2 Conclusions

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Background

2.1. On 20 November 1997 the Director General of Fair Trading (DGFT) referred the supply of underwriting services for share issues to us for investigation and report. Our terms of reference (which were amended twice in the course of our inquiry) are set out in Appendix 1.1.

2.2. The Office of Fair Trading (OFT) had been investigating underwriting services for some years before the reference was made. In November 1994 it published a study by Professor Paul Marsh[1] which concluded that the sub-underwriters of rights issues in the period 1986 to 1993 had made excess returns. Professor Marsh's study was an update of earlier work he had done for the period 1962 to 1975 which had reached similar conclusions.[2] A discussion of Professor Marsh's work, and of the criticisms that have been made of it, is contained in Chapter 5.

2.3. In March 1995 the then DGFT published his own report on underwriting services[3] in which he identified three sets of competition issues that caused him concern: the fixed fee structure for underwriting services; the nature of the underwriting process; and potential conflicts of interest. The DGFT decided against making a reference to the MMC at that time but instead called upon practitioners to improve the competitive functioning of the market and said that the OFT would monitor the position.

2.4. The DGFT published a second report in December 1996[4] in which he reviewed developments since his predecessor's first report. He concluded that there had been some real but limited change and decided to continue to monitor the market for a little longer. The main element of progress noted by the DGFT was the introduction of tendering for sub-underwriting which was initiated by the Stakis PLC (Stakis) rights issue in late October 1996. Details of the tendering process are given in paragraphs 5.25 to 5.29 and Appendix 5.1. Another development was the publication of a joint position paper by the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) in July 1996 which welcomed the use of a wider range of equity-issuing methods (within the framework of pre-emption rights), including deep-discounted non-underwritten rights issues (see Appendix 6.1).

2.5. The DGFT reviewed the underwriting services market again in the autumn of 1997 and concluded that the innovations he had noted in his second report had not yet gone far enough. He remained concerned that competition was not working effectively and decided that the time had come for an MMC inquiry.

2.6. The OFT's investigations had involved rights issues only. The DGFT wanted our inquiry to be broader, and in particular to include initial public offerings (IPOs). Our terms of reference were amended to ensure that they covered IPOs. Prior to 1995, offers for sale or subscription were commonly-used issuing methods for IPOs and involved the same underwriting fee structure (which we call standard fees—see paragraphs 2.12 to 2.14) as rights issues. On 1 January 1996 the London Stock Exchange Limited (LSE) changed its listing rules to make it easier for IPOs to be made by means of a placing. Since then offers for sale and subscription have become rare: we found no evidence of any in the period we investigated (1995 to 1997). As a consequence, for the reasons given in paragraphs 2.36 and

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[1] OFT research paper 6: 'Underwriting of Rights Issues: a study of the returns earned by sub-underwriters from UK rights issues', November 1994.

[2] P R Marsh, 'Valuation of underwriting agreements for UK rights issues', *The Journal of Finance, 35*, 1980.

[3] OFT: 'Underwriting of equity issues: a report by the Director General of Fair Trading', March 1995.

[4] OFT: 'Underwriting of equity issues: a second report by the Director General of Fair Trading', December 1996.

2.37, IPOs are not included in our complex monopoly situations, and hence are not the subject of public interest findings.

2.7. The second amendment to our terms of reference, which was at our request, involved bringing within their scope offers of convertible unsecured loan stock (CULS—see paragraph 3.34) that provided for the automatic conversion of the stock into shares on the happening of a specified event within a year. Such CULS is sometimes issued on a similar basis to rights issues and as an alternative to them. References to rights issues in the remainder of this chapter should be taken to include equivalent offers of CULS.

Complex monopoly situations

2.8. Under our terms of reference we have first to answer the questions whether a monopoly situation exists in relation to the supply of underwriting services, and if so:

(a) by virtue of which provisions of sections 6 to 8 of the Fair Trading Act 1973 (FTA) that monopoly situation is to be taken to exist; and

(b) in favour of what person or persons that monopoly situation exists.

2.9. In this section we begin by describing the conduct (namely the use of standard underwriting fees) on which we base our findings and go on to describe our provisional findings, the comments on them that we received, and our conclusions.

