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Corporate Update

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Happy New Year and welcome to our latest edition of Corporate Update.

In our *Company Law Update*, we consider the draft guidance for corporate anti-bribery procedures. The Bribery Act 2010 comes into force in April 2011 and companies, to the extent they have not already done so, should be acting now to develop and put in place procedures to prevent bribery by persons associated with them.

The recent judicial decision in the case of **EDI v National Car Parks** addresses the meaning of the phrase "reasonable endeavours". We examine this decision and consider what practical steps companies can take to ensure that their commercial objectives are best achieved.

As the 2011 AGM season gets into its stride, in our *Corporate Governance Update* we highlight the emerging trend of early adoption of the recommendation in the UK Corporate Governance Code for the annual re-election of directors. In addition, whilst publication of Lord Davies' review on gender diversity in the boardroom is not expected until next month, we note his preliminary conclusions that quotas are not the answer to ending the under-representation of women in the boardroom.

The FSA continues its focus on stamping out market abuse. In our *Regulatory Update*, we consider the FSA's best practice recommendations for the handling of inside information. We also examine the FSA's recent, and in some cases, ongoing, market abuse and insider dealing prosecutions.

In October 2010, the Takeover Panel published an initial response to its consultation on extensive potential changes to the regulation of takeover bids in the UK. The consultation was a result of political and media commentary surrounding the Kraft Foods' hostile takeover of Cadbury. In our *Takeovers Update*, we analyse the Panel's conclusions.

In our *Antitrust Update* we focus on the OFT's draft guidance on competition compliance for directors. Directors will need to familiarise themselves with this guidance in order to ensure that they are taking the proper steps to promote competition compliance within their organisation.

We will shortly be releasing details of our Spring series of Webinars. These are live webcasts in which leading practitioners from across the firm discuss a series of topics revolving around the general themes of restructuring and M&A and capital markets activity in the current climate. For details of these Webinars, please contact Charlotte Haddock on 020 7006 1294 or at **charlotte.haddock@cliffordchance.com**.

This Corporate Update has been produced by the London Corporate Practice and edited by David Pudge. For more information about the Corporate Practice and the Editor, please see page 2. If you would like more information about any of the topics covered in this Corporate Update, or to provide feedback, please email your usual Clifford Chance contact (firstname.lastname@cliffordchance.com) or contact David Pudge (details below).

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The Editor

David Pudge
David specialises in corporate finance, domestic and cross-border M&A, public takeovers, listed company and general corporate advisory work.

Recent major transactions include advising: International Power on its combination with GdF Suez's international energy assets by means of reverse takeover; Man Group on its $1.6bn acquisition of US listed alternative investment manager GLG Partners Inc; and Vale on its $2.5bn acquisition of a controlling interest in a joint venture with BSG Resources Limited to develop iron ore concessions in Guinea, West Africa.

David is a member of the City of London Law Society's Company Law Committee and a contributing author to "A Practitioner's Guide to the City Code on Takeovers and Mergers".

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Company Law Update

Government publishes draft guidance for corporate anti-bribery procedures

In our July 2010 Corporate Update we considered the implications of the introduction of the new Bribery Act 2010 (the "**Act**") which will come into force in April 2011. By way of reminder, the Act creates a new offence of failure by commercial organisations to prevent bribery. The offence arises on the occurrence of bribery by a person associated with the organisation, but is subject to a defence of having established adequate procedures to prevent bribery.

On 14 September 2010, the UK Ministry of Justice published the eagerly awaited statutory guidance on what commercial organisations have to do to comply with the Act and, in particular, to establish a defence of having "adequate procedures" in place to prevent bribery by persons associated with the organisation. The guidance was published in draft for consultation. It is fair to say that the guidance was not as precise as had been hoped and ambiguities remain in a number of areas.

The consultation closed in November 2010 and final guidance is expected to be published at the end of January 2011.

The draft guidance sets out six principles, as follows:

1. Risk Assessment

Organisations should regularly and comprehensively assess the nature and extent of both the sector and market risks relating to bribery to which they are exposed. The draft guidance accepts that whether risk assessment procedures will be "adequate" will depend on the size of an organisation, its activities, its customers and the markets in which it operates. Organisations are advised to consider:

- whether those undertaking the assessment are adequately skilled and equipped to do so, or whether using external professionals may be appropriate; and
- how best to inform the risk management. The draft guidance suggests using both internal information (e.g. annual audit reports, internal investigation reports, focus groups and staff/client/customer complaints) and external information. (e.g. publicly available reports on bribery issues in particular sectors or jurisdictions).

Comment - The draft guidance suggests that organisations should look at the level of internally reported instances of bribery or potential bribery in conjunction with the results of an external benchmarking exercise in order to determine how high the risks are, and where they present themselves. Organisations should ensure, however, that assessments are carried out on a regular, ongoing basis and that specific risk assessments are undertaken for new business.

2. Top level commitment

The draft guidance proposes that the management of an organisation should issue a statement of commitment to counter bribery in all parts of the organisation's operation. An organisation should also consider reflecting its commitment against bribery in its management structure.

Comment - "Tone from the top" is universally recommended (e.g. by the OECD Guidelines for Multinational Enterprises, the FSA, the Serious Fraud Office, the US Federal Sentencing Guidelines and by Transparency International) in the form of board-level commitment and the appointment of a senior manager with responsibility for anti-bribery efforts.

3. Due diligence

Commercial organisations should develop due diligence policies and procedures which apply to all parties to a business relationship, including the organisation's supply chain, agents and intermediaries, all forms of joint venture and similar relationships and all markets in which the commercial organisation does business. The draft guidance lists examples of enquiries that might form part of this due diligence.

Comment - Given that due diligence is likely to form the bedrock of an organisation's practical steps to prevent bribery, organisations will want to review their procedures to ensure that these enquiries are built into all relevant dealings with third parties and that the enquiries extend more broadly to the environment in which they operate (or plan to operate), to the relevant law relating to those operations, and to the nature of the project undertaken.

4. Clear, Practical and Accessible Policies and Procedures

The draft guidance advises that an organisation's anti-bribery policies and procedures should be clear, practical, accessible and enforceable, and that they should "take account of the roles of the whole work force from the owners or board of directors to all employees, and all people and entities over which the commercial organisation has control". A corporate anti-bribery policy should include:

- a clear prohibition of all forms of bribery "including a strategy for building this prohibition into the

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decision making processes of the organisation";

- guidance on political and charitable donations;
- guidance on gifts, hospitality and promotional expenses (to ensure expenditure is "ethically sound and transparent");
- advice on relevant laws and regulations;
- guidance on how to react to blackmail or extortion, including "a clear escalation process";
- guidance on whistle-blowing; and
- information on anti-corruption programmes relevant to the sector.

An organisation may, in addition, wish to have a code of conduct, setting out expected standards of behaviour and forming part of each employee's employment contract.

The draft guidance proposes that financial and auditing controls, disciplinary procedures, performance appraisals and selection criteria can act "as an effective bribery deterrent", and recommends procedures to deal with incidents of bribery "in a prompt, consistent and appropriate manner".

Comment - Most large commercial organisations will have had anti-bribery policies in place for some time, and may be in the process of revising them to ensure compliance with the Act. While the above components are not mandatory, they are already standard elements of anti-bribery policies, with the possible exception of information on sectoral programmes. A difficult question can be who should be required to comply with the policy e.g should subsidiaries, contractors or agents be covered by the policy; the draft guidance suggests that the test should be whether the organisation has "control".

5. Effective Implementation

The draft guidance emphasises that embedding anti-bribery policies and procedures throughout the organisation ensures that the development of policies and procedures "reflects the practical business issues that an organisation's management and workforce face when seeking to conduct business without bribery".

Larger organisations may need to tailor training for different functions within the organisation, and should consider offering or requiring the participation of business partners in anti-bribery training courses. The draft guidance also recommends organisations communicate their anti-bribery policies externally.

Comment - The need for internal systems and controls to be genuinely effective has been spotlighted by recent FSA decisions, such as in the case of Aon, which was penalised for a failure to have systems and controls in place to prevent bribery. Organisations must now expect courts (and regulators) to scrutinise closely, not only their codes and policies, but every aspect of the way in which such codes and policies are communicated, monitored and enforced. Active implementation of anti-bribery rules will be as much the focus as the rules themselves.

6. Monitoring and review

The draft guidance suggests larger organisations ensure they have financial monitoring, bribery reporting and incident management procedures, and that they may wish to disclose findings and recommendations for improvement in the organisation's Annual Report to shareholders. Organisations should ensure that their risk assessments and anti-bribery policies and procedures are updated to take into account events such as "government changes, corruption convictions, or negative press reports", as well as "external methods of issue identification and reporting as a result of the statutory requirements applying to their supporting institutions, e.g. money laundering regulations reporting by

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accountants and solicitors". Larger organisations or those with a higher risk profile may also "wish to consider whether to commission external verification or assurance of the effectiveness of anti-bribery policies, or to seek membership of one of the independently-verified anti-bribery code monitored by industrial sector associations or multilateral bodies".

Comment - Although the draft guidance suggests public disclosure of the findings of internal monitoring, and says "[t]ransparency is an important anti-bribery tool", organisations which seek to adopt this measure will need to ensure that policies on disclosure take account of the legal risks that may arise, for example defamation, breach of confidentiality, tipping off and loss of legal privilege, as well as reputational and commercial risk.

Some specific issues

In addition to the six principles, the draft guidance seeks to clarify the application of the law in certain difficult areas.

- *Offset arrangements* (where an additional investment is offered or made by a tenderer for a contract) will not be an offence under section 6 (the foreign public official offence) where this is permitted or required by local applicable law, but may otherwise be at risk of prosecution.

  Comment - The requirement that payments to foreign public officials be permitted or required under written law is likely to lead to a greater need for local legal opinions.

- *Hospitality and promotional expenditure* "can be employed improperly and illegally as a bribe", but the draft guidance says it will be permissible where it is "reasonable and proportionate" and where it "seeks to improve the image of a commercial organisation, better to present products and services, or establish cordial relations". The draft guidance suggests that hospitality or promotional expenditure given to a foreign public official will not be an "advantage" for the purposes of section 6 where the cost of such hospitality would otherwise be borne by that official's government.

  Comment - Until the law is clarified by case law in this area commercial organisations are advised to exercise extreme caution when providing hospitality to foreign public officials, even in cases which would appear to be covered by the final statement.

