of industrial mutation that incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one. The process of creative destruction is the essential fact about capitalism. It is what capitalism consists of and what every capitalist concern has got to live in.

Free-market capitalism requires creative destruction. The market must allow the weakest companies to be taken over and absorbed by a rival company, broken up or to simply go into liquidation. It is important that non-performing companies go out of business and it is equally important that new companies are able to replace them.

This is not just a theory: during the last half century, telexes have been replaced with faxes, which have themselves been replaced with emails; bankers’ orders have been replaced with electronic transfers, cheques have been replaced with contactless cards; corner shops were replaced by supermarkets that are now being replaced by internet grocery shopping; public post office phones were replaced by house landline phones that in turn were replaced by personal mobile phones; vinyl disc records were replaced by CDs that were replaced by music downloads, and so on. In a market economy people adapt to new things quickly because it is in their self-interest to do so. They save time or money which they can re-invest creating opportunities in other parts of the economy. Companies that respond to these changes and adapt their business models thrive, while those that resist change do not. Many of these opportunities would be lost if governments intervened to protect the status quo.

This paper examines to what extent the UK's financial markets and corporate regulatory environment allow financial natural selection to occur and compares the UK to countries with more protectionist economic strategies.

The benefits of listing and secondary financial markets

Many commentators applaud the UK's banking system as a way of pooling capital which can then be lent or invested in businesses, allowing them to develop and grow. However, the same commentators often refer to the stock market as a kind of sophisticated casino for insiders that must be tamed with regulation upon regulation. They hold an even lower opinion of the secondary bond markets.

But the reality is that without such secondary markets, businesses would find it much more difficult to raise equity and debt finance. It would be very hard to convince investors to buy a new issue, Initial Public Offering (IPO), if they were subsequently unable to sell their investment.

The ability to divest at a later date is a key part of any decision to make an investment. If there were no liquid secondary debt markets, investors in debt instruments would have to wait for the debt to mature in order to get their capital back. If there were no liquid secondary share markets, equity investors would have to hope for continuous high dividends to justify the risk that they had taken by investing in a company. An equity investment would become an effective perpetuity. This could work if shareholders had enough input into a company's management to enable them to force a change of direction should the company's earnings fall. But, if this is not the case, a liquid secondary market enables investors to sell their investment and move their capital to new investments.

This is one of the great advantages of the City of London. It is home to the London Stock Exchange (LSE), the Intercontinental Exchange (ICE), CBOE Europe, interbank bond and currency trading, as well as many new trading platforms. This hub effect is one of the reasons that the UK is also home to some of the world's largest investment, pension and insurance funds, as it provides not only deep pools of capital for IPOs but also highly liquid secondary markets for trading those investments.

Shareholder rights

But raising funds on public markets also creates another market dilemma for managers and investors in a business: having accepted public capital, whose company is it? Who is ultimately in charge, the management or the shareholders?

In general, shareholders have handed responsibility for day-to-day decisions to the company management. Shareholders must then rely on the company's board of directors to protect their interests. There are certain decisions that shareholders are allowed to vote on, usually at an annual or extraordinary general meeting, but outside of this shareholders are expected to stay quiet and allow executive management to run the company and the board of directors to watch the executive management.

Listed companies are required to supply regular, accurate and timely public information on revenue, profits and future earnings projections. The price of a company's shares or debt, trading on a public exchange, should reflect all of the information known at that time about the company's financial situation, the outlook for the industry as a whole and the general economic climate. With this information the shareholders' primary decision is whether to continue to hold their shares, buy more or sell.

Although shareholders can raise questions at an Annual General Meeting (AGM) and vote to change a board member, if their grievances are unaddressed then their only recourse is to sell their shareholding. Although selling does not hurt the company directly, as the money the shareholder receives for his shares comes not from the company but from a new shareholder, it does have the potential to lower the share price. If enough shareholders lose faith in a company's management, or in its products or manufacturing ability etc., and also sell their shares, then eventually the share price could fall far enough to make it more difficult for the company to raise additional capital. The lower share price could also encourage a takeover bid by a competitor or an asset stripper.

This is all part of the process of ‘financial natural selection’. In order for the economy to function efficiently, the market must allow the weakest companies or companies with the least adaptive management to be taken over and absorbed by a rival company or simply go into liquidation. A company may go out of business because consumer tastes have moved on, or because technology has changed, or because a rival company is a more efficient producer. For new companies to be able to replace them, it is important that capital is released, new capital is pooled, and that regulators do not place too many obstacles in the way of start-up and innovative businesses.

London’s financial markets have a massive competitive advantage due to their well-established hub status and legal system. Consequently, financial services are one of the UK’s major exports. While some outside observers claim that the London market is too focused on short-term results, London still attracts more capital than most of its rivals. Its governance is based on clear principles and its standards are high. However, the UK market is increasingly composed of large multinational institutions - many of which have outsourced their voting rights to proxy advisers. Moreover, they may not take the required interest in corporate governance or may simply not wish to disrupt the status quo of existing company management. This is one of the areas addressed in the second Shareholders Rights Directive that should come into force in June 2019. If company management is not maximising shareholder value, then the shareholders, and their proxies, should be entitled, and even encouraged, to act. Regulations must not protect a company’s management, executive board or supervisory board from shareholder disquiet.

