Part II

Background and evidence

3 The share-issuing process

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Introduction

3.1. This chapter begins by describing the main organizations concerned with the regulation of the conduct of share issues and the relevant rules and guidance in force. It goes on to explain the different types of share issue, outlines the usual timetables which apply to share issues and comments on a

number of other relevant matters. Finally, an indication is given of share-issuing practice and underwriting fees in overseas financial centres.

Organizations involved in the regulatory framework

3.2. A number of organizations have a formal role in the regulation of the conduct of share issues, including underwriting, under a variety of statutory provisions. These organizations are the Bank, the FSA and the Self-regulating Organisations (SROs), the LSE, the Treasury and the Panel on Takeovers and Mergers (the Takeover Panel). In addition, some industry organizations play an important role in aspects of the share issue and underwriting process and have issued codes of conduct or have published guidance on specific matters. Such organizations include the ABI, the NAPF and the Preemption Group.

3.3. The two main pieces of legislation which currently affect regulation of underwriting services in the UK are the Banking Act 1987 (the Banking Act) and the Financial Services Act 1986 (the Financial Services Act). A single entity can be subject to several regulators because the principal regulatory statutes adopt a functional approach to regulation, that is they regulate a particular activity regardless of the entity which is engaged in that activity. Most investment banks (the main providers of corporate financial advice and of lead underwriting services) are authorized under the Banking Act. The investment services they provide will usually also be regulated under the Financial Services Act.

3.4. In May 1997 the Government announced its intention of changing the system for regulating financial services, including the introduction of a single regulator for the full range of financial business. This would be done in two stages. The first would involve transferring the banking supervisory function from the Bank to the FSA. The second would involve the FSA taking over the functions of the SROs and various other regulatory authorities. The first stage has now taken place. Under the Bank of England Act 1998, responsibility for supervising banks, listed money market institutions and related clearing houses was transferred from the Bank to the FSA on 1 June 1998. As regards the second stage, the Government in July 1998 published a document entitled *Financial Services and Markets Bill: a Consultation Document*. Under the proposals, not expected to take effect before 2000, the FSA would, in broad terms, acquire the responsibilities of the SROs and RPBs; the Building Societies Commission; the Friendly Societies Commission; and the Registrar of Friendly Societies. It would also take over most of the responsibilities of the Treasury in relation to insurance businesses.

Regulatory organizations

Bank of England

3.5. The Bank has a close interest in the stability and efficiency of the UK financial system generally and, within that, in the effectiveness of the arrangements for making new equity issues. The banking supervisory functions of the Bank concerned with the monitoring and control of large underwriting exposures and the capital adequacy arrangements for underwriting were transferred to the FSA on 1 June 1998 (see paragraph 3.4).

The Financial Services Authority, the Self-regulating Organisations and the Recognised Professional Bodies

3.6. Before any person or firm can carry on any form of investment business in the UK (including the provision of underwriting services), that person or firm must be authorized under the Financial Services Act. At present, the bodies that can grant authorization are the FSA, the SROs and the RPBs. In order to obtain authorization an applicant has to establish, to the satisfaction of the regulator, that both it and its senior staff are 'fit and proper persons'.

3.7. The Treasury's regulatory functions concerning investment business have mostly been delegated to the FSA. A person or firm wishing to carry on investment business may obtain authorization direct from the FSA, but this is not common and in practice most firms obtain authorization through

membership of one of the SROs. The principal SROs whose activities cover the supply of underwriting services are the SFA (responsible for regulating, among other things, activities relating to securities, derivatives and corporate finance business, including stockbroking) and IMRO (responsible for firms engaged in investment management and the operation of collective investment schemes). In addition, a number of professionals such as solicitors and accountants act as financial advisers. The Financial Services Act provides that such professionals can be authorized by certification by an RPB.

London Stock Exchange Limited

3.8. The LSE is the principal stock exchange for the UK and is a major market for the trading of international securities. Securities of both UK and foreign companies are listed on the Official List of the LSE. At the end of 1997 there were 12,262 listed securities including shares, bonds, gilts and warrants. In addition to overseeing the trading of securities admitted to the Official List, the LSE is also responsible for the Alternative Investment Market (AIM); offers of shares to be traded on the AIM are not included in the terms of reference for the inquiry.

3.9. The LSE is the UK's competent authority under EC Directives for listing securities. Its powers in that respect are conferred by the Financial Services Act which gives effect to EC Directives. As competent authority the LSE has responsibility for admitting to listing securities that are covered by Part IV of the Financial Services Act (official listing of securities). It also admits to listing, on a non-statutory basis, securities to which Part IV does not apply, principally gilt-edged securities. The LSE makes rules governing admission to listing, the continuing obligations of issuers, the enforcement of those obligations and suspension and cancellation of listing. These rules are collectively the listing rules and are commonly referred to as 'The Yellow Book'.

The Takeover Panel

3.10. The Takeover Panel is the regulatory body which publishes the City Code on Takeovers and Mergers (the Code). It is a non-statutory body. It is concerned with takeovers of companies the shares of which are held by the public. Since takeovers frequently involve the issue of shares (some of which may be underwritten) the contents of the Code can be of relevance to some offers of shares within our terms of reference. The Code is designed to ensure good business standards and fairness to shareholders, for which the maintenance of fair and orderly markets in listed shares is crucial. Given the relatively short timetable for offers, it is the practice of the Takeover Panel first to focus on the specific consequences for shareholders of rule breaches, before determining whether any disciplinary action is required, with the aim of providing appropriate redress.

Industry organizations

The Association of British Insurers

3.11. The ABI is the main association for insurance companies in the UK and currently has around 450 members. In 1997 ABI members owned and managed assets of some £800 billion. The investment committee of the ABI is a significant source of advice to its members on a range of corporate governance matters including those relating to issues of shares. Matters covered by the ABI include provision of guidance on appropriate limits on authorized but unissued equity capital for listed companies and, together with the NAPF, ensuring the flexible operation of the pre-emption guidelines.

National Association of Pension Funds

3.12. The NAPF represents nearly 1,100 occupational pension funds and approximately 350 other organizations providing services to those funds. NAPF members own and manage assets of some £350 billion; pension funds account for approximately one-third of the ownership of UK listed shares.

