CLIFFORD CHANCE

LABOUR'S INCLUSIVE OWNERSHIP FUNDS: NATIONALISING 10% OF EVERYTHING?

– THOUGHT LEADERSHIP

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LABOUR'S INCLUSIVE OWNERSHIP FUNDS: NATIONALISING 10% OF EVERYTHING?

One of the UK Labour Party's most striking policies is to require 10% of the shares in all UK companies with more than 250 employees to be owned by inclusive ownership funds. The dividends on those shares would then be shared between employees (but capped at £500 per employee), and the balance paid to the Government.

This briefing looks at the practical and legal implications of the proposal. We find

- IOFs would cost investors in the region of £340bn of lost capital
- At least £31bn of that cost will be borne by pension funds, and therefore ultimately by pensioners and the businesses and local authorities responsible for the schemes.
- The benefit of IOFs for employees is a small fraction of this – around £1bn a year. Over £9bn a year – 90% of the benefit-will go to the Government.
- There is therefore a remarkable mismatch between the cost of IOFs to pension funds and other investors, and the benefit to employees.
- IOFs would effectively raise the UK corporation tax rate to over 31%: the highest in the developed world.
- There are a number of serious legal impediments to implementing IOFs. The proposal would almost certainly face legal challenges in domestic courts, the European Court of Human Rights, and international investment tribunals.
- There are a number of other ways to achieve the Labour Party's objectives which would not have this large mismatch between cost and benefit, and which would be both easier to implement and considerably less vulnerable to legal challenge.
- A more considered implementation would also decrease the likelihood of UK -headqua rtered groups (particularly those with limited UK presence) opting to relocate from the UK.

We'll give the workforce a 10% stake in large companies; paying a dividend of as much as £500 a year to each employee.

—**JEREMY CORBYN**
August 2019

What is the proposal?

Labour is proposing that all large companies (those with more than 250 employees) should be required to transfer shares into an "Inclusive Ownership Fund" (IOF). Each year, for a decade, 1% of shares would be transferred into the IOF, until a 10% holding was reached. Smaller companies would be able to set up IOFs voluntarily.

The shares would be held and managed collectively by representatives of the employees. Dividends received by the IOF would be distributed to the employees up to a maximum of £500 each per year, with the balance paid as (effectively) tax to HM Treasury (with the stated intention that it would be spent on public services as a "social dividend").

The IOF would be managed by a board of trustees elected from the company's eligible employees. It would not be able to sell the shares, and the employees would not be able to sell their interest in the IOF.

Labour suggests that IOFs would receive £6bn of dividends each year, with £4bn of that being shared between employees, and the remaining £2bn to the Government to fund public services. Our analysis shows these figures to be incorrect. In fact, IOFs would receive over £10bn of dividends every year, with around £1bn being shared between employees and £9m going to Government. See box: Who benefits?

Political context and timing

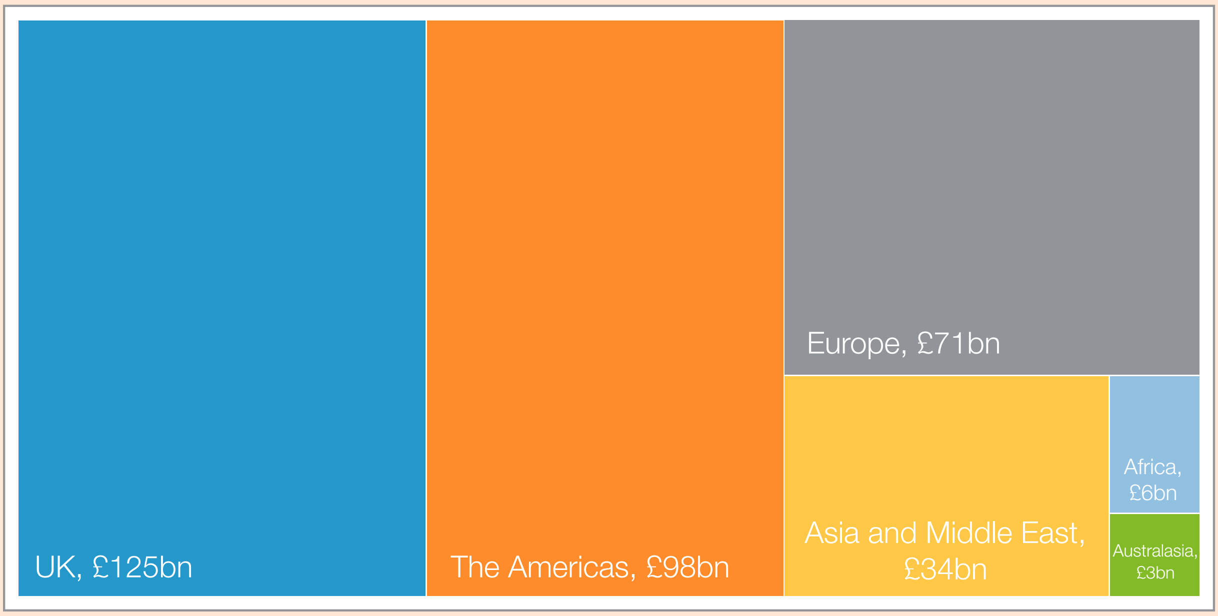
This proposal is part of a wider set of policies which Labour would seek to implement if it won a general election. Those policies include a comprehensive programme of nationalisation (see our briefing *UK nationalisation: The law and the cost*), employee representation on companies' boards, reform to existing policies on private finance initiatives, comprehensive personal and corporate tax reform, a new "National Investment Bank", and expanding the size of the co-operative sector, to name some of the main proposals.

The current Government's term technically lasts until 2022 but both the Conservative and Labour parties are preparing for the possibility of a general election in the short to medium term largely due to the heightened political risk surrounding the UK's withdrawal from the European Union.

Labour's 2017 manifesto had proposed introducing a "right to own", giving employees the right of first refusal when the company they work for is up for sale. This proposal clearly goes further than that. Whilst Labour are citing the Institute of Public Policy Research and the Co-operative movement as inspirations for the idea, neither has proposed the coercive transfer of ownership rights from shareholders to employees and Government.

The cost to investors

How much capital will investors lose to IOFs? We believe the total is at least £340bn.