Mergers and acquisitions

New businesses raise capital, established businesses merge with competitors and obsolete businesses are broken up – in this way, the market economy remains vibrant. So, should regulators ever interfere in this process? What would be a legitimate reason to prevent a takeover? Should a company itself be able to prevent a takeover with a defensive share structure or ‘poison pills’ (see below)? Or does this simply protect executives from the consequences of mismanaging a company?

In a completely free market, decisions on whether to accept mergers or acquisitions would be entirely at the discretion of the company owners. If a company is well run, the shares fully valued and the dividends high, then it is unlikely that investors would accept any offer other than an over-priced one. In this case, it would also be in the investors' best interests to accept it. So, why do some countries have rules to protect a company, its management and other stakeholders from takeovers?

Should other stakeholders be protected in a takeover?

In the UK, the Competition and Markets Authority (CMA) provides protection for customers by ensuring that takeovers and mergers do not limit competition. Stakeholders can complain to the CMA if a merger or acquisition would create a dominant market player and thus reduce consumer choice. The CMA can prevent a takeover if the combined entity, post bid, has a turnover of over £70 million and would control 25 per cent or more of the UK supply of a particular good or service, enabling 'excessive' or 'unfair' pricing due to reduced competition. Alternatively, rather than prevent a takeover, the CMA can require the merged company to sell part of its operations to reduce its UK market share.

Employees have protection under the 2006 Transfer of Undertakings (Protection of Employment) regulations (TUPE), which ensure that employment is protected or at least substantially continues, and that employment terms and conditions are not lowered. Employees must also be informed of any changes if there is an economic, technical or organisational reason to alter their employment terms.

But governments cannot legislate to protect employees if their employers fail to adjust their businesses to suit changing economic circumstances and go out of business, any more than they could be protected from their employer adjusting their business in a way that makes that employee obsolete. Unemployment could be caused by improved technology, or outsourcing a production line to a more efficient manufacturer or lower wage country, or due to management making bad investment decisions. Companies are not forever: they cannot be employers in perpetuity as they cannot guarantee to stay in business forever. Employees have a responsibility to themselves to ensure that they have skills that, if no longer required by their present employer, would be desirable to other employers. This is good for the economy as well. In theory at least, companies that go out of business provide space, staff and customers for new companies to take their place - just as the horse and carriage business provided chassis makers for early automobile manufacturers.

So, should the UK follow the example of some other countries and protect companies, company management or other stakeholders from a hostile takeover? Or having accepted public capital, has management relinquished their right to employment in perpetuity? While employment in perpetuity may sound ludicrous, far too often established incumbent companies lobby governments for regulations that make it more difficult for hostile bids to succeed or more difficult for new competitors to enter their market. Established companies are often given such protection after threatening to move their production to another country. They lobby for preferential treatment from governments, exploiting fears that their relocation would increase unemployment.

Takeovers and activist shareholders, should they be constrained or encouraged?

Some observers might have been amused to hear that the Dutch government had managed to quietly acquire a 14 per cent stake in the Franco-Dutch airline Air-France KLM with the intention of matching the French government's holding. The aim was to ensure that the main Dutch airport, Schiphol, remained a hub airport for the company.[1] The French government was incensed and declared that the Dutch government was acting like an ill-mannered 'activist fund', their derogatory term for a shareholder that simply wants to influence the policies of the company that they in fact own. Despite their behaviour in this case, the Dutch are generally equally hostile to 'activist' shareholders.

The two most obvious examples of this are the recently thwarted take-over bids of Unilever by Kraft Heinz and AkzoNobel by PPG Industries. The Kraft Heinz bid for Unilever was rejected by Unilever's Dutch management, who claimed that the bid had 'no merit, either financial or strategic' and 'fundamentally undervalues Unilever'.[2] As the offer price was at an 18 per cent premium to the share price at the time, the stock market had an even lower opinion of the value of the company's assets. Unilever is a UK/Netherlands Dual Listed Company (DLC) and UK takeover rules force a

1 'Why the Dutch state is buying shares in Air-France KLM', *De Volkskrant*, 26 February 2019.

2 'Unilever rejects $134bn Kraft Heinz takeover bid', *Financial Times*, 17 February 2017.

predator company to make a binding bid within 28 days or walk away for 6 months. Kraft withdrew its bid and Unilever's Dutch management took this opportunity to complain to the UK government that the UK needed stronger protection for its UK-listed companies and that the 28-day rule is too short to allow a target company to make a strong defence. However, the 28-day rule was added to the Takeover Code in 2011 as a way of strengthening the position of a target company in the belief that lingering, rumoured bids distract management and drive down the share price thereby making a hostile bid easier.

Unilever also asked the UK to introduce a safeguard for 'national corporate champions' and to strengthen the UK's takeover code to consider the interests of other stakeholders besides shareholders. But would protecting 'national corporate champions' be in the best interests of the UK economy? And, more importantly, who gets to decide which companies should be included in this group?