- *Facilitation payments* are likely to trigger both the section 6 offence and the section 1 offence (offence of bribing another person).

  Comment - This provides no comfort for commercial organisations struggling with such issues.

In deciding whether to prosecute, prosecutors will consider whether there is sufficient evidence to provide a realistic prospect of a conviction, and, if so, whether a prosecution is in the public interest.

Comment - This simply re-states the current test for prosecutors. The Director of Public Prosecutions and the Director of the Serious Fraud Office are currently drawing up joint legal guidance for prosecutors on the Act. This is expected to be published early in 2011.

The draft guidance is available at http://www.justice.gov.uk/consultations/docs/bribery-act-guidance-consultation1.pdf

For further information about the Act please refer to our various client briefings available at http://www.cliffordchance.com/publicationviews.html

Distributable profits: ICAEW publishes TECH 02/10

The Institute of Chartered Accountants in England and Wales ("**ICAEW**") and the Institute of Chartered Accountants of Scotland ("**ICAS**") have issued Technical Release, TECH 02/10 containing an expanded version of the guidance in TECH 01/09 on the determination of realised profits and losses in the context of distributions under the Companies Act 2006 ("**CA 2006**").

TECH 02/10 includes some significant additional guidance which was originally published in draft as TECH 03/09. Key issues covered by the additional guidance include:

- **linked transactions -** when a group or series of transactions or arrangements should be viewed as artificial, linked or circular (and consequently viewed as a whole) in assessing whether a company has a realised profit (of particular relevance where a company is attempting to create distributable reserves through intra-group transactions);
- **cash box structures -** whether a reserve arising on a cash box placing or other cash box share issue (and which is not recorded as share premium) is a realised/distributable profit;
- **distributions in kind –** how to apply s.846 CA 2006 (determination of amount) where the asset to which an unrealised reserve relates has been replaced by a different asset or where the distribution is of fungible assets

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such as shares or loan notes received as consideration for the sale of another asset;

- **distributions settled by set off –** for example, where a subsidiary wishes to make a distribution to its parent of an unrealised profit and the distribution would result in the elimination or reduction of the asset which represents the unrealised profit;
- **reduction of a liability –** whether a decrease in a liability assumed by a company from a third party for consideration is a realised profit;
- **foreign currency share capital and use of presentation currencies –** the effect of the share capital being denominated in a currency other than the functional currency, and the effect of the whole of the accounts being translated into a presentation currency of free choice;
- **cash pooling arrangements and group treasury balances –** clarification of the circumstances in which a group treasury balance will fall within the definition of "qualifying consideration" and guidance on the realisation of a profit where a balance is constantly turning over even though a substantial core balance remains outstanding; and
- **reclassification of financial instruments –** whether, if an asset is no longer readily convertible to cash, this has an effect on the "realised" status of prior fair value gains.

English and Scottish Counsel have confirmed that the guidance in TECH 02/10 is consistent with the law at 1 June 2010.

TECH 02/10 is available at http://www.icaew.com/index.cfm/route /174921/icaew_ga /Technical_and_ Business_Topics/ Technical_releases/ Tech/Tech_02_10/pdf

Reasonable or best endeavours - is there a difference?

The question of whether to give or accept an obligation to use "reasonable" or "best" endeavours to achieve a particular objective or procure its achievement commonly arises in practice in the context of commercial transactions. Commercial agreements reflect a wide spectrum of endeavours clauses ("best endeavours", "all reasonable endeavours" and "reasonable endeavours").

In **EDI Central Limited v National Car Parks** *[2010] ScotCS CSOH_141*, the Scottish Court of Session provided a useful insight into how the courts will interpret a contractual obligation to use "all reasonable endeavours". The case highlights how ambiguous this phrase can be and provides a useful review of the recent case law on such obligations. The case serves as a reminder that the best way to achieve certainty when drafting relevant clauses is to consider carefully the extent of the parties' obligations and to document specifically those actions that a party must take in using its reasonable or best endeavours.

Facts - NCP entered into an agreement with EDI under which EDI would pay £5m for the right to take forward a redevelopment of the Castle Terrace Park operated by NCP. The contract included an obligation on EDI to use "all reasonable endeavours" to pursue the development "as would be expected of a normal prudent commercial developer experienced in developments of that nature" and a requirement that NCP and the developer "use all reasonable endeavours to achieve the Main Objectives" and to "act in good faith in respect of the same and in accordance with this Agreement". When the project was no longer considered viable because alternative car parking facilities in that part of town were not available, EDI served notice to NCP asking for their £5m back (relying on a further contractual provision for the return of this sum, to deal with the situation whereby planning consent or similar could not be obtained). NCP refused to make the repayment and argued that EDI were in breach of contract because they had not used "all reasonable endeavours" to pursue the development.

Findings - Relying on **Rhodia International Holdings Limited v Huntsman International LLC** *[2007] 2 Lloyds Rep 325*, the judge held that the obligation to use "all reasonable endeavours" is a more onerous obligation than one simply to use "reasonable endeavours". The judge also noted that "best endeavours" may not require much more effort than "all reasonable endeavours" since "it is difficult to conceive that an obligation to use "best endeavours" requires a party to take steps which are unreasonable".

As held in **CPC Group v Qatari Diar Real Estate Investment Co.** *[2010] EWHC 1535 (Ch)*, in order to determine what is encompassed by the obligation to use "all reasonable endeavours", the Court must consider whether there were reasonable steps which could have been taken but were not taken. The party on whom the obligation is placed will be expected to explore all avenues reasonably open to it, and to explore them all to the extent reasonable, but the party is neither obliged to disregard their own commercial interests, nor required to continue trying to comply if it is clear that all further efforts would be fruitless. Where there are several obstacles to overcome, the party is not required to

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continue using all reasonable efforts to overcome them all once it became clear that one of them is insurmountable.

"All reasonable endeavours" might require the affected party to inform the other party of any difficulties he is encountering and to see whether that party has a possible solution to any problems faced, but this will depend on the circumstances.

Considering the effect of a clause requiring "good faith", the judge held that a duty to use good faith imposed the duty to observe reasonable commercial standards of fair dealing, faithfulness to the agreed common purpose, and consistency with the justified expectations of the other party. Combined with the duty to use "all reasonable endeavours", the judge held that it requires the party "genuinely to do their best to achieve the desired result and not merely to go through the motions".

Judgment -: The judge ruled that EDI had indeed used "all reasonable endeavours as would be expected of a normal prudent commercial developer" in pursuing the development. Even if EDI had pressed harder in other areas, the judge was satisfied that they would not have succeeded since the problem of finding alternative car parking space could not be overcome. Any further efforts by EDI would have been completely futile and so there was no obligation on them to take those further actions.

Government announces its intention to amend financial information requirements in statements of capital

Even prior to the full implementation of the Companies Act 2006 on 1 October 2009, it became apparent that a significant number of companies would have difficulty complying with the

requirement to include certain financial information in the statement of capital (see *Guidance on filing statements of capital* in our January 2010 Corporate Update for further details). As a result, the Government commenced a consultation on this issue in November 2009.

In December 2010, the Government published details of its intention to simplify the financial information requirements for all companies, in all statements of capital, except those required on formation and in the Annual Return, to require the following information:

- the total number of shares of the company;
- the aggregate nominal value of those shares;
- the aggregate amount unpaid on those shares (whether on account of nominal value of the shares or by way of premium);
- the total number of shares in each class;
- the aggregate nominal value of shares in each class; and
- the aggregate amount unpaid on shares in each class (whether on account of nominal value of the shares or by way of premium).

At the same time, the Government also intends to simplify the information requirements on the rights attached to shares which must currently be included in statements of capital.

Whilst for many of the instances where a statement of capital is required, including the Annual Return, the Companies Act 2006 contains a power for the Secretary of State to amend the requirements by statutory instrument, for a number of others there is no such power. The Government has concluded that the changes to statements of capital should be introduced simultaneously to minimise confusion and intends to publish detailed proposals as soon as a suitable legislative vehicle is available.

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In the meantime however, it intends to make an earlier change to the requirements in the statement of capital in the Annual Return, on the basis that the inclusion of a statement of capital in the Annual Return represents a significant proportion of the burden of the requirements on companies, and it is also the only instance in which a statement of capital is required when no change in share capital has taken place.

Accordingly, the Government proposes that the Annual Return statement of capital should include only the following information:

- the total number of shares of the company and their aggregate nominal value; and
- the total number of shares of each class and their aggregate nominal value.

This would have the result of removing entirely the requirement in the Annual Return for information about voting rights and the amounts paid/unpaid on shares. This change is expected to be made in October 2011. Draft regulations for consultation are likely to be published in January 2011.

For a copy of the Government's press release see http://www.bis.gov.uk/consultations/companies-act-2006-statements-of-capital-consultation

Corporate tax reform - proposals to enhance UK tax competitiveness

On 29 November 2010, HM Treasury and HMRC issued a consultative document setting out a series of proposed reforms to the corporate tax system over the next five years.

The document draws together a number of ongoing consultations including:

- *the latest proposals in relation to controlled foreign companies ("**CFCs**")* – there will be a full reform of the CFC regime from 2012, with interim changes to be introduced in 2011. Draft legislation on the interim changes was published on 9 December 2010.
- *the taxation of intellectual property* - the introduction of a preferential regime for profits arising from patents ("**the Patent Box**") from 1 April 2013. The Government will also review Research and Development tax credits.
- *the taxation of overseas branches* - an opt-in exemption from corporation tax for the profits of foreign branches of UK companies from 2011. Draft legislation was published on 9 December 2010.

The document confirms, as already announced, that there will be a staged reduction in the main rate of Corporation Tax from the current 28% rate to a 24% rate by financial year 2014. The document also confirms that the Government will not pursue significant changes to the UK's competitive regime for interest deductibility, but will continue to keep this area under review.

For further details on the key points arising from the document please see our client briefing *Corporate Tax Reform*. Details of how to access this briefing can be found on the back page of this Update.