At least £125bn of losses will be borne by UK investors, of whom a significant number are pension funds (see box: The impact on UK pension schemes) US investors will bear around £100bn of losses. The breakdown of affected investors by region is shown in the chart below.

These figures undercount the impact on UK investors, as so little data is available on privately held UK groups (disproportionately be held by UK investors).

These amounts dwarf the amount that employees will receive each year (see box: who benefits?).

Unlike "normal" taxes, IOFs therefore seem a poor vehicle for redistribution. Investors face a large loss of capital. However the employees do not acquire any capital, because the IOF shares are "locked" and will never be sold – their benefit is limited to annual distributions. Even the Government, receiving significant dividends each year, cannot access the expropriated capital directly.

Hence in practical terms, the cost of IOFs exceeds the benefit to employees and to society.

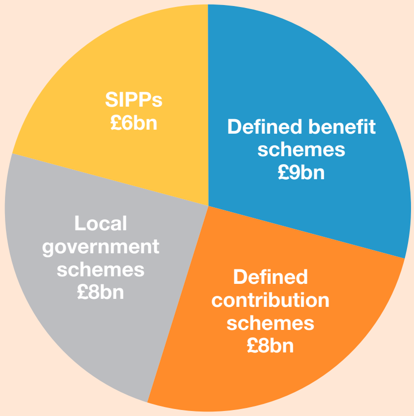
There seems to us highly inefficient compared to, for example, a more conventional tax on corporate profits or investor returns/ gains. With a tax, the cost to investors would be equal to the benefit to society as a whole (at least in a static analysis).

We set out our methodology in detail at the back of this paper.

The impact on UK pension schemes

Our analysis shows IOFs will cost UK pension funds at least £31bn, with that cost borne by different types of pension schemes as shown below.

The cost will be shared between pensioners, businesses and local authorities.



How does this compare to the Labour Party's figures?

The Labour Party have said the impact on pension schemes will limited, as only 3% of quoted UK equities is held by pension funds. That figure was taken from an Office for National Statistics report. Of course 3% of quoted UK equities is still a large sum – £78bn. But the 3% figure shows direct equity holdings only – in practice only the largest pension schemes hold equities directly. Most pension schemes instead hold equities through collective investment vehicles such as unit trusts, investment trusts and ETFs, and such indirect holdings are not included in the ONS figures. Furthermore, the ONS report excludes unquoted equities and doesn't cover SIPPs. Hence Labour's figure dramatically undercounts UK pension funds' exposure to UK equities.

Our methodology is set out at the back of this paper

Are there precedents for such a proposal?

Employee share schemes of various kinds are common in the UK and worldwide, but they are in almost all cases voluntary: the idea that a company is required by law to establish such a scheme is highly unusual.

Labour's proposal originated in a paper, *Co-operatives Unleashed*, published by the New Economics Foundation earlier this year. The NEF proposed ongoing transfers of equity into IOFs so that, eventually, employees would control the business. The NEF left open the question of whether transfers to the IOFs would be encouraged by Government (perhaps with tax incentives) or mandated.

The NEF proposal was in turn inspired by the Meidner Plan. This was a proposal made by two trade union economists in Sweden in the 1970s. Businesses would be required to pay 20% of their profits into "wage earner" funds managed by employees, with one fund for each sector of the economy. The funds would invest their funds into listed shares. The profit percentage would increase over time until eventually all businesses became majority owned by the employees.

The Meidner Plan became highly contentious across the political spectrum in Sweden. It was eventually adopted in 1983 by the ruling Social Democratic Party, but in a much watered-down and semi-voluntary form (disowned by Meidner himself). It was eventually abolished entirely in 1990. As a result, whilst the Meidner Plan was briefly considered as a model by socialist parties across Europe (particularly in Italy), it was never implemented.

Labour's proposal differs from the Meidner Plan and the NEF proposal in two significant respects:

- First, Labour is proposing that employees share in dividends – in the Meidner and NEF plans, the IOF (or equivalent) uses its resources to acquire more shareholdings.
- Second, and more significantly, Labour are proposing that the IOFs' shareholdings increase to 10% and then stop there. Meidner and the NEF proposed that the ownership percentage would increase over time until, eventually, the employees controlled the business. It is, of course, possible that could become Labour's long-term objective.

Which companies would the proposal apply to?

Labour quoted a figure of 7,000 companies, and this is consistent with the most recent Government estimate of businesses with at least 250 employees.

The figure includes publicly listed and private companies. It also includes both UK businesses and UK subsidiaries of foreign businesses. It therefore seems reasonable to assume all are in scope. It also seems reasonable to assume the proposal applies to corporate groups as a whole, not individual companies.

However, it raises a number of questions:

