

SIMPLIFYING THE BUSINESS ENVIRONMENT FOR COMPANIES

A response from the Association of Investment Companies

Background

The Association of Investment Companies (AIC) is the trade association that represents closed-ended investment companies.

Investment companies are one type of collective investment vehicle available to UK investors. The majority of the AIC's Members are publicly listed companies, formed under UK company legislation (which, in turn, implements EU company legislation), and which invest in a diversified portfolio of assets to provide a return for investors.

Investment companies employ expert fund managers with the aim of delivering the best possible return within the terms of their specific investment mandate and risk profile. There are now some 230 investment companies based in the UK with assets of around £73 billion. A substantial proportion of these assets (more than 50%), in turn, will be invested in companies which are formed under European company legislation.

UK investment companies therefore have a unique perspective in terms of the debate for simplifying the EU company legislation, as our Members are both companies which are subject to EU legislation in these areas themselves, as well as major investors in the equity and debt issued by companies which are subject to EU legislation.

General comments

The AIC welcomes the review of the company law directives and supports examining the potential to reduce the burden of regulation. A number of the directives are beginning to show their age and are unable to meet the requirements of a fast-moving and dynamic business environment. Some of the directives are also too detailed and prescriptive in their requirements, and impose restrictions on companies which are now no longer necessary or would not meet a modern cost-benefit analysis.

The case for reform and deregulation is therefore very strong. However, the retention of some aspects of EU-wide regulation may be necessary to provide a common baseline of regulatory protection. The wholesale repeal of all the EU company law directives is therefore unlikely to be a desirable proposition. For example, we consider that the retention of the principle of pre-emption rights is one area where a common EU baseline would be desirable.

Balancing these competing objectives is not an easy task. The AIC considers that the Commission should therefore proceed on the following basis:

- Deregulation should happen unless it is clearly demonstrated that regulation is required which meets a rigorous cost/benefit analysis;
- Where it is determined on the above basis that some aspects of EU-wide legislation regulation should be retained, this legislation should be revisited and redrafted with a greater focus on a principles-based approach;
- Detailed, prescriptive regulation should only be implemented in exceptional cases where it is considered that this represents the only approach that can deliver the appropriate regulatory result.

If such an approach is applied consistently to all the company law directives, the AIC believes that the end result should be a body of EU law which is greatly reduced in size, more responsive to the needs of the business community and more likely to stand the test of time.

Specific comments

We have few comments to make on the proposed areas highlighted for deregulation. We welcome the general approach taken that deregulation should happen unless respondents can justify the retention of these rules.

There are two specific areas covered by EU company law on which we would, however, comment further at this stage:

Capital maintenance

The AIC believes that a review of the current capital maintenance system is long overdue.

Investment companies provide a clear example of how these rules can inappropriately restrict commercial flexibility and lead to unintended consequences. The capital maintenance provisions are primarily focussed on the protection of creditors. However, investment companies generally have very few creditors and are asset rich. Most of the assets held by investment companies are also very liquid, though there are some investment companies where this is not the case (e.g. investment companies specialising in private equity, property etc).

As a result, very high levels of distribution could be justified without any concerns arising over the protection of creditors. Nonetheless investment companies are still required to make careful consideration of a whole range of issues (in company law, accounting, guidance on realised profits etc) in determining whether they can make distributions, due to the severe consequences that could arise from a technical transgression of the rules. In few cases would any of these issues have a material impact on creditor protection.

Until recently, for example, a UK investment company could not take its fair value profits into account when making distributions (note : although the use of fair value is often portrayed as an IFRS development, investment companies have effectively been fair valuing their listed securities for many years prior to the introduction of IFRS).

This led to anomalous situations. For example, under these rules, it would be perfectly possible to have two otherwise identical investment companies, both holding identical portfolios, and with the same level of assets and liabilities. However, one had chosen to sell, then buy back immediately, its holdings in its major investments standing at a fair value profit. The other had not. However, as the definition of 'realised profit' in the UK until recently was essentially limited to those profits arising on actual disposal, one company would have far greater profits available for distribution than the other. However, from a creditor protection perspective, both companies were in an identical position.

Recent guidance issued by the UK's Institute of Chartered Accountants of England and Wales on the meaning of 'realised profits', revised in the context of fair value accounting under IFRS, now permits the treatment of fair value gains, in some circumstances, as realised profits. However, the guidance was produced only after a long and difficult process of consultation, raising problems of how to relate the concept of a 'realised profit' to accounts which have moved to a predominantly fair value based model. The final guidance is nearly 100 pages long and extremely complex.

Though the new guidance, overall, is a step forward, practical problems of implementing the guidance remain. Similarly, though the concept of a 'realised profit' should be a common European one (stemming as it does from the Fourth Company Law Directive), we are extremely doubtful that other Member States would apply anything like the same principles in determining realised profits as currently applicable in the UK. If this is the case, this undermines the principle of the directive providing common standards across Europe.

Arguments against reform of the capital maintenance regime tend to be based around two premises:

- The existing capital maintenance regime provides a discipline to companies having to generate profits before making distributions; and
- Breaking the link between dividends and profits will mean that dividends are no longer a useful measure of corporate performance.