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Corporate capital gains

Following a consultation earlier this year, draft legislation has been published in relation to simplifying the taxation of capital gains for groups of companies. The changes relate to three sets of anti-avoidance provisions:

- **Degrouping charges –** the most significant changes relate to the way that most corporate capital gains degrouping charges are computed. In most cases, instead of the degrouping charge arising in the company leaving the group (as is currently the case) it will instead apply so as to increase the proceeds of sale for the shares being sold. Any shareholder reliefs that may apply to the share disposal (such as the Substantial Shareholdings Exemption) will apply to the degrouping charge, assuming that the relevant conditions are met. This is a welcome change. Unfortunately, these changes do not appear to be being made to the similar degrouping rules in the Intangible Fixed Assets tax code.

  One consequence of this change is that, where an exemption or relief is not available, the degrouping charge will now automatically arise on the seller and not the target. This may have some effect on the way tax warranties and indemnities in share purchase agreements are drafted.

  A further change will allow the Substantial Shareholding Exemption to apply when a trading activity is transferred to a newly incorporated group company, which is then sold out of a trading group. This will avoid the need for complex structuring where a trading company wishes to dispose of a business or part of a business. Further technical changes have been made to the degrouping charge, some of which have also been made to the Intangible Fixed Assets tax code.

- **Capital losses after a change of ownership –** the amendments will remove some existing restrictions on the use of capital losses within a group of companies after an acquisition of a business.

- **Value shifting –** the current value shifting rules will be replaced with a new motive based anti-avoidance rule that will target tax driven arrangements intended to reduce the value of a company before a share sale.

These changes will generally apply to disposals on or after Royal Assent of the Finance Act 2011.

New tax avoidance measures announced

A number of anti-avoidance measures were announced on 6 December 2010. Draft clauses have now been published on the following:

- group mismatches
- derecognition
- disguised remuneration
- functional currency
- VAT zero-rating: splitting of supplies

HM Treasury also announced that it will be setting up a study group to consider a general anti-avoidance rule (GAAR).

For further background on these changes please see our client briefing *HM Treasury announces new Tax Avoidance Measures*. Details of how to access this briefing can be found on the back page of this Corporate Update.

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Corporate Governance Update

Clifford Chance AGM and Governance Update 2011 published

You will have already received our AGM and Governance Update 2011, published in December 2010. That Update is split into three key sections:

AGM Update

- **Reporting against the new UK Corporate Governance Code –** we examine the emerging trend for early adoption of the Code. In particular, as the AGM season progresses, there is a clear move towards the early adoption by issuers of the Code provision requiring annual re-election of all directors;

- **Seeking shareholder authority to hold general meetings on 14 day's notice –** the IPCs raised concerns about such resolutions during the 2010 AGM season. Whilst the position appears more settled now, companies seeking an enabling resolution of this type will need to consider the circumstances in which they would consider holding a general meeting on 14 days' notice and explain these in their AGM circular;

Governance Update

- **Updated shareholder voting guidelines –** both PIRC and NAPF have updated their voting guidelines to bring them in line with the new UK Corporate Governance Code. Given the increased focus of the IPCs on good governance, we highlight the key changes for companies to be aware of;

- **ICSA review of Higgs Guidance –** ICSA has been tasked by the FRC to review and update the Good Practice Suggestions from the Higgs report addressing the roles of the chairman and non-executive directors. We look at the draft guidance published to date. The final guidance is expected imminently;

- **ICSA's updated terms of reference for board committees -** ICSA has updated its existing terms of reference and also prepared new terms of reference for risk committees. These have been developed in response to the recommendation of the Walker Review that boards of FTSE 100 banks and other financial institutions should establish a risk committee which is separate from their audit committee;

Financial Reporting Update

- The Update looks at the recent work of the FRC, FRRP and BIS in the area of financial reporting.

See the back cover of this Corporate Update for details of how to access our AGM and Governance Update 2011.

Lord Davies indicates board gender quota unlikely

Lord Davies, currently leading a review of boardroom diversity on behalf of the Government, has indicated in an article appearing in The Guardian that he is unlikely to recommend the introduction of mandatory female representation on boards.

Evidence shows that women represented only 12% of all directors of FTSE 100 companies in 2009. Concerns over the low proportion of women holding directorships prompted the Government to initiate a Call for Evidence on 8 October 2010. Lord Davies is expected to publish his findings and recommendations in February 2011.

Whilst recognising that quotas had proved successful in a number of countries, Lord Davies indicated that many of the women he has spoken to were not in favour of them. Other options under consideration include the creation of a best practice code for recruitment consultants tasked with board level and other senior appointments and a focus on increasing the transparency of the way in which board appointments are made by the nominations committee.

For a copy of the full article in The Guardian, see http://www.guardian.co.uk /commentisfree/2010/dec/31/women-equality-boardrooms

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FRC publishes revised Guidance on Audit Committees

In July 2010, the FRC consulted on limited changes to its Guidance on Audit Committees (formerly known as the Smith Guidance). This Guidance was last updated in October 2008. The consultation paper set out proposed changes to the Guidance which were intended to reinforce disclosure about the non-audit services provided by a company's auditor, in order reduce the perceived threats to auditor objectivity and independence arising from the provision of such services.

On 17 December 2010, the FRC published an updated version of its Guidance on Audit Committees, along with a summary of responses to its July consultation. The Guidance includes the following new provisions:

Internal audit – where the external auditor is being considered to undertake aspects of the internal audit, a recommendation that the audit committee consider the effect this may have on the effectiveness of the company's overall arrangements for internal control and investor perceptions in this regard (new paragraph 4.8);

Provision of non-audit services – in addition to developing the company policy on the provision of non-audit services by the auditor, the audit committee should keep such policy under review. In determining whether the provision of such services impairs the external auditor's independence or objectivity, a new factor to consider has been added to the Guidance, namely a requirement for the audit committee to consider whether the skills and experience of the audit firm make it "*the most*" suitable supplier of the non-audit service (amended paragraph 4.29). Further guidance is given regarding those non-audit services which may require specific approval from the audit committee before they are contracted (paragraphs 4.30 – 4.32);

Disclosure of non-audit services – a new paragraph 4.38 provides additional guidance as to the substance of the explanation to be included in the annual report regarding how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

A copy of the updated Guidance on Audit Committees is available at http://www.frc.org.uk/images/uploaded/documents/Guidance%20on%20Audit%20Committees%202010%20final1.pdf

FRC to begin review of Turnbull Guidance on risk and internal control

On 22 December 2010, the FSA announced that it intends to bring together company directors, investors and others in early 2011 to explore how companies are responding to the new UK Corporate Governance Code provision on boards' responsibilities for risk. The FRC will consider whether the Turnbull Guidance on risk and internal control will require amendment in light of these meetings.

For a copy of the FRC's press release see www.frc.org.uk /press/pub2479.html

QCA publishes updated corporate governance guidelines for smaller quoted companies

In September 2010, the Quoted Companies Alliance (**QCA**) published updated Corporate Governance Guidelines for Smaller Quoted Companies ("**Guidelines**"). The Guidelines supersede the QCA's Corporate Governance Guidelines for AIM Companies (February 2007) and Guidance for Smaller Quoted Companies – The Combined Code on Corporate Governance (August 2004).

The Guidelines have been updated to incorporate recent revisions to the UK Corporate Governance Code. The Guidelines combine the content of both the previous guidelines and have been revised to focus on the outcomes of corporate governance.

The Corporate Governance Guidelines for AIM Companies (now superseded by the Guidelines) already had strong support in the market and, in the July 2010 edition of its newsletter, Inside AIM (Issue 2), the London Stock Exchange endorsed its support for the Guidelines for AIM Companies.

The Guidelines have been prepared for use by all UK smaller quoted companies, including standard listed, AIM or PLUS-quoted companies. Whilst premium listed companies must report compliance against the UK Corporate Governance Code, the QCA believes that they may still find the Guidelines of use, particularly in explaining any areas of non compliance.

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Copies of the Guidelines can be purchased at http://www.theqca.com/shop/guides/30221/corporate-governance-guidelines-for-smaller-quoted-companies-september-2010-downloadable-pdf.thtml

EcoDa and IoD publish Corporate Governance Guidance and Principles for Unlisted Companies in the UK

On 19 November 2010, the European Confederation of Directors' Associations (**ecoDa**) and the Institute of Directors (**IoD**) published Corporate Governance Guidance and Principles for Unlisted Companies in the UK. The Guidance is based on ecoDa's guidance and principles for unlisted companies in Europe, but has been adapted to reflect UK company law and practice. The Guidance is intended to assist unlisted companies that wish to establish a corporate governance framework and includes a set of 14 principles.

A copy of the guidance is available at http://www.ecoda.org/docs/Corp%20Gov%20Guidance%20and%20Principles%20for%20Unlisted%20Companies%20in%20the%20UK_Final.pdf

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Regulatory Update

UKLA publishes List! (Issue no. 25)

In July 2010, the UKLA published Issue no. 25 of its newsletter List!. The two articles of particular note relate to reverse takeovers and break fees:

Reverse takeovers: The UKLA has outlined two key changes to its approach on reverse takeovers. A reverse takeover is a transaction consisting of an acquisition by a listed issuer of a business, an unlisted company or assets where any percentage ratio (applying the class tests set out in the Listing Rules) is 100% or more or which would result in a fundamental change in the business or in a change in board or voting control of the listed issuer.

The UKLA may suspend the listing of any securities if the smooth operation of the market is, or may be, temporarily jeopardised or it is necessary to protect investors. There is a rebuttable presumption that an issuer's equity shares will be suspended on the announcement or leak of a reverse takeover, pending the publication by the issuer of sufficient information about the transaction and the target business that the UKLA is satisfied that the market can properly price the issue's securities. The presumption can be rebutted if the UKLA is satisfied that there is already sufficient information in the market about the proposed transaction.

The rationale underlying this approach is that in the case of a reverse takeover, the target business will form the majority of the enlarged group, so the market needs sufficient disclosure on the target business to properly price the issuer's securities.

The changes in the UKLA's approach are:

- A change to the minimum level of information required to be disclosed on the target business (where it is not subject to a public disclosure regime) to avoid a listing suspension. List! sets out details of the information which must be provided by the issuer. The UKLA will also require a private comfort letter from the sponsor confirming that, in their opinion, the announcement contains sufficient information about the business to be acquired, to provide a properly informed basis for assessing the issuer's financial position. Note that in the case of acquisitions by a cash shell, or in situations where the acquisition would fundamentally change the nature or strategic direction of the issuer, the approach described above would not apply. In those situations the UKLA would suspend the issuer's equity shares until a prospectus on the new group has been published.
- A change to the approach taken where an acquisition (which would otherwise be classified as a reverse takeover) is effected by the imposition of a new holding company (topco) by way of a scheme of arrangement above both the issuer and the business being acquired. Previously the use of a topco structure avoided the risk of a listing suspension. There is now a presumption that the issuer's equity shares will be suspended until the earlier of the publication of a new applicant prospectus or of the minimum information referred to above even where a topco structure is being used.