Use of standard fees

2.10. The most frequently used method by which listed companies raise new equity in the UK is the rights issue (a description of the various different share-issuing methods is given in Chapter 3). In a rights issue, shareholders are given rights to subscribe to new shares at a specified price in proportion to their existing shareholding. They may exercise these rights within a specified period (a minimum of 21 days) or seek to sell them to third parties. Companies cannot usually be sure of the extent to which the rights will be taken up and thus have no certainty about the level of proceeds from the issue.

2.11. They solve this problem by arranging for underwriting. A lead underwriter, typically an investment bank, gives the company a commitment to subscribe, at the issue price, to any part of the issue not taken up by others. The lead underwriter lays off all or part of its risk in the course of the day of the announcement of the issue by getting the company's broker to arrange sub-underwriting for all or part of the issue. In exchange for a fee, sub-underwriters undertake to subscribe, at the issue price, to any part of the issue not taken up by others (often referred to as the 'stick'). Sub-underwriters are typically required to fulfil their obligations when the market price of the shares concerned falls close to or below the price of the new issue. They are usually institutional shareholders such as pension funds and life assurance companies.

2.12. Before the introduction of tendering for sub-underwriting, the great majority of rights issues were underwritten at a standard fee of 2 per cent of the gross proceeds of the issue for 30 days and a further 0.125 per cent for each additional seven-day period (or part of it). Of this total fee, the lead underwriter received 0.5 per cent, the broker arranging the sub-underwriting 0.25 per cent and the sub-underwriters 1.25 per cent, plus the 0.125 per cent for each additional seven-day period where relevant.

2.13. The sub-underwriters' fee is wholly for taking on underwriting risk. The lead underwriter's fee is at least partly for the risk that the broker will be unable to find sub-underwriters for the issue either wholly or in part (leaving the lead underwriter with the obligation to subscribe to shares not taken up by holders of rights) and for the risk that sub-underwriters will fail to meet their obligations. However, we were told that the lead underwriter's fee often remunerates other services as well, such as the provision of advice and documentation on the rights issue. The broker's fee is primarily for arranging sub-underwriting but, as with the lead underwriter's fee, we were told that it is sometimes treated as remunerating other services.

2.14. Throughout this report we describe the 2 per cent fee, broken down as described, plus the additional 0.125 per cent for each seven-day period over 30 days, as standard fees. When we refer to standard fees being used, we mean both that the issuing company is charged the standard fee, and that the lead underwriter, broker and sub-underwriters are paid (or retain) their normal share of this fee.

2.15. Standard fees are also frequently used for certain types of new issues by listed companies other than rights issues, namely open offers (also called placing with clawback) and cash underpinnings in acquisitions. In open offers the sub-underwriting fee is often described as a placing commission. In the past, the underwriting of IPOs by means of an offer for sale or an offer for subscription also typically involved standard fees but, as we said in paragraph 2.6, we found no evidence of such issuing methods being used in 1995 to 1997.

Provisional findings on complex monopoly situations

2.16. We set out our provisional findings on the existence of complex monopoly situations in a letter dated 11 May 1998 (the text is reproduced in Appendix 2.1).

2.17. Under section 7(1)*(c)* and (2) of the FTA, a complex monopoly situation exists when at least one-quarter of specified services supplied in the UK are supplied by or for members of a group who, whether voluntarily or not, and whether by agreement or not, so conduct their respective affairs as in any way to prevent, restrict or distort competition.

2.18. We provisionally concluded, on the basis of information on share issues in the years 1995 to 1997, that a complex monopoly situation existed in relation to the supply in the UK of lead underwriting services. At least one-quarter of lead underwriting services supplied in the UK were supplied by members of a group of lead underwriters who so conduct their affairs as to prevent, restrict or distort competition by charging standard fees either for underwriting services or for underwriting and other services.

2.19. We also provisionally concluded that a second complex monopoly situation existed in relation to the supply in the UK of sub-underwriting services. At least one-quarter of sub-underwriting services supplied in the UK were supplied for members of a group of persons who so conduct their affairs as to prevent, restrict or distort competition by paying standard fees to providers of sub-underwriting services. Members of this group included both lead underwriters who pay standard fees and brokers who procure sub-underwriting services at standard fees on behalf of these lead underwriters.