In conjunction with the ABI, the NAPF has been active in issuing guidance to its members on matters such as the operation of the pre-emption guidelines.

Institutional Fund Managers' Association

3.13. The IFMA represents the interests of some 80 fund managers who between them manage some £2,200 billion on behalf of their clients. As part of its services to its members, the IFMA has published, in conjunction with the London Investment Banking Association (LIBA), standard terms for the conduct of discretionary fund management which have also been recommended to institutional investors by the NAPF (see paragraph 3.12). These terms give discretion to the fund manager to deal in the funds' investments and accept underwritings and sub-underwritings, subject to any specific agreement entered into between the funds' trustees and the fund manager.

The Pre-emption Group

3.14. The pre-emption guidelines were introduced in 1987 by a group known as the Pre-emption Group and comprising representatives of listed companies, investment institutions and corporate finance practitioners, under the auspices of the LSE. The guidelines are not rules on the operation of pre-emption. Their purpose is to provide a basis of understanding between companies and investors on the circumstances in which pre-emption rights may be disapplied, as allowed by section 95 of the Companies Act (see paragraph 3.16). A facility exists for consultation with the Investment Committees of the ABI and the NAPF in cases of doubt over the application of the guidelines. This provides an opportunity for companies to test the likely shareholder reaction to the proposed terms of a particular issue prior to its announcement. The Pre-emption Group obtains information on the operation of the guidelines from completed pre-emption statements submitted to the LSE by companies and their advisers at the time of a rights issue, with the forms being forwarded to the Group by the LSE in order for the Group to satisfy itself that the guidelines are being applied flexibly. The pre-emption guidelines are summarized in paragraph 3.27 and set out in Appendix 3.1.

Main regulatory rules and guidance in force

3.15. The regulatory rules and guidance in force are considered under five headings: the provisions of the Companies Act; the capital adequacy requirements for banks; the relevant rules of the FSA, the SFA and IMRO on conduct of business by firms authorized by them; the LSE's listing rules; and other guidance.

Provisions of the Companies Act

3.16. The main provisions of the Companies Act affecting the issue of shares are Parts IV (allotment of shares and debentures), V (share capital, its increase, maintenance and reduction) and XI (company administration and procedure). In particular the Companies Act includes the following provisions:

(a) Section 80 provides that the directors shall not exercise any power of the company to allot relevant securities unless they are authorized to do so by the company in general meeting or by the company's articles. Such authority may be given for a particular exercise of the power or for its exercise generally and may be unconditional or subject to conditions. The authority must state the maximum amount of relevant securities that may be allotted under it and the date on which it will expire, which must not be more than five years from either the date of incorporation (in the case of an authorization in the articles) or the date of the resolution. An authority can be renewed or further renewed by the company in general meeting for a further period not exceeding five years.

(b) Section 89 requires offers of shares to shareholders to be on a pre-emptive basis. A company may not allot securities to a person for a cash consideration unless it has made an offer to each shareholder to allot to him on the same or more favourable terms a proportion of those securities which is as nearly as practicable pro rata to the existing shareholding. Under section 90 the offer of shares to existing shareholders must be in writing and it must state a period of not less than 21 days during which the offer may be accepted. However, under section 95, where directors are authorized to issue shares under section 80, they may be given powers under the articles or by special resolution to allot equity securities in accordance with the authority as if section 89 did not apply to the allotment. Use of this procedure under section 95 is generally referred to as disapplication of pre-emption rights. The power to disapply pre-emption rights ceases to have effect when the authority under section 80, for the directors to allot shares, expires or is revoked. The maximum period for which the power to disapply pre-emption rights can be granted is thus effectively five years.

(c) Section 369 deals with the notice required for the calling of a meeting of a company. In the case of a meeting other than an annual general meeting (AGM) or a meeting for the passage of a special resolution, 14 days' notice in writing is required. Under section 378, a special resolution requires a three-fourths majority of shareholders at a general meeting of which not less than 21 days' notice has been given, specifying the intention to propose the resolution as a special resolution.

3.17. The provisions in the Companies Act implement the Second Council Directive on Company Law of 1976 (Council Directive 77/91/EC, OJ 1977 L26 p1). Article 29 of this Directive requires that where public limited companies increase their capital by issuing shares for cash, those shares must be offered on a pre-emptive basis to shareholders in proportion to their existing holdings (although the Directive allows for shareholders to waive their pre-emption rights under certain conditions). Member states must ensure that where pre-emptive offers are made, the offer period must be not less than 14 days.

Capital adequacy requirements for banks

3.18. Section 38 of the Banking Act requires an authorized institution, other than one whose principal place of business is outside the UK, to notify the FSA in advance of any proposed exposure to any one person exceeding 25 per cent of its capital base and to report any actual exposure to any one person exceeding 10 per cent of its capital base. The risks involved in underwriting differ substantially from those involved in lending activities undertaken by banks. The likelihood of a loss from underwriting commitments is related to the risk of actually having to take up the securities, possibly leading to a subsequent forced sale. Although there is an element of credit risk, it is generally regarded by regulatory authorities as low. The risk of having to take up the securities is affected by the type of underwriting commitment and the risk of a forced sale by the nature of the security underwritten.

3.19. For these reasons the amount at risk on an issue is regarded for regulatory purposes as more reasonably measured in the context of large exposures policy by some proportion of the amount underwritten, rather than the full amount of the issue. There is recognition of two types of underwriting status: experts and non-experts. A bank wishing to become an expert underwriter needs to demonstrate that it has the necessary experience and skills and the systems in place to be able to monitor (on an intra-day basis) and for the life of the underwriting commitment its aggregate exposure (from all sources) to a counterparty.

Rules of the FSA, the SFA and IMRO

3.20. Under the Financial Services Act the Treasury (and hence by transfer the FSA) is given power to make rules regulating the conduct of business by authorized persons (section 48) and requiring persons authorized by the FSA or a member of an SRO to have and maintain such financial resources as are required by the rules (section 49). The financial resources rules made by the FSA under section 49 do not, however, apply to members of an SRO except to the extent that they have been designated for that purpose under section 63A. The SROs (including the SFA and IMRO—see

paragraph 3.7) do not make rules under any statutory power. Rather, their rules are derived from the contractual relationship between the organizations and their member firms. The FSA is limited to making rules that are within the powers of the Financial Services Act. The rule-making powers of the SFA and IMRO are not restricted by the Financial Services Act and they have equipped themselves with powers to impose fines for misconduct.