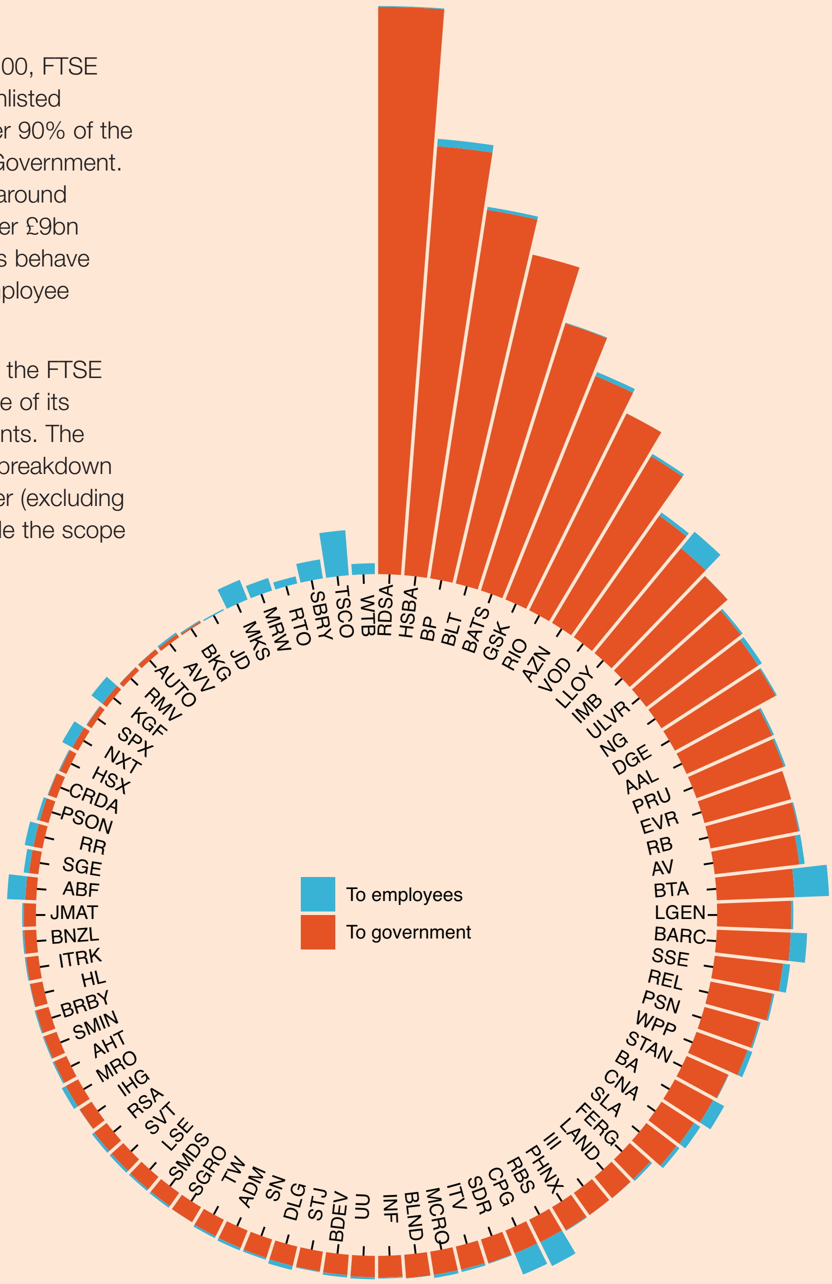
- IOFs will acquire shares; but for many groups, the shareholders also hold debt. This will put shareholders in Leveraged groups at an advantage (see box: the leverage problem).
- A UK-headquartered multinational will own subsidiaries across the world, with employees all over the world, and pay dividends out of its worldwide profits. It seems inequitable for UK employees to be entitled to a share of the non-UK profits. It would also put that UK-headquartered multinational at a disadvantage compared to a competitor headquartered elsewhere. The shareholder returns from the whole of the UK-headquartered multinational's group (including foreign subsidiaries) would be diluted by 10% whereas, in the case of a multinational headquartered elsewhere, only the returns from the UK subsidiaries would be diluted.
- Would the proposal apply to businesses that operate through branches rather than subsidiaries (e.g. airlines and banks)? Branches themselves neither issue shares nor pay dividends to their head office. If it doesn't apply to branches, then we could see foreign companies running their UK operations through branches rather than subsidiaries.
- How would the proposal affect groups that do not pay dividends? That is a fairly common situation for both private companies and tech businesses (Google, for example, has never paid a dividend).
- How would the proposal treat different forms of company? Unlimited companies have shareholders, and pay dividends, but their shareholders have unlimited liability, which directors of an IOF might find extremely unattractive.

> **We will legislate for large companies to transfer shares into an "Inclusive Ownership Fund." The shares will be held and managed collectively by the workers. The shareholding will give workers the same rights as other shareholders to have a say over the direction of their company. And dividend payments will be made directly to the workers from the fund.**
>
> —**JOHN MCDONNELL**
> **Labour conference 2018**

Who benefits?

Our analysis of the FTSE 100, FTSE 250 and the largest 350 unlisted companies shows that over 90% of the IOF receipts would go to Government. Employees would receive around £1bn, and Government over £9bn each year. In practice, IOFs behave more like a tax than an employee participation measure.

The result is dominated by the FTSE 100, given the relative scale of its members' dividend payments. The chart below illustrates the breakdown for each FTSE 100 member (excluding those that would be outside the scope of the rules).



Why does the Government take the lion's share?

Mostly because of a fundamental flaw in the IOF concept: the biggest dividends are paid by highly global businesses out of global profits, but the IOF requires the dividend to then be shared between the (relatively small) number of UK employees (see the top-right of the chart), and capped at £500.

For the other FTSE 100 members whose business is more UK-focussed, in most cases their profit per employee is significantly greater than £500. The exception is the UK retailers, which inevitably have lower profit-per-employee (which is why they dominate the top-left of the chart).

Labour estimated a much lower figure going to Government – possibly because they averaged dividends and employees across the economy, rather than looking at individual companies.

The dramatic result means that there will be a large penalty to groups that have a UK parent. A foreign-headquartered group is only subject to IOFs on its UK subsidiaries, but a UK headquartered group subject to IOFs on its worldwide business. We therefore expect to see pressure on UK headquartered groups to shift their headquarters out of the UK, particularly for groups that have little UK business.

We set out our methodology in detail at the back of this paper.

How would the IOF obtain the shares?

The Labour Party announcement does not contain any details about how this proposal might work in practice, which makes it difficult to make a proper assessment of how it might be implemented.

One approach is that all existing shareholders would be required to transfer 10% of each of their shareholdings to the IOF for no payment. That would seem complicated (particularly for private companies) and to be particularly vulnerable to legal challenges.

A more likely mechanism is that companies would be required to issue ordinary shares to the IOF, again for no payment. That would require an amendment to company law because companies are not generally permitted to issue shares for no consideration. It is unclear, however, how companies would account for any such share issue.

An alternative might be for companies to be deemed to have issued such shares for dividend and voting purposes, but not actually be required to do so.

Matters would be more complicated for companies with different classes of shares. Some companies issue preference shares which can carry significant value, often with a right to a preferential dividend which is paid out before any dividend can be paid on the ordinary shares. What would be the impact on existing preference shares of these proposals?

Query also how the proposal would interact with existing employee share schemes. Would it replace them? Ignore them? Or would the 10% target percentage take into account existing share scheme holdings?

And would the proposal exempt existing employee-owned businesses, such as the John Lewis Partnership (which takes the legal form of a company owned by a trust for the benefit of its employees)? Would it apply to building societies and cooperatives, which are owned by their members (including, but not limited to, employees)?

Labour proposes that the IOF be managed collectively by the workers and "will give workers the same rights as other shareholders to have a say over the direction of their company". It is unclear who would have the day-to-day management of the IOF, but as a 10%. shareholder in a company, it will be able to exercise influence over the company, with rights to requisition general meetings and request the inclusion of items on the agenda of an annual general meeting. The reference to "workers" is also interesting – is the intention that people other than employees (such as agency staff) will benefit from the dividend? Will part-time or zero hours workers receive the same as full-time workers?