Break fees: The UKLA has considered the application of the break fee provisions in the Listing Rules to arrangements which are designed to serve a similar purpose to a conventional break fee.

LR 10.2.7R provides some shareholder control over the ability of issuers to enter into break fee and similar arrangements where the fees exceed 1% of the value of the issuer. The UKLA considers that a break fee is "an obligation of an issuer for payment of a sum to the counterparty to a proposed transaction which will be triggered by, or linked to, the occurrence of certain specified events which have the effect of materially impeding a transaction or causing the transaction to fail".

A crucial part of this test is that the issuer must be obliged to make the payment to the other party to the failed transaction. This test must be applied irrespective of the particular arrangement.

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Any undertaking where the consequences of breach have the effect of materially impeding a transaction or causing it to fail and in relation to which a payment is made is therefore likely to be caught by LR 10.2.7R unless the fees are capped below the 1% threshold (once aggregated with any other break fee or similar arrangements). By way of example, the UKLA considers that go shop and no shop undertakings would fall within LR 10.2.7R where they meet the criteria set out above.

Other items covered by this edition of List! include:

- the factors which the UKLA will consider in determining whether a new applicant for a premium listing satisfies LR 6.1.4 – the requirement to demonstrate that at least 75% of its business is supported by a three year revenue earning record and that it is carrying on an independent business as its main activity;
- classifying joint venture arrangements;
- class tests – assessing whether an item is exceptional for the profits test;
- the advertisement provisions under the Prospectus Directive; and
- the venture capital trust board independence rules.

UKLA consolidates List! newsletters into series of Technical Updates

There are currently 25 editions of List!, dating back from 2010 to 2003. Over that period, the listing regime has experienced considerable change, including the implementation of the Prospectus Directive and the wider review of the Listing Rules in 2005. As a result of this and other Listing Rule changes, including the evolution of the interpretation of the Prospectus Directive, a number of the articles published in List! are now out of date.

Recognising this, the UKLA has published a series of technical and procedural updates, which bring together those articles which are still valid together with some updated articles (including updated rule references where relevant) under various key themes and topics.

Whilst the information in these updates is not new (they consolidate existing relevant published guidance from previous editions of List!), having the guidance consolidated in this manner is undoubtedly useful.

The updates can be accessed at: http://www.fsa.gov.uk/Pages/Doing/UKLA/ukla_publications/index.shtml

Results of Rights Issue Fees Inquiry published

In December 2010, the Institutional Investor Council published the results of its Rights Issue Fees Inquiry. The Inquiry was set up to consider the practices and pricing procedures adopted on rights issues.

The Inquiry identified that both issuers and investors have concerns about the level of fees which issuers are paying for rights issues, particularly to their banking advisers, along with concerns regarding a lack of competitiveness and opacity around what fees are actually paid, to whom and what for.

Notwithstanding that the level of risk lead underwriters bear has fallen in the last decade (with the possible exception of 2008 when the financial crisis was at its peak), the inquiry concluded that underwriting fees have not been reduced commensurate to the risks assumed. Investors have also raised concerns about the role played by leading banks as pure “financial” underwriters with an interest in the individual fund raising, rather than acting as a natural long-term owner of the shares.

The Inquiry makes a number of recommendations under three principal headings of transparency, competition and shareholder involvement. These include the following:

Transparency

- issuers should be required under the Listing Rules to disclose in detail all fees paid, to whom and for what;
- audit and risk committees should incorporate details of the issue and alternatives considered as part of their governance reporting process;
- issuers should be actively involved in compiling the proposed sub-underwriting list;

Competition

- companies should seek independent advice unless the executive team or board are particularly experienced in equity capital raising;
- companies should, wherever possible, put the primary underwriting contract out to tender;
- there should be no automatic assumption that issues should be fully underwritten;
- institutional shareholders, advisers and issuers should collectively evaluate the practicalities of sub-underwriting offset and of reintroducing tendering for sub-underwriting as a means of reducing issue costs; and

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Shareholder involvement

- institutional shareholders should consider appointing a named individual who can be taken "off market" and speak to issuers and their advisers with authority on matters such as support for a rights issue, pricing and sub-underwriting.

The Office of Fair Trading are currently undertaking a wider market study of equity underwriting and associated services.

For a copy of the Inquiry's report see http://www.iicouncil.org.uk/docs/rifireport.pdf

Prospectus and Transparency Directives – Amending Directive published

A Directive to amend the Prospectus Directive and the Transparency Directive was published in the Official Journal of the European Union on 11 December 2010. Member states have 18 months from 31 December 2010, the "effective date" of the Directive, to implement its provisions into domestic law.

Clifford Chance has prepared a client briefing *Prospectus and Transparency Directives – Amending Directive published* which considers the changes to these Directives and analyses how they might affect issuers of securities. See the back page of this Corporate Update for details of how to access this briefing.

Reminder of changes to DTR5 which took effect on 1 November 2010

Readers are reminded that changes to Chapter 5 of the Disclosure and Transparency Rules (Vote Holder and Issuer Notification Rules) (**DTR5**) took effect from 1 November 2010.

By way of recap, in June 2009, the FSA introduced changes to DTR5 which require disclosure of not only relevant holdings of voting rights attaching to shares and shares underlying qualifying financial instruments, but also holdings in financial instruments that have a similar economic effect to qualifying financial instruments, such as contracts for differences. At that time there was a lack of clarity surrounding the treatment of nil paid rights under the extended disclosure regime, in response to which the FSA published revised Questions & Answers.

In its Q&A, the FSA made clear its views that a right issued under a rights issue fell within the scope of the extended disclosure regime. However, the FSA confirmed that it did not expect persons who had received rights under a rights issue to include those rights in the calculation of their position in the issuer's shares unless they actively acquire or dispose of rights under the issue. In that case, they will be required to include all the rights, whether acquired actively or passively, in calculating a change in their position. The same analysis applies to a pro rata entitlement to acquire shares under an open offer (i.e. a person who maintained their proportionate holding by virtue of inaction would not need to disclose the entitlement).

In addition, there have been long standing concerns that DTR 5.6.1 (which requires issuers to announce changes to the total number of voting rights in issue at the end of each calendar month (**TVR announcement**)) can lead to a misleading impression of an issuer's total voting rights, where for example, a large secondary issue is conducted early in the month, but no TVR announcement is required to be made until the end of the month.

Effect of the 1 November 2010 changes:

- **Nil paid rights** –DTR 5.1 and DTR 5.3 were amended to give effect to the views expressed by the FSA in their Q&A.
- **TVR announcements** –DTR 5.6 and DTR 5.8 were amended to require issuers to announce material changes in total voting rights as soon as possible and in any event no later than the end of the business day following the day on which the increase or decrease occurs. The materiality qualification is intended to avoid issuers being required to make announcements on a regular basis as a result of issuing share options etc. The requirement in DTR 5.6.1 to announce any change in voting rights at the end of the month has been retained to ensure that any immaterial changes are captured at that time.

Market Watch No. 37 - handling leaks of inside information

On 23 September 2010, the FSA published Market Watch Newsletter Issue No. 37. This issue focused on leaks of inside information and set out the key findings of the FSA's enquiries over the previous three years into potential disclosures of inside information to the media ahead of announcements. The FSA's monitoring work mainly highlighted issues at regulated firms but the FSA believes that issuers should consider applying the recommendations and good practice points as appropriate in order to meet their obligations.

Despite its focus on how firms could tighten their controls on handling inside information and the prevention of its improper disclosure contrary to the market abuse regime, the FSA noted that

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the frequency of leaks does not appear to have reduced.

Of particular concern is the suspected practice of core insiders strategically leaking inside information. The FSA found that media reports containing leaks were often closely preceded by telephone conversations between insiders with senior roles on a corporate transaction and the journalists. The report acknowledges that some insiders may have been speaking to journalists to confirm details the journalist already held, but notes that insiders who confirm information put to them still potentially commit market abuse as they are disclosing inside information through affirmation. The report also highlights a number of areas of concern relating to the handling of inside information in the context of media enquiries.

Recommendations: The recommendations set out in the newsletter are directed at situations where a regulated or unregulated firm or issuer is handling inside information. The recommendations should not be treated as exhaustive and should be read in conjunction with the good practice recommendations made in Market Watch Issues No. 21 and No. 27.

- **Media policies (paragraphs 1 to 5):** The recommendations relate to internal media policies and procedures of regulated firms. It is expected that in most cases where a media enquiry is potentially related to inside information, it will be solely handled by the regulated firm's media relations team. Where it is necessary to involve non-media relations personnel there are a number of recommendations regarding the basis on which authorisation to communicate with the media may be granted. Concerns that inside information may already have been leaked should be escalated to compliance at the firm and the relevant issuer for consideration as to whether an immediate announcement is required under the relevant disclosure rules or under Rule 2 of the Takeover Code.
- **Handling leaks (paragraphs 6 to 17):** The FSA makes a number of recommendations in relation to handling leaks and the conduct and outcome of leak enquiries, including liaison with the FSA Market Conduct team and, where relevant, the Takeover Panel. The FSA encourages leak enquiries to be issuer-led.
- **Training staff (paragraph 18):** Relevant staff at regulated firms should receive regular and structured training on media and leak-handling policies and the market abuse regime.
- **Regularly communicating with staff (paragraphs 19 to 21):** The prohibition on leaks should be regularly communicated to staff to reinforce the message and establish an anti-leaking culture.
- **Establishing a strong reporting culture (paragraphs 22 to 24):** Regulated firms should establish a separate reporting line for staff to raise concerns about leaks, concerns about leaks should be logged and firms should monitor for an absence of reporting.
- **Disciplinary action (paragraph 25):** Staff must be clear that disciplinary action will follow for breach of internal policies in addition to any appropriate FSA action. Senior management are urged to adopt a robust stance to create a culture that firmly and actively discourages leaks.