At present, the UK Secretary of State may intervene to block a merger if the merger would cause 'specific public interest concerns' as set out in the Enterprise Act 2002. The Secretary of State for Business, Energy and Industrial Strategy can intervene on grounds of national security and financial stability. In addition, the Secretary of State for Digital, Culture, Media and Sport can intervene on the grounds of media quality, plurality and standards. The UK's CMA can prevent a merger if it believes the merger would have a detrimental effect on competition in the market. But outside of this the UK is one of the least restrictive developed economies regarding corporate mergers. This is a dilemma for a dual-listed company such as Unilever because in the Netherlands takeovers are subject to broader stakeholder interests and both the management board and supervisory boards have much greater protection from hostile acquisition. Although the UK government did announce that it would review the current policy in 2017, so far they have not decided to protect so called 'national corporate champions'. To do so would require the government to pick winners by deciding which brands or businesses should be protected, rather than letting market forces decide. It's not just that governments should not attempt to 'pick winners'; when they do so governments are *also* picking losers as well. When a government stacks the deck in favour of one company or sector, it necessarily requires that other businesses are disadvantaged - either the protected company's competitors, or the entrepreneur whose ideas can't be realised because government has preserved the obsolete. Moreover, taxpayers and consumers end up covering the cost of the government protection.

It is human nature to resist change, and governments often respond with a knee-jerk reaction to PR-organised 'public outrage' by a handful of 'squeaky wheel' businesses. Since the demise of the East India Company, a myriad of household brand names, from Blockbuster to Woolworths, have disappeared from the market without disrupting the long-term economy.

Incensed by the UK government's lack of protection, Unilever's Dutch management announced that it would streamline its DLC structure to be solely managed from the Netherlands. Unilever was created after the merger of Lever Brothers and Margarine Unie in 1929. The firm is jointly managed from both the UK and the Netherlands, and is listed on both the London Stock Exchange (LSE) and the Amsterdam Stock Exchange (AEX). While unification generally improves corporate governance and simplifies the share structure, in this particular case Unilever appeared to be seeking protection for its management as opposed to unlocking shareholder value. The Netherlands allows companies to have many structural protections from hostile takeover bids: of the twenty-five companies in the AEX index, twenty of them have some form of statutory protective measure or friendly controlling shareholders.

There is little incentive to maximise shareholder value when a country facilitates corporate structures that protect corporate managers. Consequently, listed companies need not worry if their share prices trade at a discount to other companies in the same industry internationally. For example, in the Netherlands companies have structural protections from takeover bids as well as protection from activist shareholders requesting changes to board members. These structural protections include:[3]

- Anti-takeover preference shares, priority shares, depository receipts and friendly controlling shareholders.
- Dutch corporate boards can also invoke a 180-day response time if a shareholder wants to change the company's strategy.
- Many Dutch companies have provisions in their articles of association that make it difficult for a shareholder to even nominate their own candidate for the board or the supervisory board.

3 From the submissions to the public consultation on the draft bill regarding the introduction of a response time of a maximum of 250 days that can be invoked by the executive board of a Dutch listed company. See: www.internetconcultatie.nl/wetsvoorstelbedenktijd/reacties/

- A two-thirds majority of shareholders at an AGM is needed to dismiss a board member.
- Almost all Dutch companies have articles of association that exclude shareholders from changing the articles of association.
- Dutch company law also provides safeguards against 'short-term oriented' shareholders by forcing shareholders to take into account reasonableness and fairness when proposing the dismissal of one of the executives.
- Dutch law also prohibits the abuse of power by shareholders, even though they are the company's owners.
- The company management can take measures against shareholders if it believes their actions are harmful to the company.
- Shareholders cannot convene an extraordinary general meeting except after a judicial review.
- Any proposal to an AGM to dismiss an executive or board member can be dismissed by the company executive or board.
- The ability of Dutch shareholders to hold a company executive and board to account can even be suspended by the company executive and board.

These protections completely invert the generally accepted relationship between the people who provide the capital and those who manage it.

Even though there have been no successful hostile takeovers in the Netherlands of a listed company during the last 20 years, rather implausibly, the direction of travel for Dutch corporate regulation is for even more protection. The Dutch government recently proposed to increase corporate management rights to include an additional 250-day cooling off period. Unsurprisingly, most international shareholders in Dutch companies are opposed to such a move.

Ironically, Dutch companies, while enjoying protection in their home markets are quite happy to take over foreign companies, and many Dutch companies are conglomerates of famous international brand names. Not only is their revenue globally derived, so are many of their shareholders. Rather than the mythical 'level playing field' so often proclaimed in the European Union literature, the Dutch, like many other EU governments, have entrenched asymmetrical corporate vulnerabilities.

While Unilever's proposed move to a single headquarters and listing would undoubtedly simplify the management structure and thereby increase shareholder value, it is hard to overlook the downside of the additional management protection offered by its chosen destination. The company went out of its way to tell shareholders that it would not change its spending in the UK and the Netherlands, or its employment, or the manufacturing centres, or its single board, or its application of both UK and Dutch corporate governance codes, or the dividend parity and capital return interests of shareholders.[4] Which begs the question, why bother? There would be no benefit to shareholders from the reduction of duplication of management. Shareholders would not even benefit from the closing of the share price differential as there was very little premium between the Unilever shares listed in the UK and those listed in the Netherlands. Ironically, Unilever also claimed that the simplification of its share structure would make it easier for it to make paper acquisitions[5] of other companies.