3.21. The FSA has issued Statements of Principle which are intended to form a universal statement of the standards expected of firms and apply directly to the conduct of investment business by all authorized persons. Two Principles are relevant in the present context:

(a) Principle 5, which requires a firm to take reasonable steps to give a customer it advises any information needed to enable the customer to make a balanced and informed decision; and

(b) Principle 6, which obliges a firm either to avoid any conflicts of interest arising or, where conflicts arise, to ensure fair treatment to all its customers by disclosure, internal rules of confidentiality, declining to act or otherwise.

3.22. The SFA's more detailed rules set out the standards expected of firms. Rule 5.29 (material interests) of the SFA rulebook provides that where a firm has a conflict of interest in relation to a transaction it must not advise its customer in relation to that transaction unless it takes reasonable steps to ensure fair treatment for the customer. With regard to the disclosure of a firm's charges, SFA rule 5.33 (charges and other remuneration) requires a firm, before it provides investment services to a private customer, to disclose the basis or amount of its charges for the provision of those services, and the nature or amount of any other remuneration receivable by it. Rule 5.33 (unlike rule 5.29) applies only to investment services to be provided to a private customer. Most companies to which underwriting services are supplied are non-private customers. Non-private or ordinary customers are defined as a trust with at least £10 million of investment assets or a company with at least 20 members and a called-up capital of £500,000 or alternatively a called-up capital of at least £5 million.

3.23. Relevant IMRO rules in the context of sub-underwriting activity concern suitability (a firm must ensure that transactions are suitable for customers); understanding risk (a firm must enable private customers to understand the nature of risks involved); material interests (a firm with a material interest in a transaction must not advise in relation to it unless it ensures fair treatment for the customer); reasonable charges (charges to private customers must not be unreasonable); information about remuneration (a firm's charges to a private customer must be disclosed in advance); customer order priority (a firm should deal with customers in due turn); timely execution (a firm must arrange the execution of an order as soon as reasonably practicable); best execution (a firm must provide best execution for a private customer, that is, ascertain the best price); timely allocation (a firm must allocate transactions promptly); and fair allocation (a firm must not give unfair preference to itself or any of those for whom it deals).

The listing rules of the LSE

3.24. The main requirements of the listing rules which are relevant to issues of shares and any associated underwriting are:

(a) An issuer has to have a sponsor (which may or may not be a provider of underwriting services) when the issuer makes any application for listing which requires the production of listing particulars.

(b) To be listed, shares must be freely transferable. Partly-paid securities are regarded as fulfilling this condition, provided the LSE is satisfied that their transferability is not restricted and that investors have been provided with all appropriate information to enable dealings to take place on an open and proper basis. Except where securities of the same class are already listed, the expected aggregate market value of all securities to be listed must be at least £700,000. Where an application for listing has been made for a class of shares, a sufficient number of shares of that class, normally deemed to be 25 per cent, has to be in public hands.

(c) The Yellow Book identifies six methods open to applicants without equity shares already listed and 13 methods of bringing securities to listing open to applicants with equity securities already listed. Further details are given in paragraphs 3.31 and 3.32 below.

(d) In the case of a rights issue, the offer to shareholders must remain open for at least 21 days. Where rights arising from an issue are placed before the official start of dealings, the placing must relate to at least 25 per cent of the maximum number of securities offered and the price paid by placees must not be more than one-half of the calculated premium over the offer price (the premium being the difference between the offer price and the theoretical ex-rights price (TERP)). The terms of a rights issue must provide that, where shareholders do not sell or take up their rights, the rights concerned (collectively known as 'the rump') must be sold and any premium obtained over the subscription or purchase price (net of expenses) must be for the account of such holders, except for amounts less than £3.00 which may be retained by the company.

(e) Copies of listing particulars must be available during normal business hours at the registered office of the issuer and the offices of its paying agent in the UK for a period of 14 days. In the case of a rights issue or an open offer the issuer must send to its shareholders of the relevant class, with the relevant circular, a copy of the listing particulars or summary particulars. Details of the underwriter must also be included and a statement made of the charges relating to the issue payable by the issuer, stating the total remuneration of the financial intermediaries, including the underwriting commission or margin, guarantee commission, placing commission or selling agent's commission.

(f) Chapter 9 deals with the continuing obligations which a listed company is required to observe once any of its securities have been admitted to listing. A company need not notify the LSE of negotiations with prospective underwriters and it may delay the announcement of a new issue while underwriting is in progress. Unless shareholders otherwise permit, a company proposing to issue equity securities for cash must first offer those securities to existing equity shareholders and to holders of other equity securities who are entitled to be offered them in proportion to their existing holdings. Only to the extent that the securities are not taken up by such persons under the offer may they then be issued for cash to others or otherwise than in the proportions mentioned. To the extent that shareholders in a company give their permission under section 95 of the Act to the disapplication of pre-emption rights, issues by a company of equity securities for cash otherwise than to existing shareholders in proportion to their existing holdings are permitted in accordance with the authorization.

(g) Chapter 10 deals with transactions by listed companies, principally acquisitions and disposals. Transactions are classified by reference to the size of the transaction relative to that of the listed company proposing to make it. The comparison is made by the use of percentage ratios of assets, profits, consideration to assets, consideration to market capitalization and gross capital. The different classifications are:

   (i) Class 3—a transaction where all percentage ratios are less than 5 per cent;

   (ii) Class 2—a transaction where any percentage ratio is 5 per cent or more, but each is less than 25 per cent;

   (iii) 'Super' class 1—a transaction where any percentage is 25 per cent or more; and

   (iv) Reverse takeover—an acquisition by a listed company of a business, an unlisted company or assets where any percentage ratio is 100 per cent or more or which would result in a fundamental change in the business, the board or voting control of the listed company.

   The requirements on announcements of transactions depend on the classification. In the case of Class 2 and 3 transactions the requirements are mainly to provide information to the LSE for release to the market by the Company Announcements Office in the Regulatory News Service. In the case of a 'Super' Class 1 transaction, in addition to the provision of information to the LSE, an explanatory circular must be dispatched to the company's shareholders and the

company must obtain the prior approval of its shareholders in general meeting, and any agreement effecting the transaction must be conditional upon such approval being obtained.