Who would benefit from capital gains in the IOF's shares?

Over time, the IOF's 10% holding would become more valuable if the company prospers. However, we understand the intention, the intention is that the shares are never disposed of, and therefore the capital gain never crystallises. The IOF's dividends would increase but, unless the £500 cap were increased to match dividend growth, much of the benefit would go to Government rather than employees. Employees wouldn't be able to sell their interest, and would lose it when they leave the company or retire.

> **When the fund reached a controlling level of ownership of a firm (or, in the case of businesses succession, proposed takeover or crisis, a lower but significant level of ownership) the stakeholders controlling the fund could opt to assume control of the business.**
>
> —**Co-operatives Unleashed, New Economics Foundation, 2018**

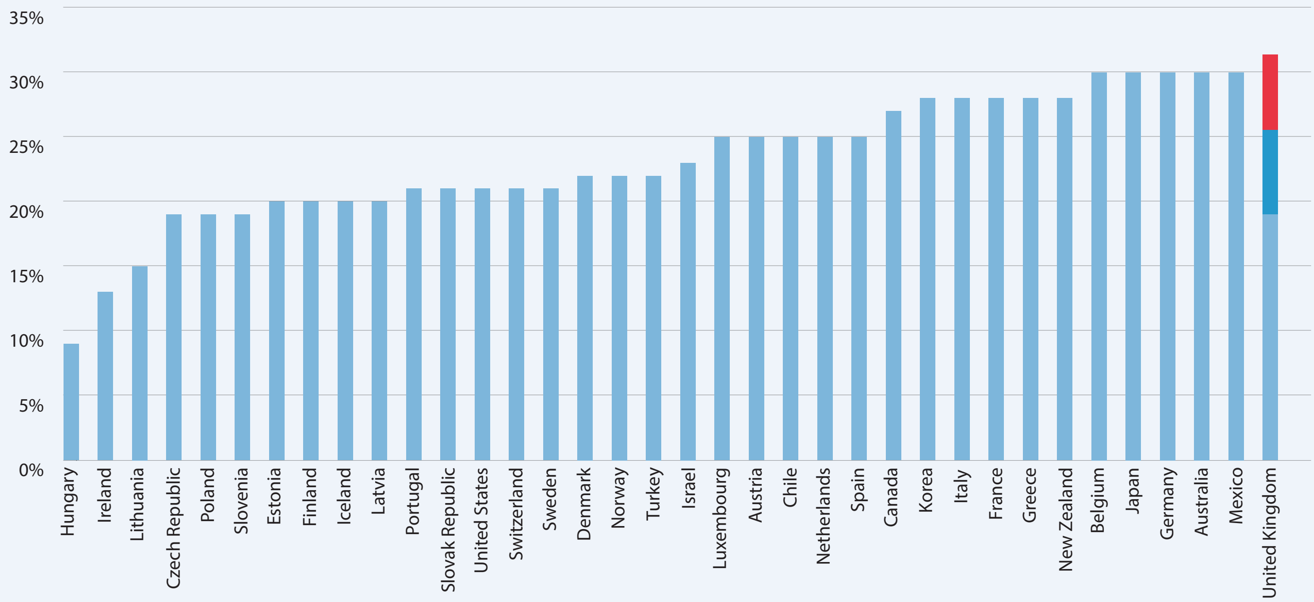
The IOF as a tax

From a shareholder's perspective, the IOF behaves in a similar way to a tax. Taken together with Labour's proposal to increase corporation tax to 26%, the UK would have an effective corporation tax rate of over 31%.

The chart below shows how that compares to corporate tax rates across the OECD in 2020. Dark blue shows the effect of the corporation tax increase; red shows the effect of IOF.

The UK would have the highest corporate tax rate in the developed world.

Our methodology is set out at the back of this paper.



> **IOFs would effectively give UK corporation tax the highest rate in the developed world**

What would the practical impact be on investors?

There would be an obvious impact on the valuation of UK businesses, and therefore on investors. This would have a number of effects, for example:

- There would be a particular impact on investors who currently have majority control (50%) or negative control (25%) but would slip below those thresholds if diluted by 10%. The economic cost to those investors could be more than the raw 10% figure.
- On average, 20% of UK pension funds are invested in UK equities: the proposal therefore implies an average long-term decline of 2% in pension fund valuations. An employee would not have to have a very large pension for this cost to exceed the £500/year benefit.
- The proposal would change the landscape for foreign businesses planning to invest in the UK. Their return from that investment would be (in the medium term) 10% less than it would otherwise be. That would presumably be reflected in decisions whether to invest in the UK, and the price paid for UK assets. We may see this impact corporate decision-making in the run-up to the next election.

What would the practical impact be on businesses?

The proposal has the potential to significantly distort business decisions. For example:

- As the proposal only impacts on businesses with 250 employees, the decision for a medium-sized company to hire its 250th employee would have to be taken with great care. At a stroke, the shareholders would lose 10% of their value. Hence, much like old-style UK stamp duty meant no houses were for sale for £251,000, we expect there would be very few businesses with 251 employees. There is the risk, therefore, that these proposals could stunt business growth.

- For the same reason, business combinations of medium-sized companies might only make economic sense if they would boost profitability by more than 10%.
- If the proposal is enacted in the territorial manner outlined above, then foreign-headquartered groups would have an incentive to extract UK profits through interest, royalty or service payments rather than dividends. Extensive anti-avoidance rules might be required to prevent companies circumventing the rules.
- Many companies will hit the £500 cap on dividend payments to employees. The IOF would then be a most unusual shareholder, with no interest in the value of its shareholding increasing (as all the excess value would go to the Government and the value of the shares could not be realised anyway).