Market Watch Issue no. 37 is available at http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter37.pdf

FSA has power to prosecute for money laundering offences

Neil Rollins, a former senior manager of PM Onboard Limited, a waste industry firm, was found guilty in November 2010 of five counts of insider dealing and four counts of money laundering in a case brought by the FSA after he traded on the basis of information he obtained as a result of his senior position and laundered the proceeds.

Before Rollin's trial his lawyers had tried to argue that the FSA could not use money-laundering charges in this case – the first time the regulator has exercised such powers. The Supreme Court upheld the Court of Appeal's decision (**R v Rollins** [2010] UKSC 39) that the FSA does have the power to prosecute for money laundering offences and is not limited in the exercise of its right to bring private prosecutions for those criminal offences specifically identified in FSMA.

The practical effect of this decision is that, whilst a money laundering offence charge can be derived from a charge of insider dealing, there is nothing to prevent the FSA from bringing money laundering charges (or any other charges such as fraud, as substantive offences) where that is consistent with the FSA's statutory functions. What this means in practice will depend on what happens to the FSA's prosecution functions following the creation of the new Consumer Protection and Markets Authority (see *A new approach for financial regulation: Government consultation and initial response* below). In the meantime, companies need to continue to maintain vigilance for money laundering.

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Rollins' sentencing and confiscation hearing will take place later this month.

Shifting the burden of proof in market abuse cases: FSA consults on changes to Code of Market Conduct

The FSA is consulting on amending the Code of Market Conduct following the European Court of Justice's decision in the **Spector** case (Case C-45/08, **Spector Photo Group NV, Chris Van Raemdonck v Commissie voor het Bank, Financie- en Assurantiewezen**). In that case, the ECJ found that the fact that a person who holds inside information trades in financial instruments to which that information relates implies that the person has 'used that information', but that is without prejudice to the person's rights of defence and, in particular, the right to rebut that presumption.

MAR 1.3.4E sets out the FSA's opinion that if the inside information was the reason for, or a material influence on, the decision to deal, this indicates that the person's behaviour is "on the basis of" inside information. This evidential provision suggests that evidence of a person's intention would be necessary, as a separate element, to prove insider dealing. In light of the ECJ's decision in the **Spector** case, the FSA's view is that it is not necessary to provide evidence of a person's intention in order to prove insider dealing. The FSA is therefore proposing the deletion of MAR 1.3.4E.

The consultation closed on 6 December 2010.

Latest market abuse and insider dealing actions

FSA hands out ban and fine to an individual for role in share ramping scheme - As referred to in our July 2010 Corporate Update, the FSA fined Simon Eagle £2.8m and banned him from working in the financial services industry after he orchestrated a prolonged share ramping scheme for his own financial benefit. Graham Betton, who, together with Simon Eagle, was the managing director of agency-only stockbroker SP Bell, has now been banned from working in financial services by the FSA pursuant to section 56 FSMA and the Upper Tribunal is now considering the fine that is appropriate for his actions.

To create a market in the shares he was seeking to sell, Betton instructed SP Bell staff to sell FEI shares to clients, many of whom were unaware that the shares were being bought and sold on their behalf. In order to defer clients having to pay for the shares, many of the trades were rolled over from client to client without being settled. The sales campaign resulted in FEI share price being pushed up from 2.5p in May 2003 to a high of 11.75p in July 2004.

Betton knew that there was a clear risk that many clients had not authorised their trading in FEI shares and that their apparent demand for FEI shares was not genuine.

Trading in FEI shares was suspended in July 2004 leaving over £9m of unsettled trades which neither SP Bell nor its clients could meet. SP Bell ceased trading and went into administration. SP Bell has received a public censure and would have been fined had it not gone into liquidation.

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The Tribunal is considering the fine that it deems appropriate for Betton's actions and will announce this at a later date. On the grounds that artificially raising the price of the stock betrayed his duty to his clients and was damaging to market confidence, the FSA has prohibited Betton from working in the financial services industry. The Tribunal commented that it would "*be wrong, damaging to market confidence and, indeed, unthinkable if Betton were allowed to continue operating*".

Parallel investigation into market abuse/insider dealing by FSA and SEC - On 25 November, the FSA announced that it had charged five individuals, including two former directors and one former senior trader of Blue Index Limited (**Blue Index**), a specialist Contract for Difference brokerage, with 17 counts of insider dealing, contrary to section 52 of the CJA, including in relation to dealing ahead of takeover announcements.

This announcement was followed, on 1 December 2010, by further announcements from both the FSA and the US Securities and Exchange Commission ("**SEC**"). In a parallel investigation with the FSA, the SEC and the US Department of Justice, with assistance from the FBI, have charged a former Deloitte Tax LLP partner and his wife, with insider trading in violation of US federal securities laws. Mr and Mrs McClennan are charged with repeatedly leaking confidential merger and acquisition information to Mrs McClennan's sister (the wife of the co-owner of Blue Index and a defendent in the FSA action referred to above) in a multi-million dollar insider trading scheme.

For a copy of the FSA's announcements see http://www.fsa.gov.uk /pages/Library/Communication/PR /2010/166.shtml and http://www.fsa.gov.uk/pages/Library/ Communication/PR/2010/169.shtml

The SEC's announcement is available at http://www.sec.gov/news/press /2010/2010-234.htm

FSA celebrates sixth successful prosecution for insider dealing - On 10 January 2011, the FSA announced its most recent successful prosecution for insider dealing. Christian Littlewood, a senior investment banker and his wife Angie Littlewood, along with a family friend, Helmy Omar Sa'id, have all pleaded guilty to eight counts of insider dealing. They are alleged to have made approximately £590,000 profit from the trades. A full sentencing and confiscation hearing are scheduled for early February 2011.

For a copy of the FSA's press release see www.fsa.gov.uk/ pages/Library/ Communication/PR /2011/002.shtml

A new approach for financial regulation: Government consultation and initial response

In July 2010, the Government announced the launch of its consultation on the implementation of reforms to financial regulation. The consultation outlined the Government's intention to overhaul the UK system of financial regulation by disbanding the FSA and establishing a new system of more specialised and focused regulators:

- *a new Financial Policy Committee (**FPC**)*: the FPC will be part of the Bank of England and will have primary statutory responsibility for maintaining financial stability;
- *a new Prudential Regulation Authority (**PRA**)*: operational responsibility for the prudential regulation of individual firms will be transferred from the FSA to a new subsidiary of the Bank of England. The PRA will be responsible for the prudential regulation of all deposit-taking institutions, insurers and investment banks; and
- *a new Consumer Protection and Markets Authority (**CPMA**)*: this body will be responsible for the regulation of conduct within the financial system, including the conduct of firms towards their retail customers and the conduct of participants in the wholesale financial markets. The CPMA will have primary statutory responsibility to promote confidence in financial services and markets. Accordingly, the CPMA is to take on all the FSA's responsibilities for conduct of business regulation and the supervision of firms.

In addition, as part of possible wider reforms to tackle economic crime, the Government stated its intention to consult on whether to transfer responsibility for prosecuting criminal offences involving insider dealing, other forms of market abuse and criminal law breaches which the FSA currently prosecutes to a new Economic Crime Agency (**ECA**).

The Government also sought views on whether it should merge the functions of the UKLA with other regulatory functions relating to companies and corporate information, notably those of the Financial Reporting Council (**FRC**). The Government stated its belief that this would have the benefit of bringing the UKLA's regulation of primary market activities alongside the FRC functions relating to company reporting, audit and corporate governance. The consultation questioned whether the UKLA should be merged with the FRC under the

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Department for Business Innovation and Skills or whether it should remain within the CPMA markets division. The consultation closed on 18 October 2010.

In November 2010, the Government published in its response document "*A new approach to financial regulation: summary of consultation responses*" that the UKLA will not be merged with the FRC. Instead, the UKLA will form a part of the FSA's partial successor, the CPMA. With regard to its plans to transfer the FSA's market abuse enforcement powers to a new ECA, the Government has now said that those powers will also fall under the remit of the CPMA.

The Government is continuing to develop its plans for regulatory reform and intends to publish a further consultation document (including draft legislation) in early 2011.

For a copy of the response paper see http://intranet/etc/medialib/practices/London/finance/facm/topicguides2010/uk_financial_supervisory/summaryofcondocresponses241110.Par.Single.File.dat/summaryofcondocresponses241110.pdf

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Takeovers Update

Proposed changes to Takeover Code – increased protection for target companies from hostile bidders

In our July 2010 Corporate Update, we discussed the Takeover Panel's consultation on extensive potential changes to the regulation of takeover bids in the UK. The consultation paper had outlined a wide range of possible changes to the UK takeover regime, in response to political and media commentary surrounding Kraft Foods' hostile takeover of Cadbury. In October 2010, the Panel published an initial response to that consultation and over the past few months it has become clearer how various issues and uncertainties covered in that response may take shape.

Overview of the Panel's conclusions

The Panel concluded that hostile bidders have been able to obtain a tactical advantage over targets, which operates to the detriment of the target company and its shareholders. It is proposed that the Code will be amended to redress the balance in favour of target companies.

The proposed reforms are more a pragmatic and politically expedient response to the post-Cadbury furore than a radical re-writing of the Code. The changes will, however, make hostile bids for UK companies more difficult. Although the Panel has rejected more draconian measures such as raising the acceptance threshold and disenfranchising shares bought during an offer period, the changes will impact "virtual bids" and require disclosure of advisers' fees upfront.

KEY PROPOSED CODE REFORMS

- General prohibition of break fees and other deal protection measures
- Requirement to identify bidders at the start of the offer period
- Fixed put up or shut up (PUSU) deadline of 4 weeks from when potential bidder publicly named
- Disclosure of bid-related fees in offer document and/or defence document
- Increased financial disclosure in offer documentation
- Statements of bidder's intentions in respect of target group will be expected to hold true for at least 12 months (unless shorter period is stated)
- Improved ability of employee representatives to make their views known on the bid
- Clarification regarding the matters which a target board should consider when assessing an offer

The proposed banning of break fees and other deal protection measures means the package of proposed changes will affect not only hostile bids, but also agreed and competitive transactions.

The Code will also be amended to make it clearer that target boards can take factors other than the price of the offer into consideration.

Whilst no formal timetable for the introduction of new rules has yet been set, it is our current understanding that the Panel expects to publish the next consultation paper (which will set out the detailed drafting of the proposed Code amendments) shortly, and that the new rules are likely to come into effect in late spring 2011, after a transitional period.