Other guidance

3.25. Other relevant guidance is:

(a) the Takeover Panel rules;

(b) the pre-emption guidelines; and

(c) ABI/NAPF guidance on limitations on issuing share capital.

These are considered in turn.

The rules of the Takeover Panel

3.26. The rules of the Takeover Panel are relevant to this inquiry because many equity offerings involving underwriting are concerned with acquisitions. They may be considered under three headings: *(a)* certainty of proceeds; *(b)* confidentiality; and *(c)* timetable.

(a) *Certainty of proceeds*. The Panel's General Principle 3 requires that when an offer is made, the offeror must be able to carry it into implementation. Under the Panel's rule 24.7, concerning cash offers, the offer document must include confirmation by the bank or financial adviser that sufficient resources are available. In a situation where an offer is made, the bidder can find cash from its own resources or bank; can arrange for underwriting of the cash underpinning; or can undertake an underwritten rights issue. If underwriting is not available, the company will need a bank loan for which it would need to pay commitment fees. In the situation of a mandatory offer, the Panel's rule 9.1 requires that if a bidder acquires 30 per cent of the voting rights of a company, an obligation is incurred to make a cash offer or be accompanied by a cash alternative at not less than the highest price paid to the bidder (or any person acting in concert with the bidders) for shares purchased during the offer period and within 12 months prior to its commencement.

(b) *Confidentiality*. Under the Panel's rule 2.2, an announcement is required of a possible offer in the case of an untoward price movement or a leak. The panel's rule 2.1 requires all persons privy to confidential information concerning a contemplated offer to treat the information as secret and only pass it to another if it is necessary to do so. The panel's rule 2.2(e) requires an announcement to be made when negotiations or discussions are about to be extended to include more than a very restricted number of people unless the Panel permits the number to be extended. Permission must be sought if a wider circle of persons is to be consulted, which the Panel normally regards as more than six people.

(c) *Timetable*. Under the Panel's rule 2.5, and General Principle 3, the announcement of a firm intention to make an offer should be made only when the offeror has every reason to believe that it could and would be able to continue to implement the offer. Under the Panel's rule 2.7, where there has been an announcement of a firm intention to make an offer, the offeror must, except with the consent of the Panel, proceed with the offer. Once an announcement of a firm intention to make an offer has been made, an offer document is required within 28 days (rule 30.1). The offer has to be open for a minimum of 21 days (rule 31.1). Rule 31.6 generally prevents an offer becoming unconditional as to acceptances more than 60 days after the initial offer document was posted. A further period of 21 days is permitted for other conditions to be fulfilled before the offer has to lapse (rule 31.7). The offer has to remain open for acceptances for at least 14 days after it has become or been declared unconditional as to acceptances (rule 31.4). All this can stretch out the underwriting period.

The pre-emption guidelines

3.27. The pre-emption guidelines set out the conditions within which the members of the investment committees of the ABI and the NAPF and shareholders are willing to disapply pre-emption rights on a routine basis. The main features of the guidelines (which are set out in full in Appendix 3.1) are that non-pre-emptive cash placings are permitted provided that the issue discount is restricted to 5 per cent of the mid-price between the best bid and offer prices, including commissions, and the issue size is limited to 5 per cent of shares in issue (and to 7.5 per cent in any rolling three-year period).

Other ABI/NAPF guidance

3.28. In addition the ABI has issued guidelines that permit vendor placings (see paragraph 3.32*(d)*) on a non-pre-emptive basis provided the discount is restricted to no more than 5 per cent including commission and the issue size is restricted to 10 per cent of the shares in issue. Limits to vendor placings can be exceeded if provision is made to claw back shares to satisfy existing shareholders. The investment committees of the ABI and the NAPF will consider approaches from companies for confidential advice on proposals for particular transactions involving more extensive disapplication of pre-emption rights.

3.29. The ABI has also issued guidance on the limitations it would expect to see placed on the directors' authority to allot share capital under section 80 of the Companies Act. The sample resolution provides authority to issue the lesser of the unissued share capital or a sum equal to one-third of the issued ordinary capital. To the one-third level can be added amounts for which the company requires further additional powers under section 80; for example, to allot shares in respect of deferred consideration or options. The recommended level is not an absolute limit on the amount of share capital that directors may allot: it is intended to require the board to return to shareholders if the company proposes to increase significantly the amount of issued share capital.

3.30. Table 3.1 summarizes the limits on issue sizes and discounts set out in the pre-emption and ABI guidelines, and (for open offers) the listing rules.

TABLE 3.1 **Limits on share issue sizes and discounts**

Option	*Maximum size*	*Discount*
Placing (without clawback)	5% of the issued share capital in single year 7.5% in a rolling three-year period	5% or less—inclusive of fees and commission
Vendor placing (without clawback)	10% of issued share capital	5% or less—inclusive of fees and commission
Open offer (ie placing or vendor placing with clawback)	No formal maximum	10% or less—inclusive of fees and commission
Rights issue	No relevant limit	No relevant limit

Source: Credit Suisse First Boston and MMC.

Different types of share issue

Applicants without equity securities already listed

3.31. There are six methods of bringing securities to listing described in the Yellow Book for applicants without equity securities already listed. These are usually referred to as IPOs:

(a) An *offer for sale* is an invitation to the public by, or on behalf of, a third party to purchase securities of the issuer already in issue or allotted. It may be in the form of an invitation to tender at or above a stated minimum price.

(b) An *offer for subscription* is similar to an offer for sale, except that the securities of the issuer are not yet in issue or allotted. With the relaxation of restrictions on the sorts of issues that could be dealt with by way of a placing (see *(c)* below), particularly since 1 January 1996, offers for sale or subscription have become relatively rare.