A move to the Netherlands would risk reinforcing everything most shareholders oppose: a destruction of value and the entrenchment of management. As Unilever's profitability is about a third less than that of its international competitors,[6] why should the Netherlands or any other country instigate regulations to protect its management? Surely underperforming management deserves to be castigated by the markets.

Many investors believe that there is a 'Dutch discount' due to the protection of managements from activist shareholders, as well as the protection of companies from takeovers. It is generally believed that such protection does not benefit shareholders but is protecting the private interests of managers, often to the detriment of shareholders' collective interests as well as the Dutch economy. This can frustrate shareholders, as happened in 2017 when a bid for AkzoNobel at €99 cum dividend per share by PPG industries, a US firm in the same industry, was rejected by the management even though AkzoNobel shares had been trading below €70 for most of the previous year.[7] But AkzoNobel management refused to even meet

4 'Building the Unilever of the Future', Unilever global company website, 15 March 2018. https://www.unilever.com/news/press-releases/2018/building-the-unilever-of-the-future.html

5 Where the target company is acquired by swapping its shares for those in the purchasing company.

6 See: 'Unilever has chosen to protect itself from British capitalism', *Financial Times*, 16 March 2018. https://www.ft.com/content/d6807a36-284a-11e8-b27e-cc62a39d57a0

7 See: 'PPG walks away from battle to buy Akzo Nobel', *Reuters*, 1 June 2017. https://www.reuters.com/article/us-akzo-m-a-ppg-inds-bid/ppg-walks-away-from-battle-to-buy-akzo-nobel-idUSKBN18S4I2

with the PPG board. Many major international shareholders complained about the company's dismissive attitude especially as AkzoNobel is itself a conglomerate of other companies including ICI, once one of the biggest companies in the UK and part of the FTSE30. At the time, one major long-term shareholder described AkzoNobel's management as presiding over 'relatively low margins, low growth and poor discipline around investment decisions' that had diminished the company's long-term value.[8]

EU takeover regulations

The Dutch are not alone in protecting national corporate champions. In France, while the legal regime is broadly favourable towards takeover bids, concentration of ownership prevents many hostile bids. The French government and a selected group of private investors still hold large proportions of the shares in privatised companies, reinforced with cross-shareholdings and reciprocal board positions. In 2002, 30 directors held 160 seats on boards of major French firms. France has declared 11 sensitive sectors of national interest where French government authorisation is required to approve a takeover, including artificial intelligence, microchips, space technology, data storage, energy, telecoms, transport, water and the health industries. France's once 'free market' supporting President Macron has also proposed using state owned 'golden shares' to prevent foreign takeovers and substantial fines on investors who buy stakes in companies considered strategically important. France allows companies to issue double voting shares to long-term shareholders and instigate voting ceilings to limit the voting rights of outsider investors. Double voting rights after two years of share ownership are a particularly useful French anti-takeover device as these are not a separate class of share and lose their double voting status on sale.

In both France and Germany, family ownership of large firms, or a controlling proportion of the shares, remains a common occurrence, as companies have traditionally used bank loans rather than financial markets to raise capital. As a consequence, there were only 18 hostile bids in France between 1991 and 2005 compared with 176 in the UK and 332 in the US.[9] Germany has recently lowered the threshold at which the government can

8 See: https://www.tweedy.com/resources/library_docs/general/AkzoLtrToTheBoardMay2017.pdf

9 Clift, B. (2009) 'The Second Time as Farce? The EU Takeover Directive, the Clash of Capitalisms and the Hamstrung Harmonization of European Corporate Governance'. *Journal of Common Market Studies* 47(1): 55-79.

intervene to block a foreign takeover involving critical technology from 25 per cent to 10 per cent. And European Union leaders agreed to consider screening investments by state-owned Chinese firms as well as blocking Chinese investments. A draft EU law that proposes to limit the ability of non-EU firms to acquire companies and technology is being discussed.[10] Ironically, in 1990 the UK introduced the Lilley doctrine to prevent the 'nationalisation by the back door' of UK listed companies by state-owned foreign companies, but the perpetrators then were European companies, predominantly from France and Germany.

In the US 'poison pills'[11] are legal and became a popular protective measure following a hostile takeover boom in the US in the 1980s which was blamed for an increase in 'short-termism' in corporate management. The United States' Committee on Foreign Investment can also intervene to block foreign takeovers.

At the beginning of this century the EU did try to harmonise the patchwork of national protections from takeovers towards a single corporate governance framework with the EU Takeover Directive EC/25/2004 modelled on the UK's Takeover Code. The Directive aimed to dismantle the many defences that EU insiders were able to use to derail hostile takeovers. However, as it allows both member states and firms to 'opt in' or 'opt out' of its provisions, the Directive has resulted in increased protection for firms within some EU member states.

