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BRIEFING

Treasury shares

Executive summary

From 1 December 2003, listed companies that buy back shares out of distributable profits will be able to hold those shares in treasury, rather than having to cancel them. This briefing looks at the potential benefits of treasury shares and some practical points companies should consider if they want to take advantage of the changes in the law.

From 1 December 2003, listed companies that buy back shares out of distributable profits will be able to hold those shares in treasury, rather than having to cancel them. This briefing looks at the potential benefits of treasury shares and some practical points companies should consider if they want to take advantage of the changes in the law.

A company can hold up to 10 per cent of any class of listed shares in treasury and sell those shares for cash or use them for employee share schemes. While the shares are in treasury the company is shown as the registered owner and the shares remain listed and part of the company's share capital. They will not affect inclusion in a FTSE index. However, the company cannot attend meetings, vote the shares or receive any distributions (apart from any issue of bonus shares). The shares are not shown as an asset on the balance sheet but as a deduction in arriving at shareholders' funds. They are ignored in calculating earnings per share and net asset values.

Buying treasury shares

If a company wants to buy back shares to hold in treasury it must do so out of distributable profits. The usual provisions relating to purchases of shares under the Companies Act and the Listing Rules apply whether the shares are to be cancelled or held in treasury. Assuming the company has power in its articles to buy back shares it should be able to continue to use its customary resolution authorising the repurchase of shares. Although there is no specific rule on this, the UK Listing Authority (UKLA) expects the circular sent to shareholders asking for approval of repurchases to indicate whether the shares will be cancelled, held in treasury or a combination of both. Details of the repurchase and the total number of shares held in treasury after the repurchase must be announced (see disclosure requirements below).

Using treasury shares

Treasury shares can be sold for cash (but not for a non-cash consideration) or can be transferred for the purposes of or pursuant to an employee share scheme. The company can also cancel treasury shares at any time. If they are sold for cash, the company's distributable profits will be increased by the sale proceeds up to the weighted average of the price paid to buy in the shares. Any excess amount must be credited to a share premium account. The ability to increase distributable profits reduced in buying treasury shares is one of the principal benefits of having treasury shares rather than cancelling repurchased shares and then issuing new shares.

The pre-emption provisions in the Companies Act and the Listing Rules apply to sales of treasury shares in the same way as to issues of equity securities. The company must therefore offer the treasury shares to existing shareholders pro rata to their holdings unless a special resolution has been passed to disapply the pre-emption rights. The Pre-Emption Group has not yet formally published its approach to disapplying pre-emption rights

for sales of treasury shares. However, it is expected that the approach will be the same as for issues of new shares ie treasury shares can only be sold either in a rights issue or as part of the usual 5 per cent pre-emption disapplication – and new issues and sales of treasury shares would be aggregated for this purpose. There may be more flexibility in applying the rolling 7.5 per cent over three years test. Companies should check the wording they use to disapply the statutory pre-emption rights, as it is likely they will need to change this to cater for treasury shares, particularly if the articles of association contain wording to allow the pre-emption provisions to be disapplied.

Under the Listing Rules, companies will not be able to sell or transfer treasury shares when the company has unpublished price-sensitive information or in a close period subject to certain exceptions for transfers related to share schemes. On a sale for cash the shares cannot be sold at a discount to the middle market price of more than 10 per cent. Transfers of treasury shares to all employee share schemes can, however, be made at a greater discount.

One practical point on selling shares is that treasury shares can only be registered in the company's name and cannot, therefore, be transferred to a broker as nominee to facilitate settlement of a sale using CREST. Companies will therefore need to become a sponsored member of CREST and should discuss the arrangements with their brokers or registrars.

If companies wish to use treasury shares in their employee share schemes, amendments to the Listing Rules provide that companies will need to obtain shareholder approval for any employee share scheme that uses treasury shares to satisfy share options or awards. The UKLA has stated that this requirement applies equally to existing schemes. Some companies may be reluctant to return to shareholders to obtain approval for a scheme that may have been approved some time ago, or may never have required approval. If companies do wish to have the flexibility of using treasury shares for existing schemes, the easiest method of satisfying the UKLA's requirement is to seek approval at the AGM for a simple amendment to the relevant scheme rules enabling share options and awards to be satisfied using treasury shares.

As a practical point, companies should be aware that the preliminary view of the Association of British Insurers (which has not yet been published) is that treasury shares should be counted in calculating equity dilution limits in employee share schemes (10 per cent in 10 years etc). For companies that use employee trusts because they have issues with their dilution limits, this stance will prevent such companies from using treasury shares to avoid this problem.