(c) A *placing* is a marketing of securities already in issue but not listed or not yet in issue, to specified persons or clients of the sponsor or any securities house assisting in the placing, which does not involve an offer to the public or to the existing holders of the issuer's securities generally. The mechanisms for placing vary widely and include those made on the basis of a fixed price and ones where the pricing forms part of the placing process (book building). Under the book-building process a sponsor of an issue of securities, or its agent, approaches potential purchasers of the securities who indicate (on a non-legally-binding basis) the number of shares they are willing to take up and the price they are willing to pay. In some cases a potential shareholder may give alternative indications of interest, typically involving a higher number of shares, but at a lower price. From these indications of interest a sponsor is able to assess the best price obtainable for an issue, consistent with any other constraints, such as the identities of the shareholders to whom the securities are to be sold.

(d) An *intermediaries offer* is a marketing of securities already or not yet in issue, by means of an offer by, or on behalf of, the issuer to intermediaries for them to allocate to their own clients.

(e) An *introduction* is a method of bringing securities to a listing that does not involve an issue of new securities or any marketing of existing securities because the securities are already widely held by the public—for instance, as a result of admission to the AIM.

(f) The sixth method is stated to be any such other method as may be accepted by the LSE.

Applicants with equity securities already listed

3.32. There are 13 methods included in the Yellow Book for companies whose securities are already listed to bring further securities to listing (known as new issues by listed companies). The procedure under an offer for sale, an offer for subscription, a placing and an intermediaries offer are similar to those for companies without equity securities already listed. In the case of a placing of securities of a class already listed, the placing price must not be at a discount of more than 10 per cent to the existing middle market price, unless the LSE is satisfied that the issuer is in severe financial difficulties or that there are other exceptional circumstances. As with applicants without equity securities already listed, such other method as may be accepted by the LSE is also permitted. Other methods of bringing securities to listing are:

(a) A *rights issue* is an offer to existing holders of securities to subscribe or purchase further securities in proportion to their holdings made by the issue of a renounceable allotment letter (or other negotiable document) which may be traded (as nil-paid rights) for a period before payment for the securities is made. In a rights issue the LSE grants a listing for the securities in nil-paid form. The use of the rights issue method is influenced by the existence in UK law of pre-emption rights for existing holders of equity securities and the effective restrictions placed on the disapplication of pre-emption rights (see paragraph 3.27).

(b) An *open offer* is an invitation to existing holders of securities to subscribe or purchase securities in proportion to their holdings, which is not made by means of a renounceable allotment letter (or other negotiable document). As with a placing of securities of a class already listed, an open offer of equity securities cannot be made at a discount of more than 10 per cent to the middle market price at the time of announcement of the offer unless the LSE is satisfied that the issuer is in severe financial difficulties or there are other exceptional circumstances. An open offer can be made in conjunction with other methods of issue. For example, a conditional placing can be made at the same time with provision for clawback of some or all of the shares conditionally placed to meet applications from existing shareholders under the open offer.

(c) An *acquisition or merger issue* is an issue of securities in consideration for an acquisition of assets, or an issue of securities on an acquisition of, or merger with, another company as consideration for the securities of that other company. In the case of takeovers, particularly hostile takeovers, it is common for a cash alternative to be available for shareholders in the offeree company. Where shareholders in the offeree company elect for the cash alternative rather than taking shares, the sponsor of the issue arranges for the shares to be purchased at the underpinning price and this can effectively amount to a form of underwriting (we refer to such arrangements as cash underpinnings).

(d) A *vendor consideration placing* is a marketing by, or on behalf of, vendors of securities that have been allotted as consideration for an acquisition. Where the securities to be placed are equity securities of a class already listed the placing price must not be at a discount of more than 10 per cent to the middle market price of the security at the time of the placing, unless the LSE permits otherwise. In addition ABI guidelines restrict the allowable discount to 5 per cent, inclusive of expenses (see paragraph 3.28).

(e) *A capitalization (or bonus)* issue, also known as a scrip issue, in lieu of dividend or otherwise is an issue to existing holders of securities, in proportion to their holdings, of further shares credited as fully paid out of the reserves of the issuing company. In a capitalization issue (other than one in lieu of dividend) if a shareholder's entitlement includes a fraction of a security, that fraction must be sold for the benefit of the shareholder, subject to a *de minimis* exception of £3.00.

(f) An *issue for cash* is an issue of securities for cash to persons who are specifically approved by shareholders in general meeting or an issue pursuant to a disapplication of the pre-emption rights of section 89 of the Companies Act approved by shareholders in general meeting. This method is rarely used.

(g) In addition securities of a class already listed may be granted a listing if they arise from an exchange for, or conversion of securities into, another class of securities or an exercise of options or warrants to subscribe securities.

It is not unusual for a share offer to involve more than one method. For example, a company might make a placing and open offer. What this means in practice is that some shares are placed firm and some are placed conditionally subject to clawback pro rata by shareholders.

3.33. Secondary offers are offers of shares already in issue. These may be underwritten but we did not identify any in 1995 to 1997 that involved the same form of supply of underwriting services as rights issues, open offers and cash underpinnings.

3.34. CULS, which provides for conversion into shares, is sometimes issued by way of rights. Use has also been made of a form of rights issue involving an issue of CULS as an intermediate step towards the issuance of equity, which is generally referred to as a trombone issue. Where a potential acquisition is conditional in some respects, possibly because of regulatory uncertainty, a company may wish to raise money by way of a rights issue to finance the transaction, but to be able to return the money raised to shareholders if the acquisition does not proceed. In such circumstances, in order to meet any problems over trading in conditional allocations of shares or repayment of equity securities, companies have issued a CULS on a pre-emptive basis—usually partly paid—rather than engaging in a conventional rights issue of equity securities. As further monies are required additional calls can be made on the CULS, or alternatively if surplus monies are to be returned to shareholders, all or part of the CULS can be repaid. In either case the terms of the CULS will provide for conversion to equity securities of the amount outstanding on the CULS on the happening of a specified event (for example, the successful completion of the acquisition for which the funds were required).

The nature of underwriting agreements

3.35. An underwriting agreement is made between the lead underwriter and the company. The lead underwriter agrees to take up the amount of securities specified in the agreement, to the extent that the public or other persons to whom the offer of securities is made do not subscribe for them or

purchase them before a fixed date. The underwriting agreement may cover the whole amount of the securities being offered or only a part of them. The price which the lead underwriter agrees to pay is normally the fixed price at which the securities are offered. However, in the case of a cash underpinning for a bid, the cash alternative on offer to shareholders in the target company may be of a lesser amount than the market value attributable to the offer of shares.