2.20. Different lead underwriters use standard fees to a varying extent. For the purposes of provisionally determining whether any complex monopoly situations existed, we took lead underwriters who used standard fees for over 25 per cent (by value) of their underwriting fees for those share issues within our terms of reference in 1995 to 1997 to be members of a

group whose conduct prevents, restricts or distorts competition. On the information available to us when we reached our provisional conclusions, lead underwriters using standard fees involving 25 per cent of cases (by value) in 1995 to 1997 had a share of supply of 88 per cent. We included IPOs and secondary offers as well as most types of new issues by listed companies in the share offers covered by this calculation.

2.21. We provisionally found that the charging of standard fees by lead underwriters restricted or distorted competition for the following reasons:

(a) In competitive markets for differentiated services customers have a choice of price.

(b) The cost of underwriting services for a particular share issue is related to the risk faced by underwriters that they will be required to take some shares at a price above the market price, which in turn depends upon how far the offer price of these shares is at a discount to their market price immediately prior to the offer being made and on a number of other factors.

(c) Thus in a competitive underwriting market we would expect fees to vary with risk and for lead underwriters to put to their clients the scope for paying different underwriting fees associated with different share offer price discounts for any particular share issue.

(d) In practice standard fees are charged in many cases.

2.22. We have already mentioned (see paragraph 2.13) that the fee charged by lead underwriters frequently covers other services. It seemed to us that the charging of the standard fee for the supply of underwriting services alone would prevent, restrict or distort competition between lead underwriters in connection with the supply of underwriting services for the reasons set out in the previous paragraph. We did not think that this was altered by the fact that other services might be included in the standard fee.

2.23. Fees paid by lead underwriters to sub-underwriters are wholly to compensate the latter for the acceptance of underwriting risk. Our provisional conclusion was that in a competitive market we would have expected lead underwriters to pay different fees to sub-underwriters in different cases. Hence by paying a fixed fee to sub-underwriters, the underwriters were preventing, restricting or distorting competition between them.

2.24. We also provisionally concluded that each of the two complex monopoly situations identified was in favour of the members of the group whose conduct restricts or distorts competition in the way described. In addition, the second complex monopoly situation was in favour of those who accept sub-underwriting standard fees.

Comments on provisional findings

2.25. We emphasized in our letter of 11 May that our provisional findings on complex monopoly situations did not imply the existence of any facts which operated or might be expected to operate against the public interest. Few of those who commented on our letter sought to challenge our provisional findings on the complex monopoly situations and concentrated instead on discussing the public interest issues. However, we did receive the following comments:

(a) J Henry Schroder & Co Limited (Schroders) thought it was not reasonable to base a conclusion on the evidence of issues in the years 1995 to 1997 because there was a radical change in the way rights issues were undertaken beginning in late 1996. The same point was made, less strongly, by Cazenove & Co (Cazenove) and the London Investment Banking Association.

(b) ABI argued that it was not necessarily the case that standardization of contracts implied lack of competition, and that the payment of a fixed fee to underwriters would have represented a restriction or distortion of competition only if the level of the standard fee had been set at a level inappropriate to the optimum trade-off between the underwriting costs and the discounts of issues, which it did not believe was the case. Similar arguments were put forward by Schroders and Scottish Widows Investment Management Limited (SWIM).

(c) Cazenove questioned whether it was appropriate to include IPOs and secondary offers among the issues used to define share of supply. It argued that in the period 1995 to 1997 such issues would have been executed by way of a book-building process for which the 'underwriting' was quite different in nature from that in a rights issue. It also argued that it was unlikely that the fees for IPOs and secondary offers were standard ones. Prudential Portfolio Managers UK Limited (PPM) and the Institutional Fund Managers' Association (IFMA) also questioned the appropriateness of including IPOs.

(d) The ABI, the NAPF and SWIM all commented on our finding that the second complex monopoly situation was in favour of sub-underwriters. The ABI said that the experience of its members did not support the supposition of excess returns. The NAPF referred to the introduction of tendering for much sub-underwriting and also said that it was not unreasonable to charge a client for the elimination of risk. SWIM cited the fact that it had chosen to restrict its sub-underwriting activity in recent years as evidence that it was not being over-compensated for it.

We comment on each of these points in turn.