In addition, there will be a large number of complications caused by 10% of the shares of the company having a special status:

- Corporate restructurings would become more complex because of the need to safeguard the minority IOF shareholder. For example, inserting a new holding company over a UK private company is currently a simple transaction involving little more than a stock transfer form. Under Labour's proposal, the IOF would have to consent and its interests would need to be carefully protected.
- Share buybacks may become unattractive because they will increase the value of the employee shares (but, in many cases, with no benefit to employees, because of the £500 cap) as well as taking the IOF's interest above 10%. It is not obvious how this could be prevented, unless there was some statutory mechanism to cancel shares to the extent the IOF's holding exceeded 10%.
- The converse case would be corporate events that dilute existing shareholders, for example rights issues, capital raisings and acquisitions. Would dilution of the IOF be permitted? It seems more likely there would be some form of "catch up" provision requiring more shares to be issued to the IOF for no consideration, so that the IOF always holds 10%.
- If the IOF could never be diluted, then the consequence would be that new investors on any capital raising would themselves be immediately diluted (i.e. with one new share issued to the IOF for every nine issued to new investors). A rational investor would therefore expect a 10% discount against the current share price, raising the cost of capital for large businesses.
- How would the IOF's holding be treated in the event of a takeover? Would compulsory acquisition rules, which kick in when a bidder has acquired 90%, need to be amended to ignore shares held by an IOF?
- As mentioned above, it is not clear how a company would account for share capital that was issued for no consideration. This would have a particular impact on regulated businesses such as banks and insurance companies, which are required to maintain certain levels of equity.
- Even if UK regulators are required to accept IOFs as significant shareholders in UK banks or other regulated firms, those firms may encounter difficulties in other jurisdictions if non-U.K. regulators are unwilling to approve IOFs as significant indirect shareholders of local subsidiaries. Foreign banks and other financial institutions with UK subsidiaries may find that having an IOF as a significant external shareholder in those subsidiaries interferes with the ability to manage intragroup flows of capital and liquidity, complicating recovery and resolution planning and reliance on intragroup exemptions facilitating intragroup risk management transactions.

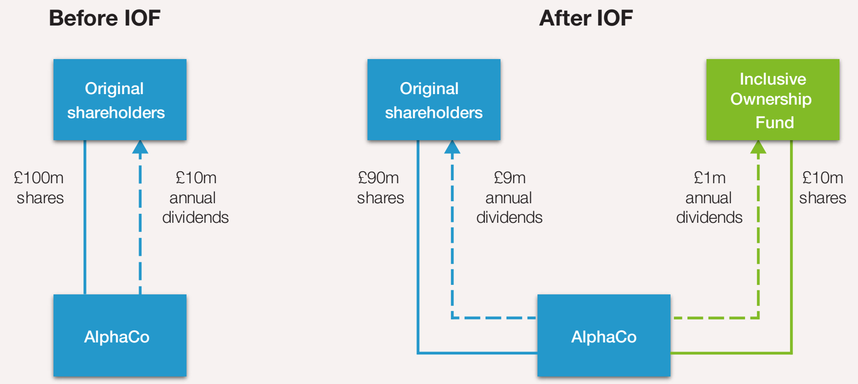
"New investors on any capital raising would be immediately diluted, raising the cost of capital for large businesses."

The leverage problem

IOFs will acquire 10% of the shares of all large companies. For a listed group, that will straightforwardly equate to 10% of the value. But many unlisted groups, and many UK subsidiaries of foreign listed groups, are leveraged, with only some of the value in the shares, and the rest in shareholder debt.

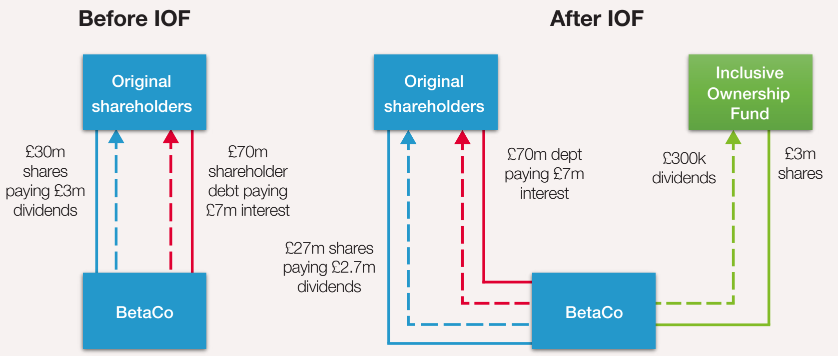
We can demonstrate this with an example of two companies: one unleveraged, one leveraged.

First, a simple unleveraged group:



The impact of the IOF is clear – the shareholders have lost 10% of the value of AlphaCo – £10m – and the IOF has gained by the same amount.

For the leveraged group, the effect is very different:



The enterprise value of BetaCo is exactly the same as AlphaCo, but it has leverage of 70%. Hence whilst the shareholders lose 10% of the value of their shares in AlphaCo, that only represents 3% of the company's enterprise value.

This level of leverage would by no means be unusual, although leverage naturally differs between industries and ownership structures.

This gives privately owned groups, and foreign-owned groups, an advantage over UK listed groups. And it's a difficult problem to solve. Whilst some people may leverage groups deliberately to minimise the impact of the IOF, many others will already be leveraged for a variety of commercial, regulatory and practical reasons. Distinguishing the two cases may not be possible. Granting the IOF a 10% interest in shareholder debt would be challenging (for example, many groups would be in default on their bank debt/bonds if they suddenly had a new party holding 10% of the shareholder debt).

Is the proposal a tax?

The payment of up to £500 to each employee does not look immediately like a tax (taxes generally go to the Government, though a payment required by the Government has similarities), but the payment of sums above this £500 is indistinguishable from a tax in economic terms. The practical effect is to significantly raise the rate of corporation tax (see box: the IOF as a tax).

However, that appears not to be how the proposal would be enacted. This has two consequences.

- First, it is unlikely to be creditable for foreign shareholders against their local tax.
- Second, in the event of any challenge, courts are likely to give it less leeway than if it were a tax. The state's right to impose non-discriminatory taxes is generally accepted under international law and human rights law, and therefore courts have tended to give a large degree of deference to Governments. That may not be the case with this proposal.

Will shareholders be able to block the proposal, or sue for compensation?

There are important constraints on the ability of any Government to reduce the value of private property – shares – and several approaches that aggrieved shareholders and foreign Governments could take.

European Convention on Human Rights

The European Convention on Human Rights (ECHR) is an international treaty, ratified by all Council of Europe states. It is not an EU treaty and will not be affected by Brexit. The ECHR was directly incorporated into UK law by the Human Rights Act 1998.

Article 1 of Protocol 1 to the ECHR guarantees the right to the peaceful enjoyment of property. This is a qualified right, which requires a fair balance to be struck between the person's right to peaceful enjoyment and the state's ability to act in the public interest.