3.36. The lead underwriter, for whom the broker acts as agent, enters into a sub-underwriting agreement with each of the sub-underwriters for the latter to accept the underwriting risk for a specified number of the securities being underwritten. As set out in paragraph 3.13, sub-underwriting commitments are accepted on behalf of funds by fund managers who have a discretionary agreement to accept sub-underwriting subject to any agreed restrictions in the particular case. The nature of sub-underwriting is further discussed in paragraphs 5.1 to 5.14.

Hard and soft underwriting

3.37. A distinction is made in the trade between hard and soft underwriting. In the context of fixed price issues such as rights issues and open offers, underwriting is undertaken without the lead underwriter having obtained any firm commitment from potential sub-underwriters, though the lead underwriter will be aware of any feedback obtained in the course of limited pre-marketing of the issue. This type of underwriting is known as hard underwriting, and it is this type with which the MMC inquiry is concerned. There is another type of underwriting known as soft underwriting which is the underwriting at the end of the offer period of a book-built offer (see paragraph 3.31*(c)*), principally to cover counterparty/settlement risk. For the reasons given in paragraph 2.34*(b)*, we have excluded share offers underwritten in this way from the complex monopoly situations.

Timetables of events

3.38. The timetable for carrying out a new issue is constrained by a mixture of company law requirements, LSE rules and the time needed in practice to complete the various administrative procedures involved. The elapsed time from start to completion for a new issue by a listed company—such as a rights issue—is considerably shorter than that for an IPO.

Rights issues

3.39. The two main reasons for a company to undertake a rights issue are to pay for the acquisition of another business or to raise finance for general corporate purposes. In the first case companies may seek to raise funds in anticipation of future developments, rather than to finance a specific acquisition or capital expenditure programme, but when a company proposes to raise capital for future development (sometimes referred to as accumulating a war chest) the institutional investors will generally expect the issuing company to make a particularly strong case for the issue as subsequent use of the funds will be at the discretion of management. The time periods that have to be accommodated within the timetable for a rights issue are:

(a) The LSE requires listing particulars to include a statement of the borrowings of the issuing group at a recent date, which must in the absence of exceptional circumstances be not more than 42 days prior to the publication of the listing particulars.

(b) Both section 90 of the Companies Act and the listing rules require a period of 21 days for the offer to shareholders to remain open for acceptance.

(c) Where the issuing company has insufficient unissued share capital available, an extraordinary general meeting (EGM) will be required to approve the necessary increase in the authorized capital. A notice period of 14 days is required for an EGM, but if the business includes a special resolution then the notice period is increased to 21 days. The periods in *(b)* and *(c)* do not run concurrently since dealings in nil-paid rights cannot take place on the basis of conditional allocations.

3.40. Indicative timetables for rights issues, with and without the requirement for an EGM, are shown in Table 3.2, where D is the date of announcement of the rights issue.

TABLE 3.2 **Indicative timetables for rights issue**

	EGM required	*No EGM required*
Earliest date for statement of indebtedness	D–42	D–42
Submission of draft listing particulars to LSE	D–21	D–21
Sign underwriting agreement and hold in escrow	D–1	D–1
Date of issue: D	D	
Announce rights issue		
Underwriting agreement in force		
Sub-underwriting arranged		
LSE approves circular		
Post circular to shareholders		
Post EGM notice to shareholders	D	N/A
Listing hearing with LSE	Before D+21	D
EGM to increase capital etc	D+21*	N/A
Post provisional allotment letters	D+21	D
Dealings begin in nil-paid rights	D+22	D+1
Last date for splitting nil-paid allotments	D+40	D+19
Acceptance day for offer	D+42	D+21
Level of acceptances notified	D+43	D+22
Subscribers procured for the rump	D+43	D+22
Announcement of details of acceptances and of proceeds from the rump	D+43	D+22
Sub-underwriters informed of commitments (if any)	D+43	D+22
Company receives funds	D+50	D+29

Source: Schroders.

*In practice a further two days is required to allow for the delivery of the Notice to Shareholders. Subsequent dates will be similarly affected.

Open offers

3.41. There are minimum timetable requirements applied to an open offer to ensure that valid claims from the market can be properly satisfied. There must be a period of at least 15 business days from the date of the posting of application forms to shareholders (or from the 'ex' date if that is earlier) until the close of the offer. The 'ex' date is the date from which the purchase of shares no longer entitles the purchaser to subscribe for additional shares under the offer. Where this date is earlier than the date of posting, then the application forms must still be posted no less than ten business days before the close of the offer. Because an open offer is made pro rata to existing holdings and the requirement for 15 business days to elapse between making the offer and its closure should provide 21 days for shareholders to accept the offer, an open offer will normally meet the pre-emption requirements of section 89 of the Companies Act.

Initial public offerings

3.42. In the case of IPOs the issue period might typically cover several months. The main constraints on the timetable are the requirement for the date of the most recent audited balance sheet to be no more than six months before the date of issue of the prospectus, the maximum time for the statement of indebtedness (42 days) and the submission of listing particulars in draft to the LSE at least 28 days before publication. For an IPO placing involving book building, the appointments of the global co-ordinator and of key advisers would need to be made at least three months before the official launch of the issue. For a UK domestic IPO, the sponsor and broker to the issue would typically be appointed four to six months before the launch date.

Other matters

3.43. A number of further factors arise in the course of the securities issue and underwriting processes which affect the choice of issuing method. The main ones of potential relevance to the terms of reference for the inquiry are the use of deeply-discounted issues, the impact of taxation, the presentation in accounts of the effects of rights issues and the position of overseas shareholders in a rights issue by a UK company.

Deeply-discounted rights issues

3.44. The following paragraphs discuss deeply-discounted rights issues, that is rights issues carried out at a discount sufficiently deep for them not to require underwriting. The main reason for an issuing company to arrange for an issue to be underwritten is to obtain certainty over the proceeds. In the case of a rights issue the elapsed time between the announcement and pricing of the issue and the close of acceptances will be not less than 21 days (when no EGM is required) and not less than 42 days (where an EGM involving 21 days' notice is required). In that time there could be substantial movements in the level of the stock market as a whole or in the price of the shares of a particular company; underwriting provides cover against such an adverse movement. Where a rights issue is being undertaken to finance an acquisition, certainty of proceeds is of particular importance as the issuing company may be committed to a particular price. Should the rights issue not be taken up in full, the issuing company might not have the necessary borrowing facilities to meet the shortfall.