However, though these arguments and concerns are valid, it could be argued that:

- The capital maintenance regime was not intended, or designed, to provide commercial discipline to companies. It was designed to protect creditors. If creditors can be protected adequately in other ways, there is no reason not to consider alternatives to the present system.
- It can be argued that dividends alone are not a useful measure of current performance. Dividends can be increased during periods of poor corporate performance as a result of retained profits from earlier years. Earnings may be a better measure of performance and would not be affected by changes to the capital maintenance regime.
- Shareholders who feel that the dividend policy of the company is not supported by its current earnings, or who believe that the company would be better off retaining profits for reinvestment, can make their views known to management and, if necessary, exercise their rights as shareholders to bring about change. Holders of listed securities could, of course, sell their shares on the market.

We would therefore expect there to be differing views in response to this consultation. Nonetheless, in view of some of the clear problems caused by the capital maintenance regime (another example is given below), we believe that careful consideration of alternatives is justified to see if a different regime can alleviate the problems caused by the current regime, whilst addressing the concerns of those more cautious or sceptical about change.

For these reasons, we support further work by the Commission to consider reform of the capital maintenance regime, and we look forward to seeing the results of the study launched by the Commission into possible alternatives.

IFRS

It is very welcome to see the EU Commission moving towards a principles-based approach to legislation, and seeking to justify legislation in terms of a cost/benefit analysis.

The UK is already applying such an approach in other areas of regulation, and has recently revised its Listing Rules relating to investment entities. The results of this approach have been encouraging, with a significant reduction in the length and complexity of the rulebook but not, in our view, any reduction in consumer protection.

The company law directives, of course, have traditionally had a significant role in terms of accounting. We also note the Commission's comments regarding the fact that the current IASB work on SME accounting will not provide sufficient elements to simplify the life of European SMEs.

We would, however, go further than this. If there is a view in the Commission that principles-based regulation, subject to a rigorous cost/benefit analysis, is the approach that should be taken to the company law directives, and these directives are to continue to play a significant role in accounting, then the whole question of the direction and momentum of IFRS needs to be reconsidered.

Although IFRS, and the IASB, make reference to principles-based standards, and the need to balance benefit with cost, we see little evidence that this is observed in practice. The standards are extremely detailed, prescriptive and complex in nature, offer very little in terms of flexibility to cater for specialist companies such as investment companies, and in their development seem motivated more by the desire to catch every conceivable abuse than to ensure that the majority of reporting entities can provide their shareholders with the best quality information.

This problem is compounded by the fact that the audit professions, more so than has even been the case before (no doubt due to the legal risks arising from a major audit failure) are taking a mechanistic approach towards interpreting the standards. That said, we consider that IFRS actively encourages this type of approach.

This is not just a matter of accounting, important though this is. It can also potentially have a major impact on how a company can operate within the existing capital maintenance framework.

One example of how inflexible accounting standards can lead not only to anomalous accounting treatments but also problems due to the interaction between these standards and the capital maintenance regime arose in relation to the accounting for companies with limited lives.

The investment company industry is unusual in the sense that investment companies are often launched with a fixed life, at the end of which the company will be liquidated. The liquidation is not prompted over any concerns over the company's viability, but is simply fixed so that shareholders have greater certainty over when they can realise their investment without selling their shares in the market at a time when the share price might be temporarily depressed. Such companies are also often formed with different classes of shares, some of which are entitled to the income of the company (and therefore receive all their returns in the form of dividends) and some only entitled to the capital profits.

Under the terms of the relevant IFRS standard, this resulted in a company's entire share capital being classified as a liability, with the result that the company's accounts technically showed that the company had nil net assets, even though in reality the company might have had hundreds of millions of pounds of assets, and liquidation might be more than a decade away.

It should be noted that, due to the complexity of the standards, it took the accounting profession well over a year to reach an agreed position as to whether it was required to account for these shares as liabilities and, in some cases, different answers were reached depending on the precise legal wording of the company's articles. However, in substance, all these companies were, economically, trying to do much the same thing.

This accounting treatment, in addition to being highly confusing and misleading for shareholders, also interacted with the UK's company law in such a way that, for a time, it was thought that UK investment companies with a limited life would be unable to pay distributions at all. This would have had catastrophic consequences for the shareholders who owned shares that were only entitled to dividends and who therefore faced a complete collapse in their value. At the same time, it was seriously questioned by the legal profession whether it was necessary for the company to comply with the requirements applying on a "serious loss of capital" (a requirement which stems from the Second Company Law directive), due to the fact that the company's accounts showed nil net assets.

Eventually, as a result of changes to UK company law, and a more pragmatic approach to the interpretation of company law and the standards, it was possible to mitigate the worst aspects of this standard. However, the problem, in the AIC's view, should never have arisen in the first place, and arose by virtue of prescriptive standards being applied in a mechanistic way.

The IASB has since proposed a revision to its standards to cater for this problem. However, the AIC found it almost impossible to respond to this consultation, as the generally sensible proposals were bound up in yet more detailed and prescriptive conditions, which we were unable to understand and so could not

say with any certainty whether our Members would be able to take advantage of a different accounting treatment.

Our view, therefore, as appears to be the Commission's view in respect of the IASB's work on the accounting for SME's, is that its welcome move to more principles-based legislation will be frustrated in terms of some of the accounting aspects of the company law directives unless the same approach is taken in the formation of the standards themselves. There is no evidence that this is happening at present.

It therefore follows that, if an alternative to the capital maintenance regime is proposed which relies, in whole or in part, on the accounts of the company concerned meeting certain tests, this may not achieve the desired outcome, as the ability to pay distributions could be subject to future developments in IFRS which might unnecessarily restrict the companies' flexibility to make distributions even where no creditor protection issues arise.

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