2.26. We chose the three-year period 1995 to 1997 as the basis for assessing share of supply partly because we believed that a shorter period would have contained insufficient issues on which to base an accurate assessment (particularly as there have been relatively few issues in recent years, a point put to us by many parties), and partly because we thought it premature to assume that the changes introduced since October 1996 were necessarily permanent.

2.27. However, even if we had chosen to take the period from 31 October 1996 (ie after the start of tendering) to the end of 1997 as the basis for assessing share of supply, it would have made no difference to our finding on the existence of a complex monopoly situation. As Table 2.1 shows, during this period lead underwriters who used standard fees for over 25 per cent by value of their underwriting fees (our criterion for membership of the group whose conduct prevents, restricts or distorts competition—see paragraph 2.20) had a share of supply of 46 per cent. We are therefore satisfied that we have adequate grounds for finding that the complex monopoly situations exist.

TABLE 2.1 **Lead underwriters: share of supply**

	1.1.95 to 31.12.97	*31.10.96 to 31.12.97*
Total underwriting fees* in period (£m)	439	79
Lead underwriters charging standard fees† in over 25 per cent of cases (by value):		
– Number of lead underwriters	38	22
– Fees charged (£m)	390	36
– Share of supply (%)	89	46

Source: MMC.

*Includes fees for rights issues, open offers (placings with clawback) and cash underpinnings to provide a cash alternative in an acquisition. Fees comprise the lead underwriter's own fees, the broker's fee and the sub-underwriters' fees.

†The lead underwriter's fee, the broker's fee and the sub-underwriters' fee all at the standard rate (see paragraph 2.14) for the whole of the underwriting (ie partially tendered issues excluded in full).

2.28. It was open to us to choose either number of issues or value of fees charged as the basis for calculating share of supply. We chose the latter because we thought it gave proper weight to larger issues. Tendering has been more common for larger issues than for smaller ones. Had we chosen to use number of issues, the share of supply of the group whose conduct prevents, restricts or distorts competition would have been higher.

2.29. On the argument that standard fees do not restrict competition, we think it unlikely that the discount for a rights issue involving standard fees is invariably set at the level which will match the underwriting risk to the fee. However, even if that were done, it would not affect our finding that standard fees restrict or distort competition. Some issuing companies might prefer to have a deeper discount than would be necessary with the standard fee, and to pay lower underwriting fees. In a market where there were no restrictions on competition we would expect issuing companies to be offered this choice by competing underwriters. This does not occur under the standard fees regime.

2.30. We are therefore satisfied that the use of standard fees prevents, restricts or distorts competition in that it deprives issuing companies of a choice between lead underwriters who are willing to offer different combinations of fees and discounts (the first complex monopoly situation). Lead underwriters do not offer variable fees to their clients mainly because they pay a standard fee to sub-underwriters. Hence the payment of this standard sub-underwriting fee also prevents, restricts or distorts competition (the second complex monopoly situation).

2.31. We think that Cazenove's arguments against the inclusion of IPOs and secondary offers in the group of issues used to calculate share of supply are substantially correct. We return to this point in paragraphs 2.34 to 2.37.

2.32. We do not accept that the comments on our provisional finding that the payment of standard sub-underwriting fees is in favour of sub-underwriters are such as to overturn the finding. We conclude in paragraph 2.100 that the use of standard fees results in sub-underwriting costs being higher than they otherwise would be for at least some issues. As sub-underwriters benefit from this situation, we find that the use of standard fees is in their favour.

Types of share issue included in complex monopoly situations

2.33. We have reviewed the types of share issue to be included in the complex monopoly situations for the purposes of calculating share of supply.

2.34. In our provisional findings we included the following types of new share issues by listed companies: rights issues, open offers and cash underpinnings. We excluded placing without clawback. Our reasons for this exclusion were:

(a) We doubted whether placing agreements were, in general, within our terms of reference as the underwriters' undertakings to take up shares that they fail to place are arguably not 'engagements in respect of an offer of shares' within the meaning of our terms of reference, whether 'offer' is read in its contractual sense or in, for example, the sense used in Chapter 4 of the listing rules (see paragraph 3.24).