3.45. Where security of proceeds is a priority, an alternative to a conventional underwritten rights issue at a discount to the market price in the range 10 to 20 per cent is to make a rights issue at a sufficient discount to the market price that any likely subsequent movement in stock prices would not eliminate the value of the rights. The value of the rights is, in principle, the difference between the TERP of the securities and the subscription price. If the rights have no value, a shareholder will be able to buy shares in the market more cheaply than subscribing to the rights issue and so the issue will be unsuccessful. There is no consensus as to what level of discount constitutes a deep discount. The only recent example of a significant non-underwritten UK rights issue was the 1 for 4 issue by Bodycote International plc (Bodycote) in December 1997 which was priced at a 40 per cent net discount.

3.46. We were told that companies were reluctant to make deeply-discounted rights issues for a number of reasons. These included a belief that the cost of capital of the issuing company increased with the level of discount; that investors expected the rate of dividend to be maintained on the increased capital (rather than adjusting the dividend in recognition of the substantial scrip issue element in a deeply-discounted issue); a perception that a deeply-discounted issue was a sign of financial weakness on the part of the company and might indicate lack of market support; and that in some cases there could be adverse CGT consequences for some shareholders (see paragraphs 3.49 to 3.51).

3.47. A rights issue at a discount to the market price can be regarded as a combination of an issue of shares at full value and an accompanying bonus or scrip issue (see paragraph 3.32*(e)*). As the discount increases, the extent of the accompanying scrip element increases. Provided shareholders take up their rights in full, they should not be affected by the level of the discount. If the same shareholders own the company before and after the rights issue (in the latter case the value of the company includes the cash subscribed for the issue), shareholder value is not affected by the actual number of shares in issue.

Restatement of dividends per share

3.48. In the case of a rights issue at a conventional discount we were told that it is common practice on behalf of companies at least to maintain the dividend rate on the capital as increased, despite the presence of a scrip element in the issue. The ASB issued on 1 October 1998 Financial Reporting Standard 14 'Earnings per share'. This standard updates the guidance on calculating earnings per share data and advises companies to restate dividends per share data in historical summaries to reflect the effect of rights and scrip issues.

Taxation

3.49. A CGT liability may arise when an individual shareholder decides to sell rights wholly or in part. Broadly speaking, the chargeable gain for tax purposes is given by the proceeds of the disposal less part of the original cost of the shares (Appendix 3.2 describes the taxation treatment of sales of rights in more detail). Because rights are more valuable when issues are deeply discounted, the proceeds of disposal are greater in such cases. However, the effects of CGT are mitigated in various ways. In particular, where the proceeds are small (which means in practice 5 per cent or less of the total value of the shares held or not above £3,000, whichever is the greater), the sale of rights is not normally treated as a disposal for tax purposes (see Appendix 3.2, paragraph 5). The chargeable gain may be reduced by an indexation allowance or the new taper relief introduced in the 1998 Budget. In addition CGT is only payable if a taxpayer's total chargeable gains in any one year exceed the Annual Exempt Amount (currently £6,800).

3.50. Taking these various factors into account, the Inland Revenue told us that it was unlikely that many small shareholders would have to pay CGT arising from the sale of rights, even with a deeply-discounted issue.

3.51. As it currently operates, CGT makes no distinction between shareholders who simply sell their rights and use the proceeds for other purposes and those who sell only part of their rights and use the proceeds exclusively to take up the remainder of them (a practice known as 'tailswallowing'). The Inland Revenue told us that tailswallowing left a shareholder with no cash realization and maintained the absolute value of the shareholders' interest in the company, but left a shareholder with a smaller proportionate share of the company. The basis of CGT was the taxation of the realization of gains if the whole or part of an interest in an asset was disposed of. Part of the value of selling rights might be attributable to unrealized gains on the original shareholding. It was the gain element in the realization of rights that became taxable. To the extent that tailswallowing involved a reduction in the interest in the company, part of that gain was being realized. The deeper the discount on the rights, the greater the value of rights being sold and so the greater the proportion of the previously unrealized gain that was being taxed.

Overseas shareholders and UK rights issues

3.52. Many UK listed companies have overseas shareholders, of whom shareholders in the USA are a particularly important group. We were told that there were restrictions on the ability of US shareholders to take up rights offers by UK companies and we looked into the reasons for this.

3.53. US law requires registration of every offer of a security in the USA except where there are specific exemptions. This means that a UK company cannot approach shareholders in the USA with a rights offer unless this offer has been registered with the Securities and Exchange Commission (SEC). Few UK companies choose to register share offers with the SEC because they want to avoid the cost of doing so (including the risk of litigation in the USA).

3.54. US law distinguishes between companies which do not have a substantial US market interest (type I) and those which do (type II). A company is considered to have a substantial US market interest if it does more than 20 per cent of its trading in the USA. The restrictions on share offers by type II companies are tighter than those for type I companies but we were told that very few UK companies were in the type II category.

3.55. UK companies in the type I category may offer unregistered shares to their US shareholders provided that the latter have a presence in the UK. We were told that in practice this need be no more than a UK address. US institutions that own a significant number of shares in UK companies normally have a UK address and can therefore participate in UK rights offers.

3.56. We are not aware of any similar restrictions on shareholders from countries other than the USA.

3.57. There are also US legal restrictions on the ability of certain classes of US shareholders to engage in sub-underwriting in the UK. In particular, US pension funds and some mutual funds are not permitted to do so.

Overseas practice

3.58. In our questionnaire for investment banks and brokers, we asked respondents who had experience of issuing equity in other countries about issuing methods and the level of underwriting fees in the USA, Australia, Germany, France, Switzerland and Japan. We also conducted our own research into issuing costs in the USA and obtained information from some other sources.[1]

3.59. There are major differences in the legal framework and in market practice among the countries we asked about and between most of them and the UK. For our purposes, the most important differences are:

(a) Shareholders have pre-emption rights in Germany, France, Switzerland and Australia but these rights are rare in the USA and Japan.