Key proposed Code amendments

The key proposed Code amendments are summarised in the box above and are discussed in further detail below.

Some of the more controversial suggestions set out in the original Panel consultation are not being progressed at the current time. These are listed in the box on the following page.

Up-front identification of potential bidders and a fixed PUSU (put up or shut up) deadline of 4 weeks from when a potential bidder is publicly named - The new rules are expected to require all potential bidders who have approached the target to be named in the announcement which starts the offer period.

Once a bidder has been publicly named there would be a fixed 4 week PUSU deadline, within which it must either announce an offer or announce that it will not be making an offer. This deadline will only be extendable with the consent of the target.

These changes are designed to give target companies greater protection against "virtual bids" (where a potential bidder announces that it is considering making an offer, but without committing itself to doing so). The Panel considers that the changes will give target

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companies more certainty over the length of the offer process and reduce the time period during which they are effectively "under siege".

The protection against extended "virtual bids" may raise challenges for bidders in terms of their ability to meet the 4 week announcement deadline and the obligation to post within a further 28 days. This is particularly likely to be a concern in the case of cross-border deals, or offers involving share-exchange consideration or complex financing arrangements.

In light of the proposed changes, a bidder will have a strong incentive to avoid a leak of its interest in the target company, given the fixed 4 week time period during which it would then need to table a formal offer. However the changes will also impact the time at which a potential bidder is likely to approach a target, given the risk of being "outed" at an early stage, and the need to be well progressed with bid planning if a potentially hostile offer is in contemplation. As a result, we may well see changing tactics on the part of potential bidders in this regard.

As a result of the above changes, there may be more instances of potential bidders preferring to agree with the Panel to "down tools" to avoid being named (e.g. where they consider it unlikely that they will get the target board to agree to a process intended to lead to a firm intention to bid announcement within 4 weeks) and it is expected that the Panel may seek to formalise the current "downing tools" regime.

General prohibition on break fees and other deal protection measures – this would include a ban on not only break and inducement fees, but also what have become currently market standard undertakings from a target board to a bidder to take certain actions to implement a Code offer (or refrain from taking actions which might arguably facilitate a competing bid), generally contained in implementation agreements. It seems that undertakings not to actively solicit rival bidders will also be subject to this prohibition.

Going forward, only limited specific undertakings from the target board are expected to be permitted (i.e. confidentiality, non-solicitation of employees and customers, and provision of information for regulatory approvals etc).

The Code will be amended to provide that, for recommended bids implemented by way of a scheme, a scheme timetable must be agreed with the Panel in advance and adhered to by the target. The Panel considers that this will effectively remove the need for implementation agreements on schemes.

Deal protection measures will, however, be permitted where a target is put up for sale via a formal public auction process.

The general ban on break fees and other deal protection measures is to address a practice which the Panel considers has become typical in the context of Code offers, for target boards to be presented with (and put under considerable pressure to accept) a standard "package" of deal protection measures. The Panel considers that such packages may cause competing bidders to make an offer on less favourable terms, or deter them completely.

However, these changes may be a major impediment for some types of buyers (in particular private equity buyers) who may be unwilling to commit to the upfront costs associated with due diligence and other bid and financing related expenses, in circumstances where they can no longer rely on a break fee or other contractual provisions to protect them against being out of pocket if a competing bidder intervenes.

It is not clear to us that deal protection measures have in practice been a significant impediment to rival bids but, going forward, bidders may need to focus more on other non-contractual deal protections such as stakebuilding and obtaining irrevocables. These non-

SUGGESTIONS FROM THE INITIAL PANEL CONSULTATION PAPER WHICH ARE NOT BEING PROGRESSED AT THE CURRENT TIME

- Increasing the acceptance condition above 50%
- Disenfranchising shares acquired during the offer period
- Introducing bidder shareholder protections
- Introducing a private PUSU regime
- Banning success fees
- Reducing the Rule 8 disclosure threshold from 1% to 0.5%
- Re-introducing the Substantial Acquisition Rules (SARs)
- Shortening the formal bid timetable
- Requiring separate advice to target shareholders
- Requiring publication of offer acceptances and scheme voting decisions

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contractual deal protections are more effective in the context of a traditional contractual offer structure (as opposed to a takeover implemented by way of a scheme of arrangement), and therefore we may once again see greater debate around the relative merits of the use of offers rather than schemes once these changes are implemented.

Disclosure of bid-related fees – estimated advisory fees are to be set out in the offer document and/or defence circular. Estimated aggregate fees for each party need to be disclosed (by category of adviser). Fees relating to financing are to be disclosed separately.

Incentive and success-based fees will continue to be permitted within existing parameters but the minimum and maximum amounts payable as a result of any success, incentive or ratchet mechanism will have to be disclosed. Although commercially sensitive information will not have to be disclosed, it is not clear how this will work in practice. Material changes to disclosed amounts must be announced promptly.

Increased financial disclosure in offer documentation – there is to be a new requirement to include pro forma information on the combined group where the offer is material to the bidder (note, there is currently no guidance on what is material in this context), and details of changes to the ratings attributed to a bidder as a result of the offer will need to be set out. In addition, increased disclosure of bidder financial information (e.g. for cash bidders) will be required and all financing agreements will need to be disclosed and put on display.

Intentions regarding target group employees, locations of business and fixed assets – the existing rules are regarded as requiring adequate disclosure but a new requirement for negative statements where the bidder has not formulated plans will be introduced. In addition, the Panel will require that statements in the offer documentation regarding a bidder's intentions for the target group will be expected to hold true for at least 12 months from the bid becoming wholly unconditional (unless a shorter period is stated).

Improving the ability of employee representatives to make their views known on the bid – in particular the target will be required to inform employee representatives at the earliest opportunity of their right to circulate their opinion on the offer to shareholders and to pay the costs reasonably incurred by employee representatives in verifying information in their opinion.

Clarification regarding the target board's considerations – it will be made clearer that a target board is able to take account of factors other than price when giving its opinion on an offer and reaching a conclusion as to whether it should recommend. This largely reflects directors' existing statutory duties and is unlikely to make a significant difference in practice but addresses concerns raised by politicians and the media that target boards do not sufficiently consider the interests of other stakeholders such as employees.

The Panel response published in October 2010 can be found at http://www.thetakeoverpanel.org.uk/wp-content/uploads/2009/12/2010-221.pdf

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BIS Call for Evidence: A Long-Term Focus for Corporate Britain

In October 2010, the Government published a Call for Evidence "A Long-Term Focus for Corporate Britain" as the first stage of a review into corporate governance and economic short-termism in the UK capital markets. This Call for Evidence follows on from the Government's Command Paper and Vince Cable's announcement in September 2010 that the Government would carry out a comprehensive review into corporate governance and economic short-termism, looking at the economic impact of takeovers, shareholder responsibility, corporate incentives and pay. The Government's Call for Evidence follows the Panel's consultation and response reviewing certain aspects of the regulation of takeover bids (discussed above).

The Government welcomes the Panel's proposed changes to the Takeover Code relating to the conduct of bids and agrees with the Panel that some rebalancing of the rules of the Takeover Code away from the bidder and in favour of the target and target shareholders is necessary.

In light of the Panel's review, the Government is looking into the economic case, and the corporate law framework, for takeovers. In particular, it would like to consider:

- whether on balance, the economic framework for takeovers is likely to improve the long-term competitiveness of UK companies;
- whether boards consider sufficiently carefully the long-term implications of takeover bids, and whether they communicate these effectively to shareholders and wider stakeholders; and
- whether bidder shareholders should always be invited to vote on takeover bids. This particular issue raises a number of concerns, not least the suggestion that it would be appropriate or indeed feasible for UK laws to seek to regulate the protections afforded to a non-UK offeror's shareholders simply because the offeror was making a bid for a company to which the Takeover Code applies. In addition, any such requirement could reduce the certainty of the offer being concluded, possibly to the detriment of the offeree's shareholders. In a situation where market conditions changed after an offer had commenced, the offerors' shareholders could vote against the bid, causing the offer to fail in circumstances where the offeror would have otherwise been unable to lapse its offer.

In addition, the Call for Evidence considers Part 22 of the Companies Act 2006 (information about interests in a company's shares) and ss.215 – 222 CA 2006 (payments for loss of office).

Part 22 CA 2006 (information about interests in a company's shares): The Call for Evidence comments that effective communication between companies and shareholders demands that directors know the identity of the owners of their company. Under Part 22 of the CA 2006, boards of public companies can require disclosure of information about the beneficial owners of a company's shares. Many public companies make use of this

in order to enhance investor relations and to monitor potential changes in the profile of its shareholder base. It has been suggested that better overall transparency would be achieved if this information were required of all investors and not disclosed only at the instigation of the company. It is not clear whether the Government is going to take this suggestion any further. Given UK publicly traded companies, which are subject to the Disclosure Rules and Transparency Rules, are notified of the identity of 3%+ controllers of voting rights and any further movements through a percentage point, it is unclear to what extent any change to the Part 22 regime (with the related costs of compliance for investors) will increase transparency to any material extent.

Payments for loss of office (ss.215 – 222 CA 2006): The CA 2006 requires specific prior shareholder approval of payments to directors for loss of office (so-called "golden parachutes"). These are payments made to directors to compensate them for ceasing to be a director, or losing any other office or employment with the company (including as the result of a takeover). However, shareholder approval is not required if the payment is made under an existing contractual entitlement (which is almost always the case in practice and which does not require shareholder approval). The Government believes there is a case for removing this exception to give shareholders more direct involvement in deciding the amount of payments to directors for loss of office, particularly if they consider they are not warranted on the basis of a particular director's performance. There are, however, significant practical difficulties to this proposal, not least the fact that an individual considering employment with a company is extremely unlikely to agree to such a public process, particularly where he or she is still employed elsewhere.

The Call for Evidence can be downloaded at http://bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

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Antitrust Update

OFT draft guidance on competition compliance for directors

As we reported in our July 2010 edition of Corporate Update, last year the Office of Fair Trading ("**OFT**") announced a shift in policy towards greater use of its powers to seek disqualification of directors of companies that have committed breaches of the competition rules (i.e. the prohibitions on anticompetitive agreements and abuse of a dominant position that are contained in the Competition Act 1998 and the Treaty on the Functioning of the EU ("**TFEU**")). This includes an increased risk of disqualification in circumstances in which a director was not aware of infringing conduct carried out by employees of his or her company, but – in the eyes of the OFT – should have been aware of it.