(b) If any placing agreements are within our terms of reference, we would regard such agreements and the underwriting of the other transactions mentioned in the first sentence of this paragraph as different forms of supply of underwriting services. This is because, unlike the other transactions, the risk of incurring financial loss as a result of having to take up the shares is very small (see paragraph 4.6). Furthermore, placing does not involve the engagement of sub-underwriters. For these reasons, we think it would be appropriate to treat placing agreements as separate from the other forms of supply of underwriting services for the purpose of determining whether any complex monopoly situations exist.

(c) We were not aware of any practice that seemed likely to be the basis of a complex monopoly situation in relation to placing agreements.

2.35. No one who commented on our findings suggested that we should include placing. So for new issues by listed companies, we conclude that the view we took in our provisional findings is the right one.

2.36. As we said in paragraph 2.6, certain types of IPO, namely offers for sale and offers for subscription, appear to have used standard fees. For this reason we included IPOs in the group of issues covered by our provisional findings. However, in the period 1995 to 1997, we did not find any evidence of the use of offers for sale or subscription. Many parties told us that this type of IPO was a thing of the past. IPOs were now normally made by a placing, often involving book building (see paragraph 3.31*(c)*).

2.37. Consequently we decided to exclude IPOs from the calculation of share of supply, for the same reasons as we excluded placing agreements for new issues by listed companies (see paragraph 2.34). We were not aware of any other practice that seemed likely to be the basis of a complex monopoly situation in relation to these types of IPOs. For similar reasons we decided to exclude secondary offers.

2.38. Thus the relevant group of issues for our purposes becomes rights issues, open offers and cash underpinnings. Table 2.1 shows share of supply of underwriting services based on this group of issues for the 1995 to 1997 period. It shows that lead underwriters who used standard fees for over 25 per cent (by value) of their underwriting fees (our criterion for membership of the group whose conduct prevents, restricts or distorts competition—see paragraph 2.20) had a share of supply of 89 per cent in 1995 to 1997.

Conclusions on complex monopoly situations

2.39. Section 10(2) of the FTA provides that 'No account shall for those purposes be taken of any provisions of an agreement in so far as they are provisions by virtue of which it is an agreement to which the Act of 1976 applies'. The 'Act of 1976' is the Restrictive Practices Act 1976. We have seen no evidence of there being such an agreement in relation to fees for underwriting services.

2.40. We have found that:

(a) at least one-quarter of lead underwriting services supplied in the UK are supplied by members of a group of lead underwriters who engage in the practice of charging standard fees for the underwriting of rights issues, open offers and cash underpinnings (see Table 2.1 and paragraph 2.38);

(b) at least one-quarter of sub-underwriting services in relation to rights issues, open offers and cash underpinnings supplied in the UK are supplied for members of a group of lead underwriters who engage in the practice of paying standard fees to sub-underwriters (see Table 2.1 and paragraph 2.38);

(c) the services of sub-underwriters at standard fees are procured by brokers on behalf of the lead underwriters (see paragraph 2.11); and

(d) for the reasons given in paragraph 2.30, the practices referred to in *(a)* and *(b)* above prevent, restrict or distort competition.

2.41. We conclude accordingly that at least one-quarter of lead underwriting services supplied in the UK are supplied by members of a group of lead underwriters who so conduct their affairs as to prevent, restrict or distort competition by charging standard fees either for underwriting services or for underwriting and other services.

2.42. We also conclude that a second complex monopoly situation exists in relation to the supply in the UK of sub-underwriting services. At least one-quarter of sub-underwriting services supplied in the UK are supplied for members of a group of persons who so conduct their affairs as to prevent, restrict or distort competition by paying standard fees to providers of sub-underwriting services. Members of this group include both lead underwriters who pay standard fees and brokers who procure sub-underwriting services at standard fees on behalf of these lead underwriters.

2.43. We further conclude that the first complex monopoly situation is in favour of lead underwriters who charge standard fees because this enables them to pay the standard fee to sub-underwriters, which reduces their underwriting risk by helping them to procure sub-underwriting. The second complex monopoly situation is in favour of this group of lead underwriters for the same reason and is in favour of brokers who procure sub-underwriting for lead underwriters at standard fees because it strengthens their commercial relationships with sub-underwriters (see paragraphs 2.57 and 2.58). The second complex monopoly is also in favour of sub-underwriters who receive standard fees because they benefit from these fees being higher than they otherwise would be (see paragraph 2.32).