The EU had hoped to base the Directive on liberal market practices, including the principles of 'one share, one vote', the outlawing of frustrating actions such as poison pills or selling off valuable assets, as well as the principle of board neutrality.[12] In the new Directive, shareholders are treated equally, given sufficient information and time to make a decision. Target boards must act in the interests of the company and are prevented from initiating frustrating actions after a bid is announced. Information must also be given to the employees of the target company. These are mandatory

10 'France to bolster anti-takeover measures amid foreign investment boom', *Reuters*, 19 July 2018. https://uk.reuters.com/article/uk-france-investment/france-to-bolster-anti-takeover-measures-amid-foreign-investment-boom-idUKKBN1K92QN

11 Typically, 'poison pills' give shareholders the right to buy more shares at a discount if a hostile bidder buys a certain percentage of the company's shares, thus diluting the bidder's holding and increasing the cost of a potential bid. The existence of these diluting mechanisms discourages hostile bids.

12 Clift, B. (2009) 'The Second Time as Farce? The EU Takeover Directive, the Clash of Capitalisms and the Hamstrung Harmonization of European Corporate Governance'. *Journal of Common Market Studies* 47(1): 55-79.

bid provisions, with the bid thresholds defined at national level, along with a breakthrough level where a bidding company could annul any pre-bid defensive structures including multiple voting rights.

However, several of the largest economies in the EU were accustomed to stakeholder protections including for the employees of the target firm. The eventual Directive did not force firms to abolish multiple voting shares, allowed the continued protection of national champions, and made the board neutrality (Article 9) and breakthrough rules (Article 11) optional at both country and individual company level.[13] The Directive also included a reciprocity rule which was meant to create a level playing field but increased protection by allowing a company to 'opt in' or 'opt out' of the key provisions. Firms can 'opt in' to a more liberal regime voluntarily to facilitate a takeover when they are the bidder but 'opt out' again if they are the target of a bid.

The European Commission has jurisdiction over mergers that would impede effective competition across the whole of the European community. However, this could result in them requesting a bidding company to sell its holdings in one member state while allowing it to retain its competitive dominance in another member state.

The EU will introduce an updated Shareholder Rights Directive (SRD II) in June this year. It is designed to encourage long-term shareholder engagement with management and increased transparency. Although SRD II may make another regulatory burden for custodians, it is a step in the right direction. SRD II even mandates that shareholders must be given the right to vote on the company's remuneration policy at the AGM. However, as the name implies, it is a Directive and so will be subject to different interpretations in the various EU member states.

More importantly, what is the point of improving shareholder rights if the company management and executive have so many ways of protecting themselves from active shareholders and hostile takeover bids? Surely being held accountable by the market is the ultimate protector of shareholder value. Protectionist regulations and government interventions are more likely to lead to entrenched management and inefficient use of capital.

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13 Papadopoulous, T. (2007) The Mandatory provisions of the EU Takeover Bid Directive and their deficiencies. *Law and Financial Markets Review* 1(6): 525-533.

What's wrong with government protection of company management?

The Anglo Saxon capital markets generally accept that there is a trade-off between the benefits of access to public capital through listed markets and the job security and performance tolerance a company's management can enjoy in a private company. The shareholders in a business should have a voice in the direction of the company and not be simply captive to the desires of the management. A shareholder's voice is even more important in a takeover situation as in all likelihood the personal interests of board members or management may not be in alignment with the best interests of the company or its shareholders. After all, does a shareholder own a fraction of the business or an option on the possibility of eventually more competent management taking over?

It would be a mistake to allow government regulation to undermine the rights of the capital providers to favour the company's management or employees. If this were to happen, investors would be less likely to risk their capital in equity investments which would then have a knock-on effect on the general economy. It is a fundamental right of the shareholder to be able to question management and if necessary, change non-performing management or board members.

An AGM is designed as a platform for holding the executive and supervisory boards to account, ensuring they are fulfilling their duties. It is a fundamental part of good corporate governance. Shareholder rights should include the appointment or dismissal of board members and the initiation of amendments to the articles of association regarding the same. Shareholders must be able to hold management to account.

Government regulation that undermines the rights of capital providers is not just picking winners; it is also disadvantaging the protected company's competitors and innovators whose ideas can't be realised because regulation has preserved the obsolete. Furthermore, it harms taxpayers and consumers who end up covering the cost of the government protection. These are the unintended consequences of government protection for inefficient management. Even when a government 'protects' companies for fear of short-term job losses, the impact usually hurts poorer families who end up with a higher cost of living or an additional tax burden. Although it is impossible to measure the 'jobs not created or livelihoods not provided' when governments interfere with value creation and innovation, these are real costs to the wider economy.

UK takeover code

The UK is one of only a handful of countries across the world that permits hostile takeovers. They are seen as a key discipline underpinning corporate governance, promoting the efficient deployment of capital and supporting strong management performance for shareholders.

In the UK, mergers and takeovers are regulated by the Takeover Panel, following the City Code on Takeovers and Mergers (The Code). The Takeover Panel has the power to monitor and enforce 'post-offer undertaking', the legally binding commitments made by the acquirer with respect to the future of the target company. These commitments could relate to the level of future employment, pension fund contributions or research and development expenditure.

The Code requires that the board of a targeted company must give its recommendations on a bid and act in good faith to promote the success of the company for the benefit of all shareholders. The UK takeover code recognises that the intentions of a bid must be communicated to shareholders along with the potential impact. As a consequence, boards on either side of the bid must disclose to shareholders the consequences of the decision they are being asked to make and the choices they must weigh up. In addition to financial information, including annual/interim results and debt facilities or other instruments entered into in order to finance the offer, the company making the bid must state its plans regarding the future operations of the target company, including the continued employment of staff and management, the impact on company locations, along with any redeployment of the firm's fixed assets.