We expect that Labour's proposal would be regarded as a de facto expropriation of 10% of each large company. If so, it would require a public interest justification, and whether it can be said to be in the public interest to move 10% of a company to a trust to benefit the company's employees and the Government without compensation is, at the least, open to question. A deprivation without compensation in an amount reasonably related to the value of the property would normally be considered disproportionate, and require exceptional circumstances to justify the lack of compensation.

Article 1, Protocol 1 can be relied upon by individuals and companies, whether resident/established in the UK or elsewhere.

How would the ECHR be relied upon in practice?

Before the introduction of the Human Rights Act 1998, enforcement of rights under the ECHR could only be pursued by costly and lengthy legal proceedings, commonly requiring litigants to take their case to the European Court of Human Rights in Strasbourg (ECtHR). Since then, the implementation of the HRA in 1998 has significantly changed the enforcement landscape in the UK.

There are three main pillars to the HRA, which substantively implements the ECHR into UK law:

- First, public authorities must not act in a way that is incompatible with the ECHR. This means that if an Act of Parliament gives a Minister, tribunal or other body any discretion relating to compensation, then that discretion must be exercised in accordance with Article 1, Protocol 1. Failure to do so would give shareholders a direct right of redress against the Government before the UK courts. The usual remedy in these circumstances would be an order quashing whatever had been done in breach of ECHR, requiring it to be done again in accordance with the law as laid down by the court.
- Second, primary legislation must, to the extent possible be given an interpretation which conforms with the principles of the ECHR. This permits

UK courts some (though not complete) latitude in the interpretation of Acts of Parliament, allowing the courts, where there is ambiguity in the language, to "read in" adequate compensation rights to ensure that the UK complies with its ECHR obligations. Again, this potentially gives shareholders a direct right of redress and compensation.

- Third, if the primary legislation is not sufficiently ambiguous to permit a conforming interpretation, the UK courts may make a "declaration of incompatibility". A declaration of incompatibility does not affect the validity or continuing operation of an Act of Parliament as a matter of domestic UK law, and does not allow the UK courts to award damages. It is merely a statement that the UK courts consider that Parliament has acted in breach of the UK's international obligations in the ECHR. The matter is then taken back to the political arena, the general expectation being that the Government and Parliament will wish to bring UK law into line with the ECHR. But whether or when this might happen in the context of a highly political expropriation is less clear.

Once all domestic remedies had been exhausted, a shareholder could take a case against the UK Government to the ECtHR, which can award compensation for wrongful expropriation.

In principle, the UK could withdraw from the ECHR – however, that may not be politically feasible for a Labour Government.

Bilateral investment treaties

A bilateral investment treaty (BIT) is an agreement between two states, facilitating private investment by nationals and companies of one state in the other state. It does so by providing investors with guarantees including that they will not be discriminated against and that their investments will not be expropriated without appropriate compensation for fair market value. Similar provisions can also be found in some multilateral investment treaties (such as the Energy Charter Treaty and free trade agreements that contain investor dispute mechanisms).

Aggrieved shareholders in a UK business, if they are established in a state that is party to a BIT with the UK, may have potential redress under a BIT

The UK has around 100 BITs with foreign states, shown on the map above. There are significant absences from this list, as there are no BITs with, e.g., Western European countries, the US or Australia (nor, of course, between the UK and the Crown Dependencies or Overseas Territories, who do not have the authority to enter into international treaties, and who only benefit from BITs that the UK Government has extended to them). There are, however, some important potential shareholder jurisdictions with whom the UK does have BITs: in particular, Singapore, Korea, Hong Kong, China, Russia, India and the UAE. Significant investment into the UK has come from private investors and sovereign wealth funds in these jurisdictions.

Labour's proposal, depending on the form in which it is finally implemented, could potentially give rise to BIT claims for qualifying investors. For example, investors may argue:

- There has been a breach of the "fair and equitable treatment" standard, e.g. if the UK government had made particular representation when they invested, or the proposal discriminates against foreign investors (perhaps by protecting UK pension fund investors and/or employee shareholders)
- There has been an expropriation of their shares and /or their contractual rights attaching to these shares, e.g. causing them to lose a controlling interest in the company, or
- If the 10% figure is increased significantly over time (as may be the intention) investors could claim there has been a "creeping expropriation".

The UK Government would argue that the measures are not a breach of the BIT, and are within the scope of its legitimate regulatory powers (which international law accepts does not give rise to a compensation claim). The novel (indeed unprecedented) nature of the proposal makes litigation highly likely.

> The unprecedented nature of the proposal makes litigation highly likely

A BIT also provides procedural safeguards. Most importantly, UK BITs provide an alternative dispute resolution procedure – the ability to claim compensation before an international arbitral tribunal, rather than pursuing any claim before the UK courts (though the validity of these provisions in BITs with EU member states, such as Poland, Czech Republic, Hungary and Croatia, may be open to question).

The nature of the arbitration process means that the UK Government has little ability to circumvent its obligations under an investment treaty – any domestic legislation that purported to override an investment treaty would not relieve the UK Government from its treaty obligations. The UK could terminate its BITs, but under most BITs, investor protections would remain in place typically for 10-20 years following termination.