This prompted a number of calls for greater guidance from the OFT regarding the steps that it considers directors should take to promote competition compliance within their companies, and to uncover potential breaches of the competition rules. Consequently, the OFT has issued some draft guidance for directors for consultation with a request for comments by 21 January 2011. It is also conducting a separate consultation on draft compliance guidance for businesses.

The draft guidance for directors makes it clear that the OFT's expectations of directors' knowledge of the law, and the steps that they ought reasonably to take to prevent or detect infringements, will both depend on the nature of their role.

What are directors expected to know of competition law? The draft guidance states that all directors are expected by

the OFT to have a level of understanding that is appropriate for their position and the nature of their companies' activities, and to update and refresh their knowledge on an ongoing basis. At minimum, they must:

- be aware of the importance of competition compliance and the possible legal consequences of a breach, both for them and for their company;
- understand the "hard core" breaches of competition law, i.e. price-fixing, market sharing, bid-rigging, market sharing (including of customers or territories); agreements between rivals to limit production; sharing certain categories of commercially sensitive information; and resale price maintenance.

The OFT recognises that it would be disproportionate to expect all directors to understand the detailed application of competition law to other types of infringement (and, in particular, those the legality of which depends on their actual or potential effect on competition). However, it believes that directors ought to have sufficient understanding of the principles of competition law to recognise risks, and to realise when to make further enquiries, to seek legal advice, or to take steps to address risks or breaches that are identified.

In particular:

- directors with responsibility for competition compliance will be expected to have a sufficient grasp of the principles of competition law to identify and assess the types of risk to which the company is exposed, and to take steps to address those risks;
- directors with responsibility for the company's dealings with competitors should be aware of the law relating to indirect exchanges (e.g. via a supplier) of commercially sensitive information between competitors, often referred to as "hub and spoke" or "ABC" information exchanges;

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- directors with responsibility for commercial contracts should understand that certain types of contractual arrangements carry greater competition law risks, such as joint ventures with rivals, long term exclusive supply agreements (and agreements that have the effect of creating or inducing exclusivity), terms restricting another party's pricing freedom, non-compete obligations or terms obliging a buyer to purchase all (or substantially all) of its requirements from the company; selective distribution arrangements; and "standardisation" agreements between competitors on industry or technology standards; and
- directors with responsibility for commercial strategy or market conduct should appreciate whether the business has market power and therefore whether it is appropriate to consider whether the rules on abuse of a dominant position might apply. If so, directors should understand that additional compliance steps are required, and that it is likely to be necessary to seek legal advice when considering new pricing terms, or any conduct or commercial strategy which could exclude competitors from the market.

What are directors expected to do to prevent or detect breaches? For all directors, evidence of anticompetitive intention or secretive behaviour will be viewed as indicating that a director was aware that his or her actions, or those of others, might infringe competition law and that steps ought to have been taken to address this. The draft guidance also sets out an "*overriding principle… that a director cannot be absolved from the responsibility to keep himself informed*". Beyond that, expectations vary according to the role of the director.

For directors with direct or indirect responsibility for a particular area of activity (e.g. for sales staff or setting prices), the OFT may take the view that they "*ought to have known*" of infringing conduct if sufficient evidence of that conduct was available to them (or should have been available). Such evidence could include, for example, unexpected price increases, abnormal commercial contracts, staff in possession of information about a rival's prices or strategy, attendance by employees of meetings with competitors, or unexplained travel or other business expenses.

Those with specific management responsibilities are expected to have a greater awareness of any anticompetitive behaviour within their business unit. Consequently, the draft guidance states that "*the OFT will generally take the view that directors in smaller organisations who are personally involved in day-to-day business ought to be aware of any anticompetitive behaviour which is occurring*". For directors in larger organisations having overall responsibility for a business area, but no immediate management responsibility, the OFT will consider what evidence that director actually saw (or was presented with), and what he or she should have seen, having made reasonable enquiries. In particular, the draft guidance states that the OFT will assess whether the information was of the type that would usually be made available to a director in that position and/or whether the information would have come to light if the company had an effective compliance programme. The OFT does not, however, expect directors to be aware of information in circumstances where an appropriate compliance programme and culture are in place, but information was deliberately concealed from them.

All directors are, in the OFT's eyes, responsible for espousing an unambiguous commitment to competition compliance, and those tasked with specific compliance functions or decisions will be treated in the same way as any other director with responsibility for executive decisions. In particular, they are not expected to take any additional steps to detect possible breaches of competition law.

Non-executive directors are not expected to have an intimate knowledge of the company's day-to-day activities, but are expected to challenge decisions of executive directors and, in particular, to ask questions to ensure that appropriate compliance methods have been adopted to prevent and detect breaches. In particular, they should satisfy themselves that the company's executive directors have demonstrated a commitment to competition law compliance, taken appropriate steps to identify and assess the company's exposure to competition law risks, taken appropriate steps to mitigate those risks, including ensuring that training is provided to staff in higher risk positions, and reviewed the company's exposure to risk and compliance measures on a regular basis.

Where non-executive directors are involved in board level decisions to approve commercial activities (for example, a decision to enter into a new joint venture), they are also expected to satisfy themselves that the proposal has, where appropriate, been reviewed for compliance with competition law.

Comment - The guidance is still in draft form and it is hoped that certain points will be clearer in the final version. It is nevertheless a good indication of the high standards to which the OFT intends to hold company directors. It also serves to underline the importance of a well designed and rigorously implemented

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competition compliance programme and a commitment to preventing and deterring breaches at all levels of business.

The draft guidance is available at: http://www.oft.gov.uk/shared_oft/consultations/OFT1277.pdf

Court of Appeal strikes out Safeway's claim to recover a cartel fine from former directors and employees

The Court of Appeal has confirmed that an undertaking that infringes provisions of the Competition Act 1998 relating to anti-competitive activity cannot recover any penalty imposed on it from its directors or employees.

On 21 December 2010, the Court of Appeal handed down its judgment in **Safeway v Twigger** *[2010] EWCA Civ 1472*, reversing the first instance decision and holding that the case brought by Safeway against eleven of its former directors and employees to recover a £10.7 million fine imposed on it by the OFT for breaches of competition law should be struck out.

Background - In 2007, the OFT announced that it proposed to impose fines on a number of supermarkets and dairies that it alleged had engaged in anticompetitive exchanges of pricing information regarding the prices of milk, butter and cheese in 2002-2003. Several parties to the investigation, including Safeway (which had been taken over by Morrisons in 2004), entered into "early resolution agreements" (ERAs) with the OFT – a form of settlement, under which they admitted liability and agreed to pay a reduced penalty. The ERA entered into between Safeway and the OFT provided for Safeway to pay a fine of £10.7 million.

In September 2008, Safeway brought the claim against eleven of its former directors and employees to recover the amount of the fine and the costs it had incurred during the course of the OFT's investigation. Safeway alleged that the directors and employees, in causing Safeway to breach the Competition Act, had acted in breach of their employment contracts and/or fiduciary duties, and/or had been negligent. It was recognised by the courts at first instance and on appeal that Safeway's motivation was to recoup the fine and costs from its directors and officers (D&O) insurance policy.

The defendants applied for the claim to be struck out or for summary judgment in their favour, on the basis of the legal maxim *ex turpi causa non oritur action* which prevents a claimant from recovering for damage arising from his own criminal act. It was assumed for the purposes of the strike-out application that the defendants were responsible for the alleged breach. At first instance, the defendants also argued that as a matter of broader public policy an undertaking fined for breaches of the Competition Act should not be allowed to pass on the amount of the fine (by effectively claiming under a D&O insurance policy).

Although unsuccessful at first instance, the Court of Appeal found in favour of the defendants and, in a unanimous judgment, struck out Safeway's claim.

Application of the ex turpi causa maxim - Both at first instance and on appeal, the courts held that contraventions of the Competition Act were sufficiently serious to engage the maxim *ex turpi* causa, and a penalty imposed under section 36 of the Competition Act 1998 was akin to a fine. This follows a number of earlier cases in which the quasi-criminal character of competition law infringements has been recognised.

The Court of Appeal held that Safeway was personally (not vicariously) liable for the penalty imposed on it. The court stated that a penalty is imposed on an undertaking under the Competition Act

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where the undertaking itself has intentionally or negligently committed an infringement of the Act. In those circumstances, the court held, it is the undertaking which is personally at fault (there can be no one else who is) and, once the *ex turpi* causa maxim is engaged, the undertaking cannot say that it was not personally at fault in order to defeat the application of the maxim. Whether or not the defendants were Safeway's "directing mind and will" – such that their actions could be viewed as directly attributable to the company - was not, the Court of Appeal said, relevant. On the contrary, the court held that if it were the law that the *ex turpi* causa maxim could only be used against a company if the act was specifically authorised by the whole Board of Directors or the shareholders in a general meeting, there would be little scope for the maxim to be used at all in a corporate context.

D&O insurance - Pill LJ noted that the policy of the Competition Act attributes liability to *undertakings* and it is for the undertakings to organise their affairs in such a way as to prevent infringements of the Act. That policy would be undermined if undertakings were able to pass on the liability to their employees, or the employees' D&O insurers.

Comment - This is an important judgment for companies found to have infringed the competition rules who were considering bringing a claim against their directors and employees in an effort to pass on to D&O insurers the costs of the OFT investigation and the penalty imposed. The Court of Appeal's judgment is unequivocal in rejecting such an approach. The financial consequences of breaching the competition rules therefore falls squarely on the company found to be in breach – and no-one else.

The court's approach should be welcomed by companies and competition regulators as good news for leniency programmes. For *companies*, individuals will surely be more willing to report (or confess to) a suspected infringement if they are not at risk of being sued by their employer for the amount of a fine that may ultimately be imposed. The *OFT* should also be glad of this outcome, as a judgment in Safeway's favour would have had a chilling effect on the OFT's leniency programme in circumstances where individuals are reluctant to speak out, sources of information dry up and companies' ability to blow the whistle on a suspected infringement is hampered. The criminal cartel offence and the OFT's powers to disqualify directors already present serious disincentives to individuals who might otherwise infringe competition law (or cause their employer to do so).