In reply, the targeted board's communication to shareholders must set out its own objective opinion of the bid, including its views on the effects on all the company's interests, as well as the strategic plans for the target company and their likely repercussions. Just as importantly, there should also be a statement from an employee representative, as a recognised key stakeholder group, about their impressions of the bid and the likely impact on employment within the company.

The targeted board has an obligation not to frustrate the bid by using a 'poison pill' or shareholder rights plan that would reduce a hostile shareholder's stake. This is prohibited by the UK takeover code which ensures that all shareholders maintain their proportionate share of the ownership of a corporation on the occasion of new share issuance.

Changes to UK government intervention in takeovers

The UK government has amended the Enterprise Act 2002 to lower the turnover threshold for intervention in the military and advanced technology sectors from £70 million to only £1 million. It has also published a white paper on proposed reforms that would allow the government to intervene more widely and frequently if it felt that national security was at risk.[14]

The government wants to overhaul its capacity to scrutinise and intervene in investments that raise national security concerns. Circumventing the CMA, the government would be directly responsible for national security assessments and have a broader set of trigger events such as a bidder gaining significant influence over a company or a sensitive asset of the company. The government expects that there could be up to 100 notifications each year that will require full national security assessments. At the moment, there is less than one public interest intervention by the CMA each year.

However, the former CEO of the Office of Fair Trading and Chair of the International Competition network, John Fingleton, has pointed out that ‘the proposals will apply to any takeover, not just those involving foreign companies and that the concept of national security is not adequately defined so that the proposals would enable the government to intervene in any sector’. He goes on to say that the proposals introduce a much more restrictive approach to foreign investment in the UK and would allow the government to extract commitments to economic activity in the UK rather than national security.[15]

How would the proposal address situations where companies agree to be taken over by foreign companies, or are taken over by another UK company such as Melrose and GKN? For example, when the UK technology firm, Imagination Technology, lost its biggest customer, it agreed to be taken over by Canyon Bridge, a Chinese government backed private equity fund. Canyon Bridge promised to maintain Imagination’s UK headquarters and its 1300 staff. ARM holdings, a Japanese/Saudi Arabian owned, UK based technology firm offered to step in as a buyer of last

14 Department for Business, Energy and Industrial Strategy (2018) National Security and Investment, Draft Statutory Statement of Policy Intent. London: BEIS.

15 Fingleton, J. (2018) ‘Mergers and the public interest: a wolf in sheep’s clothing?’ Fingleton Associates, 15 October. http://www.fingletonassociates.com/publications/mergers-and-the-public-interest-a-wolf-in-sheeps-clothing/

resort if the UK government blocked the sale on national security grounds.[16] ARM hadn't bid for Imagination during the takeover auction for fear of attracting CMA scrutiny of its domination of the UK market. Had the proposed regulations been in place, the government would have been left with a choice between letting Imagination Technology go under with the loss of 1300 jobs, allowing a foreign company to buy a strategically important company, or allowing a UK based but also foreign owned rival, ARM, to breach the government's competition laws. Canyon Bridge was able to buy Imagination Technology after it sold its US venture MIPS to avoid US national security concerns, even though MIPS has engineering facilities all over the world, including in Shanghai, China.

16 See: 'ARM ready to swoop on Imagination if Chinese takeover blocked', *Daily Telegraph*, 25 September 2017. https://www.telegraph.co.uk/business/2017/09/25/arm-ready-swoop-imagination-chinese-takeover-blocked/

Stock market indices and passive investment funds

Another way that companies have been protected by shareholder activism has surprisingly come from passive fund managers. The ever increasing number of index tracking fund managers objected when Unilever's proposed rationalisation meant that it was in danger of being removed from the FTSE100 index, as they claimed this would force them to sell their holdings at short notice.

It is important that stock markets have clear and transparent listing regulations and index calculations. The rules of the FTSE Russell group, the owner of the UK indices, are easy to find[17] and reflect the needs of the wider user groups for whom the index is a benchmark for their investments or a proxy for the wider UK economy. FTSE Russell determines the nationality of a company for index inclusion by where the company is incorporated and where it is listed. Only premium listed equity shares that have been admitted to the London Stock Exchange (LSE), with a sterling-denominated price and traded on the Stock Exchange Trading Service (SETS), the LSE's electronic order book, are eligible for inclusion in the FTSE index series.

FTSE Russell reviews each index's components every quarter and makes changes when necessary after the close of business on the third Friday of the month, following the expiry of the ICE futures and options contracts. Removal and replacement rules have always allowed for delisting due to takeovers or the company ceasing to be eligible due to its free float or capitalisation falling below prescribed levels. In such cases, the company

17 'Ground Rules: FTSE UK Index Series', FTSE Russell. https://www.ftse.com/products/downloads/FTSE_UK_Index_Series.pdf

is replaced in the index by the most appropriate company from the reserve list. It is also possible for a new company to come into the FTSE indices if its IPO meets the free float criteria, valuation and nationality requirements. This of course would knock out an existing firm as the FTSE100 and FTSE250 indices are limited in the number of companies they include, as their name implies.