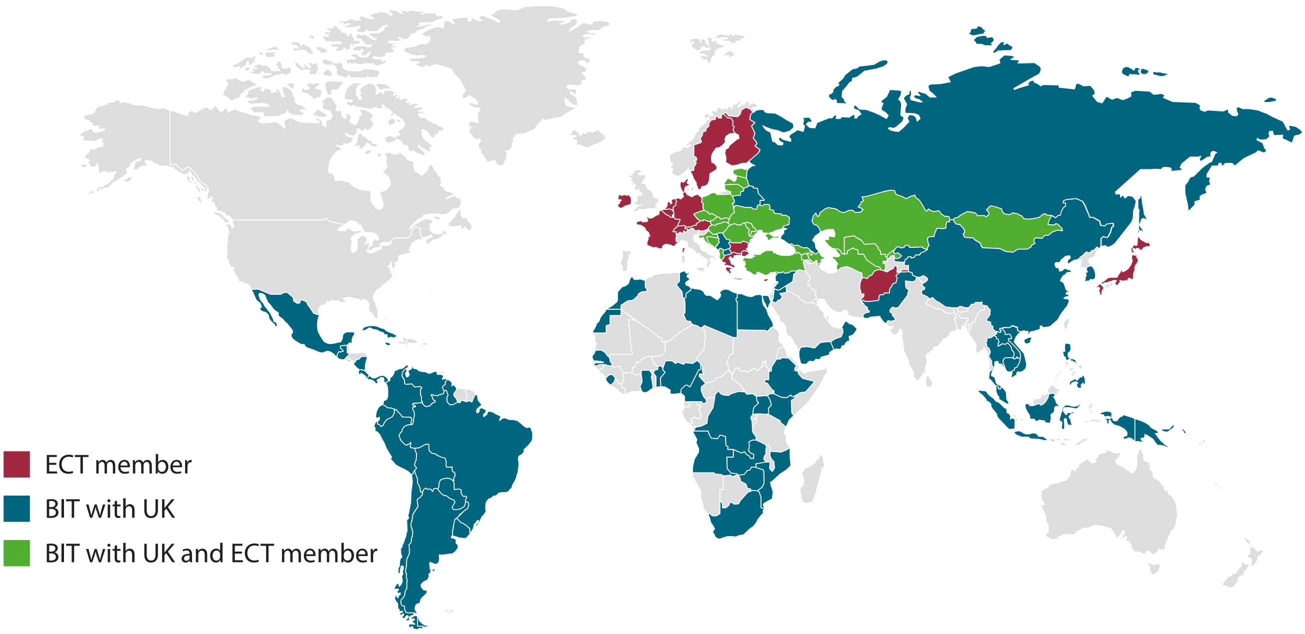
In addition to its BITs, the UK is also party to the Energy Charter Treaty. This provides investors with broadly equivalent protection to BITs. The ECT applies to investments in energy companies only; however it has a wide membership, including all the EU.

Free trade agreements

Investor protection provisions, similar in substance to BIT protections, have been included in a number of recent FTAs and, in particular, in the EU's FTAs with Canada, Singapore and Vietnam.

It is, however, currently unclear whether the UK will remain a party to the EU's FTAs following Brexit. One possibility is that the UK, the EU and an FTA partner state agree that the relevant FTA will continue to apply, or that a variation of the FTA will apply as between the UK and the FTA partner. Another is that a new FTA is negotiated (but that would take considerably more time). Of course, there is also the possibility that there could be no successor FTA at all.

Another possible outcome of Brexit is that there could be an FTA between the UK and the EU. One model discussed for such an FTA is CETA. If such an FTA contained a CETA-style investment chapter, EU investors would gain significant investment protections.



Conclusion – and an alternative approach

The proposal raises a large number of difficult practical questions, will distort commercial decision-making, and is likely to be subject to challenge in the UK courts and international tribunals.

An alternative approach could achieve the objectives of the proposal, whilst minimising these difficulties. Looking at the key objectives:

- *To increase employee participation in management:* Labour are already proposing that the UK adopt rules (similar to Germany) requiring employee representation on boards.
- To *ensure that employees share in the profits of the business:* this could be achieved by requiring that all large companies pay a bonus equal to 10% of dividends from UK profits, capped at £500. In principle, this would be no more than an addition to the existing minimum wage rules (although implementation would undoubtedly be complex).
- *To increase employee share ownership:* tax incentives could be created for companies to create employee share ownership plans. The Government introduced "Employee Ownership Trusts" in 2014, but they have been little used because they require employees to own 50% of the business – if this threshold were relaxed, then there might be increased take-up.
- *To capture a higher percentage of corporate profits for public services:* this could be achieved by a simple increase in corporation tax.

Whilst it is a political question whether these kinds of approaches would be desirable, they would not have the large mismatch between cost and benefit which is the hallmark of the IOF proposal. The alternatives would raise significantly fewer legal and practical challenges and would be considerably less vulnerable to legal challenge. They would also likely prevent what could otherwise be a significant exodus of UK-headquartered groups from the UK.

Further information

If you would like further details on any aspect of this briefing, please speak to your usual Clifford Chance contact or any of those listed overleaf.

Methodology

The figures in this briefing were compiled from a variety of public sources, and from original research and analysis by Clifford Chance LLP. A detailed explanation of the methodology follows:

Who benefits?

Our analysis started with the FTSE 100 and the FTSE 250. We excluded groups with a non-UK parent (which would be out of scope for the IOF) and investment trusts (who we assume would also be out of scope). We then applied 2018 dividend yields to current market capitalisation figures.

We then obtained data on the number of UK employees of each group from a variety of public sources. In order of preference this was: the statutory gender pay gap report, the annual report, the company website, press reports, and pro rating by UK revenues vs worldwide revenues. In some cases no reasonable estimate could be made, and so the global figure for employees was used (which means our figures somewhat overstate the percentage going to employees).

For completeness, we also included data compiled by the Sunday Times for the 350 largest private companies. The data includes pre-tax profitability and employees. We proceeded on the conservative basis that half the pre-tax profit would be paid out as dividends, and that all employees were based on the UK.

We then applied the IOF proposal to that dataset, with IOFs receiving 10% of all dividends, and employees sharing in the IOF's receipts subject to a £500 cap each (and any excess going to Government). The result was as follows:

	Government	Employees	Total
FTSE 100	£8,272m	£612m	£8,883m
FTSE 250	£496m	£338m	£834m
Sunday Times 350	£676m	£336m	£1,011m
	£9,444m	**£1,286m**	**£10,729m**

Due to lack of data, these figures exclude AIM dividends – although since AIM dividends totalled less than £1bn in 2018, IOF receipts would be less than £100m and therefore would not materially change the above results.

No figures are available for dividends paid by foreign-owned unlisted groups.

We assume that IOF will work on the basis of full time equivalent employees, not total number of employees (it would seem anomalous if someone working for a few days a month received the same IOF dividend as someone working full-time).

An important caveat is that this is a static analysis, which ignores dynamic effects such as, most obviously, companies responding to IOFs by reducing their dividends (perhaps in the anticipation that a subsequent Government will reverse the expropriation).

What is the cost to investors?