A company selling treasury shares will not have to produce listing particulars but the usual rules on financial promotions will apply. Normally if there is a financial promotion a company should be able to take advantage of one of two exemptions in the Financial Promotions Order. The first relates to non-real time communications or solicited real-time communications by the company to persons it reasonably believes are its shareholders (article 43); the second relates to unsolicited real-time communications that are an inducement about the treasury shares (but not an invitation to enter into a transaction) and, if they refer to past prices or yields, state that past performance is not a guide to future performance (article 69).

There was some uncertainty about whether a company frequently buying and selling treasury shares might need to be authorised under the Financial Services and Markets Act on the basis that it was carrying on a regulated activity. However, HM Treasury thought it was unnecessary for companies to be subject to financial services regulation and a new exclusion to the Regulated Activities Order means that UK companies will not need to be authorised.

Disclosure requirements

Under the Listing Rules there is an obligation to announce purchases of shares (giving such details as how many shares are to be held in treasury and the total number of treasury shares in each class) and to announce details of any sale or transfer and the resulting position. In each case the announcement must be made to a Regulatory Information Service as soon as possible and, in any case, by 7.30am the next business day. There are also announcement obligations under the Listing Rules if

treasury shares are cancelled or shares are allotted to the company as part of a capitalisation or bonus issue. The market should therefore be kept fully informed of the number of shares in treasury at any time.

This is important, as it affects the obligation under the Companies Act to notify the company of interests in its voting share capital of 3 per cent or more and changes in those interests. Treasury shares are ignored in calculating whether a person has a holding of 3 per cent or more and changes in the numbers of treasury shares held by the company can therefore give rise to an obligation to make a notification. The company need not notify itself if it holds 3 per cent or more of its shares in treasury.

There is also a Listing Rule requirement on disclosure of certain sales of treasury shares in the annual report and accounts.

Effect on Listing Rule obligations

The UKLA's general approach is to ignore treasury shares. So, for example, they are disregarded in calculating whether 25 per cent of the company's share capital is in public hands. They are also disregarded for the consideration to market capitalisation and gross capital ratios when classifying transactions under chapter 10 of the Listing Rules. A transfer of treasury shares to a related party is caught by chapter 11 of the Listing Rules unless it is part of an offer made to all shareholders on the same terms.

Tax

New tax rules have been introduced to ensure that, for most tax purposes, shares bought back into treasury are treated in the same way as if they had been cancelled. For example, therefore, a company will not be subject to tax on any profit made from acquiring and disposing of shares into and out of treasury, and if it makes a loss that will not be relievable. In addition, a purchase of own shares into treasury will attract 0.5 per cent stamp duty (as with a purchase for cancellation), whereas a sale out of treasury will generally attract a fixed duty of £5 only.

Other things to check

Various changes have been made to the Companies Act to deal with the introduction of treasury shares, for example to deal with takeover offers for companies with treasury shares and compulsory squeeze out rights. However, the regulations that introduced treasury shares did not make any changes to any agreements. Companies therefore need to check whether any existing agreements might be adversely affected if the company has treasury shares. The provisions most likely to be of concern are those with a formula or other reference to issued share capital that do not take account of the existence of treasury shares. For example, if a financing agreement provides for mandatory prepayment out of the proceeds of any new share issue, some thought should be given to whether the language covers a sale of shares out of treasury. Although for accounting purposes, treasury shares are to be presented in the balance sheet as a deduction from equity, not as an asset, consideration should be given to whether a sale of shares out of treasury might be caught by a covenant restricting disposals. Any financial covenants that measure a company's 'net worth' will also require close scrutiny (depending on drafting, it is highly likely that the repurchase of shares into treasury by a company will cause its 'net worth' for the purposes of finance documentation to decrease). If companies have provisions in their articles relating to variation of class rights they should also check if these need to be altered to take account of treasury shares.

A real benefit?

When the idea of treasury shares was first mooted, it was hoped they would give companies increased flexibility to manage their capital structures effectively, leading to a reduction in the cost of capital. The decision to make treasury shares subject to pre-emption rights has reduced this flexibility. However, the benefit for companies of being able to top up their distributable profits on a sale and the flexibility treasury shares can offer should outweigh the administrative requirements that companies will have to meet.

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Checklist

Listed companies that wish to have treasury shares should:

- check if their articles of association need to be changed;
- check their standard buyback resolution;
- add a statement to the circular containing the buyback resolution;
- make disclosures, if needed, in the annual report;
- amend their special resolution disapplying pre-emption rights so as to cover treasury shares;
- check agreements that refer to issued share capital, including financial agreements;
- consider becoming a sponsored CREST member; and
- check any internal procedures dealing with announcement obligations.

For further information please contact
Vanessa Knapp
T +44 20 7832 7030
F +44 20 7832 7244
E vanessa.knapp@freshfields.com

7187.qxd