The failure of shareholders to agree to Unilever rationalising its management to the Netherlands in 2018 was blamed by some parts of the media on the fact that the company could no longer be included in the FTSE100 as it would no longer be a UK registered company. However, this argument is implausible. Once a fund manager becomes a passive fund investor benchmarking an index, they have outsourced any choice about the companies that they invest in. It is an absurdity to then demand that the index they have chosen to follow should include stocks chosen by their fund managers. The point of a passive investment is that the human 'investment decision' risk is removed: for good or for bad, an investor will get the same return as the index they track. It is up to the index owners to decide which companies are eligible for inclusion. So, a fund manager complaining that a company will drop out of the UK indices, if it ceases to be a UK company, is pointless. Unilever, or any other company, could drop out of the FTSE100 due to any one of the events listed in Unilever's own risk statement, such as if their global brands no longer met consumer preferences, or if they failed to innovate or remain competitive etc. Just look at Carillion, Debenhams or ICI if you don't think that it is possible for a large, established company to drop out of a major index.

However, it is hard to argue for the maximisation of shareholder value and the rights of shareholders to dismiss management and then also argue for a company's inclusion in an index because it suits passive investors. Passive fund investing is the antithesis of activist shareholding. Being included in an index followed by many passive funds could to some extent give a company's management a free ride, so to speak. They only need to stay inside the index criteria for passive index investors to hold their shares, regardless of their return on capital or other performance criteria. It would be nice to believe that a company's share price was buoyed by good management decisions and a healthy return on capital rather than held up by its index inclusion. Countering this trend are some large passive fund managers who take an active interest in corporate governance issues and have supported some activist shareholder proposals in the past.

There are, of course, significant positive aspects of index funds. They guarantee the return of the index they follow when many active fund managers fail to equal or outperform the index. Index trading attracts large amounts of investment capital into UK financial markets. The UK's liquid index futures markets also helps fund managers hedge their investments and invest new capital immediately into the index.

There are good reasons why the UK indices should only hold UK listed companies that meet the free float and currency criteria of the index. It is also not unreasonable for an investor who buys a FTSE100 portfolio to expect it to reflect the performance of the UK's largest companies, just as another investor who buys a portfolio of AEX Index shares would expect it to reflect the performance of the most traded 25 companies on Euronext Amsterdam - even though the companies in both indices are predominantely multinationals with global income streams.

Although index tracker funds would be forced to sell their shares if a company moved its listing to another country, most actively managed UK equity funds are now permitted to invest some proportion of their capital in overseas stocks. However, activist investors, who can buy shares in most countries, have strong incentives to oppose a company moving to a more protective regulatory environment whether it is in an index or not.

There are some institutional investors, such as pension or insurance funds, which can only own shares that are domiciled and listed in the same country as the fund's primary liabilities. Consequently, many companies have secondary listings on other exchanges for facilitating non-domestic investors. Some of these exchanges may also have listing rules that allow a foreign company to become part of the index. But that does not mean that the UK's FTSE Russell group should follow suit. However, the FTSE Russell group, or anyone else, could start a new index of international companies listed in London or of global commodities companies listed in London etc. if there were demand from investors for such an index.

Corporate nationality and multiple listings

Multiple stock market listings

While only UK companies can be included in a FTSE Russell UK stock index, there are many companies with additional stock-market listings in other markets as well as their home market. The LSE has over 2,600 listed companies from more than 60 different countries. Many additional listings will be for historical reasons: potentially a company starts off in a small city, but if it grows into a national or multinational company it will attract investors from all over the world who will generally want to trade in their own time zone, currency or regulatory jurisdiction. There are many examples of this, such as News Corporation, which started in Adelaide, South Australia, and retains an Australian Stock Exchange (ASX) listing even though its business has outgrown not only Adelaide but also Australia. Its headquarters is now in New York and it is also listed on Nasdaq. Or Hong Kong Land which started in Hong Kong as its name implies but now owns and manages property all over Asia, is headquartered in Bermuda and has its primary stock market listing on the London Stock Exchange, as well as secondary listings in Bermuda and Singapore.

There are many reasons why a company incorporated in a Pacific time zone would want to have an additional listing in London. Besides a shareholder friendly regulatory environment and the rule of law, London gives companies access to large pools of international investment funds and a central time zone. Although electronic trading has made it is possible to trade 24 hours a day, in general most major fund managers do not stay up all night making investment decisions.

Another advantage of an additional London listing is that the UK is a relatively safe haven for investments, with its deep-rooted legal system, property rights and independent currency. This has encouraged some European, Middle Eastern and African companies to have additional listings in London even though their home market is in a similar time zone. Many international commodity companies such as Antofagasta, Rio Tinto, BHP and EVRAS plc, have a listing or an additional listing in London because they are providing alternate investment products for UK and European investors who do not have a significant domestic mining sector. Other companies have multiple listings due to historical mergers, such as Carnival (headquartered in Florida and created from the merger of Reed International and Elsevier), which retains listings in London, Amsterdam and New York.