Clifford Chance acted for the 8th Defendant. The claim against the 8th Defendant was discontinued shortly before the appeal hearing.

OFT Stock-take of Infrastructure Ownership and Control

The OFT has reported on its investigation into UK infrastructure markets – including energy, water, waste, communications and transport – and the impact of different forms of ownership on competition in those markets. The OFT's hope is that this study will provide greater certainty to investors about when and how competition policy might apply in infrastructure markets and procurements for work on infrastructure projects.

A clean bill of health - Importantly, the OFT found no evidence that the merger regime is not operating as intended, and had no "immediate" concerns about overall levels of concentration and cross-ownership in the market across infrastructure as a whole.

In particular, the OFT concluded that no particular infrastructure ownership model could be singled out as providing better or worse outcomes for consumers, as, overall, there is more variation in performance within than between different ownership types, and there was conflicting evidence regarding the relative benefits of 'not for profit' or non-conventional companies (including public sector operators). Moreover, the increase in infrastructure asset prices over time (at least until the recent economic downturn) could not, in the OFT's view, be attributed to ownership types, financing models or inflated asset valuations by infrastructure funds, but was instead likely to reflect the underlying market power of the assets themselves. As regards foreign investment, the OFT considered this to have a positive effect on capital market competition, and that increased potential for takeovers can place an important discipline on managers and costs.

The OFT's enforcement policy - While many infrastructure markets have a degree of market power, even where there is no direct price regulation, the OFT highlighted its desire not to deter investment through excessive intervention. The report sets out the framework that the OFT will follow in order to assess whether intervention in an infrastructure market is desirable. While this largely reflects the factors that the OFT will consider in any case (and not just those involving infrastructure), there is an important policy statement that the OFT will take into account the source of an infrastructure owner's market power. In particular, the OFT will be markedly less inclined to intervene to address substantial market power that has arisen due to innovation, as this could risk

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deterring future innovation, or when it results from a process of competition for the market (such as competition for a contract, in which bidders take on some degree of risk about future returns), as this could risk chilling the market and undermining the bidding process.

Where the OFT identifies a problem, it will only act if a proportionate and effective remedy is likely to be available (which will not always be the case, given the desirability of maintaining the economies of scale associated with a particular infrastructure asset). The report's case studies suggest that a focus of remedies in infrastructure markets will often be the removal of government-created entry barriers, such as those created by the planning process, or promoting a more effective process of competition for the market, through well designed procurements.

Comment - The outcome of the report is broadly positive for infrastructure operators and for infrastructure funds in particular. In particular, it finds no evidence to support accusations that are commonly levelled at private infrastructure investors - such as unwarranted inflation of asset values or under-investment associated with particular ownership models – while identifying benefits arising from foreign investment and competition in capital markets.

The report and the associated data and case studies are available at: http://www.oft.gov.uk/OFTwork/markets-work/infrastructure-ownership/

OFT publishes review of barriers to entry in retail banking

The OFT has published its review of barriers to entry, expansion and exit in the provision of retail banking services to both individual consumers and Small and Medium Sized Enterprises ("**SMEs**") within the UK.

In its review, the OFT considered that:

- regulatory requirements are not a major barrier. The process of obtaining FSA authorisation to accept deposits can be problematic, but this procedure has just been revised which should lead to improvements;
- there are no significant barriers to accessing essential inputs for retail banking services. However, the OFT noted that it can be difficult for new entrants to lend to the smallest SMEs as there is less credit and risk information in existence about these entities. The OFT also recognised that the recent lack of interbank funding could constrain certain banks from operating normally;
- there are no significant barriers to exit; and
- there may be significant challenges to new entrants in attracting customers and achieving scale and expanding market share. The OFT considered the chief cause of this to be customer inertia, but high levels of brand loyalty and preferences for providers with a branch network may also form significant barriers to entry that can deter potential new entrants.

Comment - Although the OFT has not issued any recommendations following the publication of its review, its findings can be expected to inform future regulation of the sector. The OFT has stated that a copy of the review will be

passed to the Independent Commission on Banking, which is examining issues of competition and stability in the banking market, and may be useful to both the FSA and Department for Business, Innovation and Skills. The OFT has stated that it hopes the review will contribute to the wider debate on the future of banking in the UK.

The OFT's report is available at: http://www.oft.gov.uk/shared_oft /personal-current-accounts/oft1282.

Deutsche Telekom margin squeeze appeal dismissed

The European Court of Justice (the "**ECJ**") has dismissed an appeal from Deutsche Telekom ("**DT**") against a fine imposed by the European Commission (the "**Commission**") for abuse of dominance by way of "margin squeeze".

Background - In 1997, the incumbent telecoms operator DT was required to provide fully unbundled wholesale access to the local network (local loop) to competitors on the retail market. DT's wholesale prices were subject to approval by the telecoms regulator and some of its retail prices were subject to price caps. However, DT had some discretion in setting its prices, in particular its price for ADSL broadband services. In 1999, the Commission received complaints from DT's competitors in relation to DT's pricing practices.

Facts - In May 2003, the Commission fined DT EUR 12.6 million for abuse of a dominant position. The Commission considered that DT had charged its competitors higher prices for access to the local loop than DT's retail prices, which resulted in a margin squeeze discouraging new competitors from entering the market. In April 2008, the General Court upheld the Commission's decision. On 14 October 2010, the ECJ decided that the General Court had not committed an error of law in dismissing DT's appeal against the Commission's decision.

The ECJ decided that:

- although wholesale prices for access to the local loop were approved by the national regulator, the General Court was entitled to find that the margin squeeze was attributable to DT on the basis that DT had sufficient scope to adjust its retail prices;
- the General Court correctly held that the margin squeeze was capable of constituting an abuse of dominance under Article 102 TFEU, and that there was no need to demonstrate that the wholesale or retail prices were in themselves abusive; and
- a pricing practice such as that adopted by DT has an exclusionary effect on competitors who are at least as efficient by squeezing their margins and is capable of making market entry more difficult or impossible for those competitors to the detriment of consumers. The General Court and Commission were entitled to rely on an "as-efficient competitor" test which considered only a dominant company's charges and costs instead of the particular situation of its competitors.

Comment - The ECJ's judgment endorses the as-efficient competitor test contained in the Commission's Guidelines on Article 102 and confirms that the costs of a dominant firm, not those of its competitors, are an appropriate measure for assessing exclusionary pricing practices.

Google: Commission investigates alleged abuse of dominance

The Commission has initiated a formal antitrust case against Google Inc. ("**Google**") to investigate alleged abuses of a dominant position in online search.

On 26 July 2010, the Commission announced the initiation of a formal investigation of whether Google's conduct was compatible with Article 102 TFEU. This follows a preliminary inquiry, launched on 24 February 2010, in response to three complaints that Google gave preferential treatment to the ranking of its own services in unpaid search results (also referred to as "natural", "organic" or "algorithmic" results) as well as sponsored links (i.e., the paid-for third party advertisements).

However, the Commission's formal investigation will cover a wider scope of issues than those raised in the complaints it received initially and, more particularly, whether Google has abused a dominant market position in online search by allegedly:

- demoting, in unpaid search results rankings, competing service providers specialised in specific online content, e.g. price comparisons ("vertical search services");
- lowering the 'Quality Score' for sponsored links to competing vertical search services, whilst according preferential placements to Google's own vertical search services;
- imposing exclusivity obligations on advertising partners, and computer and software vendors, with the aim of excluding competing search tools; and/or

- imposing restrictions on the transfer of online ad campaign data to other online advertising platforms.

The Commission stressed that the initiation of proceedings does not imply proof of any infringement.

Comment - The Commission is believed to be the third antitrust authority to have begun formally investigating Google's conduct. Cases launched in the past two years by France and Italy's national antitrust authorities have both been settled recently by Google – and Google may yet choose to settle the case brought by the Commission, if only to avoid a formal finding that it is dominant in any market. The case continues a line of technology sector cases recently initiated by the Commission under Article 102 – such as investigations into IBM, Intel, Rambus and Qualcomm and several cases against Microsoft – of which an increasing number are settled. Google, Foundem and several industry alliances have already made numerous public pronouncements on the allegations. This is perhaps unusual in the context of Article 102 investigations by the Commission, but appears to be a feature in common with the formal investigations that the Commission launched earlier this year against IBM.

The Corporate Update series

In addition to this bi-annual edition, we publish shorter ad hoc briefings as part of the Corporate Update series throughout the year. Copies are available to download from www.cliffordchance.com/publicationviews.html

Recent briefings include:

Briefing	Date
• AGM and Corporate Governance Update 2011	December 2010
• Changes to DTR5 taking effect on 1 November 2010	October 2010
• Stopping and fixing a leak: Market Watch 37	October 2010
• Proposed changes to UK Takeover Code	October 2010
• The hunt for a red October	October 2010
• Changes to issuer liability regime taking effect on 1 October 2010	September 2010
• Corporate Update	July 2010
• Publication of FRC's Stewardship Code	July 2010
• Pensions – first contribution notice/historic liabilities	July 2010
• OFT to probe equity underwriting fees	June 2010
• Publication of the new UK Corporate Governance Code (formerly the Combined Code)	June 2010
• Possible Review of the Regulation of UK Takeover Bids	June 2010

Other relevant publications

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Examples include:

Publication	Date
• Prospectus and Transparency Directives – Amending Directive published	December 2010
• HM Treasury announces new Tax Avoidance Measures	December 2010
• New EU rules for cooperation between competitors	December 2010
• The SEC grants a temporary reprieve for certain non-US transactions from compliance with Rule 17g-5(a)(3)	November 2010
• New horizons for structured debt transactions	November 2010
• Interim Changes to the CRC Energy Efficiency Scheme	November 2010
• Business and Human Rights – Update	November 2010
• Corporate Tax Reform	November 2010
• Fly me to the Courtroom	November 2010
• AXA UK PLC ECJ case C-175/09 – Impact in Luxembourg and the UK	November 2010
• The changing role and responsibilities of the trustee in capital markets transactions	November 2010
• Employee Benefits Newsletter October 2010	November 2010
• Contentious Commentary: A review for litigators	November 2010
• Remuneration Reform in the Financial Services Sector: New Disclosure Rules	November 2010
• The changing contractual landscape	November 2010
• ECJ rejects legal professional privilege for corporate counsel in EU investigations	September 2010

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