(b) Where pre-emption rights exist, there are significant differences in the extent to which they are waived. In Germany companies may issue up to 10 per cent of their share capital non-pre-emptively subject to limits on the discount. We received conflicting views about what this meant in practice but there is some evidence to suggest that, at least for larger issues in recent years, non-pre-emptive offers are more common in Germany than in the UK. Morgan Stanley identified 27 IPOs and new issues by listed companies of over $250 million in 1996 and 1997, of which 18 involved the waiver of pre-emption rights and none were rights issues. Although the legal position differs in France, the extent to which pre-emption rights are waived appears to be broadly similar: of 22 issues of over $250 million identified by Morgan Stanley, 18 involved the waiver of pre-emption rights and these rights were applied in only one case.

(c) The form of underwriting is generally different from that in the UK. Except for Australia, sub-underwriting is rare and the primary underwriters retain the underwriting risk. Underwriting is frequently 'softer' than in the UK, with *force majeure* clauses protecting the underwriters from severe market risk; this is particularly marked in the USA.

(d) The marketing of shares before the issue price is set and the use of book-building techniques is normal practice in the USA and Japan and less common, but increasing, elsewhere.

3.60. Comparing the level of underwriting fees between countries is not a straightforward matter. In addition to differences between legal frameworks, market structure (for example, the extent of concentration) and tax systems, all of which could affect fees, the following points need to be borne in mind:

(a) There may be a range of services remunerated by the fee in addition to underwriting itself. For example, in the USA much of the fee is for marketing the issue and in a French rights issue part of it is for processing subscriptions. The amount of financial advice covered by the fee will vary.

(b) Even that part of the fee which is for underwriting itself does not always buy the same service. For example, the extent of the underwriter's commitment varies (see paragraph 3.59*(c)*).

(c) The issue price discount presents a double complication: in non-pre-emptive issues it is a cost to shareholders whereas in rights issues it is not, making a simple comparison of fees between the two types difficult; within each type of issue, the greater the discount, the smaller the risk for the underwriter, which may have consequences for the fee charged.

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[1]In particular from LIBA and the book by Robert Lilja, *International equity markets: the art of the deal,* Euromoney Books, 1997.

(d) Underwriters may be at risk for widely different periods of time, from several weeks at one extreme to a couple of days at the other, and this too needs to be factored into any comparison of fees.

3.61. With these caveats, the information provided by investment banks and secondary sources suggest that fee levels in other countries are in the following ranges (Switzerland has been omitted because we received relatively little data about it):

(a) USA: 3 to 6 per cent;

(b) Germany: 1 to 5 per cent. We were told by Dresdner Kleinwort Benson (DrKB) that fees for underwriting a rights issue normally amounted to 1 to 1.75 per cent of the issue price, usually at a discount of 15 to 25 per cent to the market price at or about the time of the announcement.

(c) France: 2 to 4 per cent;

(d) Australia: 2 to 2.5 per cent; and

(e) Japan: 3 to 5 per cent.

These figures must be treated with great caution. But to get better ones would have required an elaborate exercise which we did not think that our terms of reference justified.

3.62. We did, however, look in a little more detail at the cost of issues in the USA because US practice was frequently mentioned to us as an example either to be followed or to be avoided. We looked at the gross spread (in effect the gross fee earned by underwriters) of all new US issues, excluding IPOs, in 1997 for which these data were available. We also looked at the percentage change in the share price between the file date and the offer date (that is, between the date the issue was announced and the date at which the shares were taken up by subscribers). We compared the gross spread for these issues with the fees for UK rights issues in 1995 to 1997 for which we had full data on fees (including financial advisory fees as well as underwriting fees). The results are shown in Table 3.3.

TABLE 3.3 **Comparison of US and UK underwriting fees**

Size of proceeds	*UK total fees; * % of underwritten proceeds*	*UK total; * % excluding sub-underwriting*	*US gross spread;† % of amount raised*	*US % price change;†‡ file to offer date*
Up to £10m	5.1	3.8	5.7	–14
£10m to £50m	3.6	2.3	5.3	–8
£50m to £100m	2.9	1.5	4.7	–4
Over £100m	2.5	1.4	3.3	–3
All issues	2.8	1.6	4.1	–4

Source: MMC based on Securities Data Corporation (US figures).

*Rights issues 1995 to 1997 for which full fee information available (117 issues). Includes fees for underwriting and financial advice.

†New issues (excluding IPOs) in 1997 for which file date and offer date are less than two months apart (463 issues).

‡Price change adjusted by change in Standard and Poor 500 index. We also calculated the price change adjusted by the Russell 2000 index: this was –3 per cent for all issues.

Note: All figures are weighted averages.

3.63. In comparing US and UK fees some important points must be taken into account:

(a) As we have said, US offers are non-pre-emptive and any discount to the market price represents a cost to existing shareholders. We did not collect information on such discounts but evidence from elsewhere suggests that they are very small: the market price is usually similar to the offer price following a book-building operation.

(b) In the US system, the issue price is set at the end of the period and underwriters do not provide insurance against share price falls between the file date and the offer date. If such insurance were required, additional charges would be incurred.

(c) The higher fee in the USA reflects, at least in part, the fact that underwriters in the USA are offering a different service from those in the UK; in particular, they are marketing the new issue to a wide body of potential investors including many non-shareholders.

(d) In the UK, shareholders who are unable or unwilling to take up their rights face broking costs and below mid-market prices when they sell their rights or leave them to be treated as part of the rump. Costs associated with the sale of the rump appear to be modest: the broking charge would typically be 0.2 to 0.3 per cent of sale proceeds, and we found that on average the rump was sold at 1.9 per cent below the closing mid-market price on the day after the offer closed while these closing mid-market prices tended to be slightly higher relative to the FTSE All-Share Index than closing prices on the day before the rights issue announcement (see paragraph 4.39). Thus the costs incurred by non-subscribing UK shareholders in rights issues appear to be smaller than the 4 per cent share price fall experienced, on average, by US shareholders between the announcement and offer dates.[1] Moreover the US price fall affects all of the issuing company's existing shares.

3.64. The US underwriting market is a concentrated one and this may affect the level of underwriting charges.

[1]It should be borne in mind that the UK results are for a limited sample of issues.