Dual-listed company structures

Both BHP and Rio Tinto, like Unilever, are dual listed companies (DLCs), a corporate structure created when two companies merge their operations into a single unit combining cash flows, income and liabilities but retain their separate legal identities, separate share registers and stock exchange listings. There is no legal transfer of assets between the two entities. In a DLC structure both companies have mutual ownership of each other's assets and earnings but retain their separate entities for tax or regulatory reasons. In almost all cases DLCs are cross-border mergers and involve well established companies in their home market which both want to keep their primary listing and management. Usually DLCs share a board of directors and a management structure. An 'equalisation agreement' ensures that shareholders retain proportional voting rights, cashflow rights, dividends, liquidation rights and corporate governance.

DLCs are often formed for tax reasons if capital gains tax would be owed under a straight forward merger or where cross-border dividend payments would be more highly taxed in one jurisdiction than in the other.

Other benefits to DLC structures include:

- They allow companies to retain local corporate names that investors trust and understand;
- Institutional investors that cannot own shares in a foreign company can still invest in the local part of a DLC;

- A DLC retains its local stock market listing and potential index inclusion which provides better access to capital or sale of new issues in their home market;
- DLCs may also be able to avoid competition regulations and foreign investment review boards.

However, there are also disadvantages. The complex DLC structure is less transparent for investors and less efficient for management. It is much harder for a DLC to issue shares for an acquisition, or conduct share buy backs or stock splits. Another disadvantage is that even though the two companies own each other's businesses in proportion to their 'equalisation agreement', one company often trades at a discount to the other even after currency risk, political risks and taxation differences are considered.

DLCs were a useful corporate structure when many pension funds were restricted from investing outside of their home market to avoid any currency risk between their assets and liabilities. But with present cross-border financial markets, it is harder to justify retaining a DLC structure in most cases.

DLC structures are often used where two countries have very similar company law and property rights such as the UK and Australia. So, while there may be a financial advantage to simplifying the corporate structure there is unlikely to be a regulatory disadvantage to shareholders from not doing so.

If a company wanted to streamline its structure, it would have to ask the question: who is more important for management to be close to, its customer base, its production base or its investors? Mondi, a DLC producing pulp, paper and container board, with both South African and UK listings, has recently announced that it will simplify its structure to become a single holding company based in London. Although the company started in South Africa, its revenue from outside South Africa has grown much faster, so that it now accounts for 90 per cent of the group's underlying earnings. Mondi now has 100 production sites in 30 countries. The group believes that streamlining the corporate structure will facilitate investment and capital raising for modernisation.

One of the benefits of having a single listing and management structure is that companies with a single share structure find it easier to make big acquisitions with paper bids - that is issuing shares in their own company to swap for shares in the target company. A simplified share structure also makes it easier for the management to sell off divisions of a conglomerate company that are no longer core businesses or considered to be a good use of capital. But if a company is not maximising shareholder value then a simplified share structure would also make it an easier takeover target.

Some DLC companies have managed to streamline their management but still retain two non-fungible lines of shares so that they can retain both their stock-market listings. For example, Shell was formerly a DLC from the merger of the Royal Dutch Petroleum Company of the Netherlands and the UK’s ‘Shell’ Transport and Trading Company. The UK and Dutch companies maintained their legal existence but operated as a single-unit partnership for business purposes. The company unified in 2005. Shell is now incorporated in the UK with its primary listing on the London Stock Exchange, but it retains its corporate headquarters in The Hague, its tax residence in the Netherlands, and is also traded on the Euronext Amsterdam exchange (AEX), although only its ‘A’ shares are included in the AEX index.

Conclusion

Increasing regulatory protection or government subsidies in order to prop up failing companies or industries is never successful in the long run. Like King Canute, government subsidies, or regulatory protection cannot stop the inevitable demise of a badly run company, nor can it stop innovation that would make established companies obsolete.

A government might attempt to educate its population well enough to produce efficient employees, as well as innovators and entrepreneurs. It can create tax incentives that help innovative companies start and grow, and it can ensure that excessive or unnecessary regulation does not allow established companies to become entrenched oligopolies. But regulation that allows a company's management to become entrenched helps no one except the dozen or so people on a company's board and executive team. Regulations that protect companies or their management from takeovers are only delaying the inevitable. If a company wants to avoid being taken over, it needs to maximise its shareholder value and keep its shareholders informed about its strategy.

One area that has been overlooked in the present Brexit debate has been the damage to markets and consumer welfare if the UK were to sign up to the EU's corporate governance rules as part of the 'Level Playing Field' clauses in the UK's Withdrawal Agreement and Political Declaration. While some people may welcome such a move, expecting it to increase consumer and worker protection in the long run, and possibly even the short run, this is unlikely to be the result. To adopt, without influence, another state's protective regulation that may reduce a UK company's ability to make a profit or its ability to compete against foreign competitors, could eventually force the UK firm to move its production to a lower-cost environment or go out of business. The implications of globalisation and comparative advantage are well established.

UK financial markets have been successful over the long term because they enable financial natural selection to take place. Well run companies should welcome the benefits of operating in such an environment rather than fear them. Market forces such as activist shareholders and takeovers are key disciplines for ensuring the efficient use of capital and resources. They should be encouraged not restricted.

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