We reach the £340bn figure by estimating the total value of UK companies with over 250 employees:

- The market capitalisation of UK members of the FTSE, excluding investment trusts and groups where the parent is incorporated outside the UK, is £2,259bn (source: London Stock Exchange and Clifford Chance LLP research). Of this, £1,818bn represents the FTSE 100, £259bn the FTSE 350, and £87bn FTSE Small Caps.
- The market capitalisation of AIM is £101bn (source: London Stock Exchange).
- There is no public data on the value of shareholdings in private companies. We can approximate a lower bound by taking profitability figures compiled by the Sunday Times for the 350 largest private companies, and multiplying by a conservative price/earnings ratio of 10. That results in a figure of approximately £202bn. We excluded foreign-owned non-financial groups, to avoid double-counting with the next step.
- No public data is available for the value of UK subsidiaries of foreign companies (which we understand are covered by the IOF proposal). However, a figure can be estimated by extrapolating from the data in the ONS annual business survey. In the 2017 release, the ONS estimated that foreign-owned businesses contributed 35% of turnover and 27.0% in approximate gross value added (aGVA) to the UK's non-financial business economy. aGVA is a good approximation for profit, which in turn is a good proxy for value. On the reasonable assumptions that the financial sector is at least as profitable as the non-financial sector, and that large foreign-owned companies are at least as profitable as small foreign-owned companies, we can apply this figure to the total value we found above of £2,467bn. That implies an approximate value of foreign owned companies of around £912bn.

This gives a total of approximately £3,400bn, meaning that the IOFs would expropriate around £340bn.

The investor geography figures are derived from a 2017 ONS bulletin on ownership of UK quoted shares and the 2017 annual business survey of foreign owned businesses. To this we add the companies in the Sunday Times' list, which identify who the owners are.

An obvious limitation of this approach is that we will be excluding all UK-owned unquoted companies which are not included in the Sunday Times list. That list only includes companies which are nominated for inclusion, and there are some notable omissions (particularly in the real estate sector). Hence our £125bn figure for the cost to UK investors is likely materially lower than the true figure.

Alternative methodology

The above approach is "bottom-up" – looking at individual companies – and is therefore reasonably accurate (with the exception of UK subsidiaries of foreign companies, where a "top down" approach had to be adopted).

An alternative "top down" approach can be based on the ONS national balance sheet estimates. Table 3 of the ONS data shows non-financial corporations. The equity liabilities of the sector total approximately £3,000bn. Table 5 shows financial corporations. The equity liabilities total approximately £2,500bn. This together implies a total equity value for the UK private sector of £5,500bn.

These figures are for the whole private sector, and the IOFs will only apply to large companies (250+ employees). The national accounts don't separate out large companies, but we can approximate this by looking at how the turnover of large companies compares with small companies. ONS figures show 57% of overall corporate turnover derives from large companies. If we assume that the ratio of large and small company valuations will be the same as the ratio of large and small company turnovers, this implies large private sector companies have a value of approximately £3,000bn.

The assumption above, and the approximate nature of the equity liability figures, means that the £3,000bn figure should be regarded only as a "ball-park" figure, but provides a helpful sense-check for the £3,300bn figure obtained from the "bottom-up" analysis.

Pension schemes

This was compiled from a variety of sources, choosing the most conservative (i.e. lowest) number wherever possible. We are grateful to John Ralfe of John Ralfe Consulting for his contribution to the analysis.

The most reliable source for defined benefit (DB) schemes is the Pension Protection Fund's *Purple Book*. This shows, as at 2018, total DB scheme assets were £1,573bn of which 27% were equities. Of the equities, 18.6% were UK quoted, 69.4% overseas quoted, and 12% unquoted. On the reasonable assumption that the UK/overseas split is the same for unquoted equity as it is for quoted equity, the total value of UK equities held by DB schemes is approximately £90bn. DB equity allocations are on a downward trend, reflecting "de-risking" by pension schemes, so we are prudently assuming a further 2% drop in 2019 to 25%. That would bring the UK equity estimate down to £83bn.

Local Government pension schemes (LGPS) are not included in the Purple Book figures. The England and Wales LGPS hold around £275bn of assets and the Scottish LGPS around £42bn of assets. Research by the Sheffield Political Economy Research Institute has found that both are approximately 20% invested in UK equities. LGPS therefore in aggregate hold approximately £76bn of UK equities.

Also excluded from the Purple Book figures are the two Coal Board pension scheme assets, guaranteed by the Government: BCSSS has assets of around £9bn and MPS assets around £11bn, so £20bn in total. We would expect these to be disproportionately invested in UK equities, however the relatively small figures mean that we have not included them in our totals.

Defined contribution schemes have total assets of £400bn which research by the Investment Management Association found to be approximately 20% invested in UK equities. The size of DC schemes is increasing over time, but conservatively we assume it remains static.

Self-invested personal pensions (SIPPs) hold approximately £320bn in assets. We are unaware of any figures on overall SIPP asset allocation, but would expect a disproportionately high allocation towards UK equities. In the absence of hard data, we conservatively assume the allocation is the same as for DB schemes. On that basis, total UK equity assets would be £64bn. Again, we conservatively disregard the annual increase in SIPP assets.

We therefore estimate that UK pension funds hold a total of £310bn of UK equities, implying an IOF cost of £31bn.

Willis Towers Watson's global asset pension survey takes a different approach from the sources cited above (being based on a survey rather than underlying data), but is useful as a sense-check. WTW show UK pension assets totalling 120% of GBP, with 32% invested in equities, and 36% of those being UK equities. That implies total pension fund UK equity holdings of approximately £290bn (although it is unclear if the WTW figures include SIPPs).

There are an additional £110bn of assets in drawdown, which we conservatively assume include no UK equities. A further £250bn of assets is owned by insurance companies to back annuities: these assets are excluded from our figures.

All these figures exclude the impact on ISAs, which hold an additional £330bn of assets

Tax rates

We compiled the dividends paid by each UK member of the FTSE 100 in 2018, and the pre-tax profits reported in their accounts. We then calculated the weighted average dividend as a proportion of pre-tax profits: the figure was 54%. If IOFs had held 10% of the shareholdings in these companies then it follows that, from the shareholders' perspective, the IOF would have behaved like a 5.4% profits tax.

We then took this together with Labour's proposal to increase corporation tax from 19% to 26%, and make some reasonable assumptions: that the level of dividends would stay the same, and that the FTSE 100's dividend policies are representative of large companies as a whole (but the disproportionate size of dividends paid by FTSE 100 members means that the overall figure would in any event be dominated by the FTSE 100).

Our source for international corporate tax rates was the OECD, updated by original Clifford Chance LLP research. The rates include national and regional corporate taxes where applicable.

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