2.44. In order to consider the implications of the complex monopoly situations for the public interest, we need to examine the markets for underwriting services. We do so in paragraphs 2.45 to 2.77; we turn to the remaining questions in our terms of reference in paragraph 2.78.

The markets for underwriting services

Definition

2.45. The definitions of the economic markets relevant to our inquiry are discussed in paragraphs 4.11 to 4.19. In summary, we are concerned with the following two UK markets:

(a) the market for the services of corporate financial advisers and brokers in connection with rights issues, open offers and cash underpinnings, of which underwriting services provided by lead underwriters and brokers are a part; and

(b) the market for sub-underwriting in connection with rights issues, open offers and cash underpinnings.

2.46. The definitions of these two markets are based primarily on considerations of demand-side substitution. Considerations of supply-side substitution could lead to much wider definitions. For example, a financial adviser engaged mainly in providing advice on debt issues could diversify without difficulty into rights issues. However, it seemed to us that wider market definitions would introduce factors that had no bearing on the provision of underwriting services and would make no difference to our conclusions. We therefore decided to use the definitions summarized in the previous paragraph.

2.47. We considered whether it would be appropriate to define separate markets by reference to the size of the issuing company. We were told by several parties of the special problems faced by smaller listed companies in raising equity and we will refer to this point several times in the course of this chapter. However, although the problems of smaller companies deserve special consideration, we do not think it would be sensible to treat them as comprising a separate market for share-issuing services. There is no generally agreed definition of what constitutes a 'smaller' listed company (we heard of several different definitions in the course of our inquiry; for example, CISCO, an association representing smaller listed companies, defined them as those outside the FTSE 350, which is broadly equivalent to a market capitalization of less than about £300 million; some other parties used lower figures) and company size is a spectrum without clear break points. Although financial advisers frequently specialize in one part of the market, there is a continuous chain of substitution.

Financial advisers and lead underwriters

2.48. Corporate financial advice is provided by investment banks, corporate brokers, integrated houses (those providing both banking and broking functions), some accountancy firms, particularly the bigger ones, some solicitors and small so-called 'boutique' advisers. With very few exceptions lead underwriting is provided by firms also offering financial advisory services but not all financial advisers have the capital to act as lead underwriters. The largest firms (measured by lead underwriting fees earned) are listed in paragraph 4.27 and market shares in 1995 to 1997 are given in Table 4.7.

2.49. The main requirement for entry as a financial adviser is a reputation for giving good advice. However, such a reputation might be based on the experience and credibility of the individuals providing the advice, rather than the firm having a long-established reputation. Financial advisers who wish to act as lead underwriters will also require sufficient capital (both a practical and a regulatory requirement). There was agreement among those who gave us evidence that the market was a relatively open one. Several large

overseas banks have entered it in recent years and although many of them did so by buying existing UK firms, some (for example, Morgan Stanley Group (Europe) PLC (Morgan Stanley) and Goldman Sachs International) did not. At the other end of the spectrum, we were told about new financial advice boutiques that had been set up, although they did not provide lead underwriting services.

2.50. Financial advisers who gave us evidence all insisted that their market was vigorously competitive and, by and large, this assessment was supported by their customers. Large companies told us that they experienced strong competition from financial advisers to win their business and in our survey of companies (see Appendix 2.2) which had made share issues in the 1995 to 1997 period (predominantly medium-sized or smaller listed companies), 64 per cent said that they experienced at least some such competition. However, several smaller companies told us that it had been difficult for them to find any financial advisory firm at all which was willing to act for them, and CISCO confirmed that smaller companies find it more difficult than larger ones to procure financial advice. The root of the problem appears to be that many small companies are not financially attractive to potential advisers. Financial advisers told us that there were certain companies to which it would not be profitable for them to provide services.

2.51. We examined whether the nature and strength of the relationship between a company and its financial adviser might inhibit competition. In particular, we considered whether there was a tendency for companies to keep the same financial adviser for a very long time and whether switching costs inhibited a change of adviser. We heard from several financial advisers that it was no longer normal practice for companies to keep the same financial adviser for long periods. Our questionnaire to companies indicated that about 75 per cent of financial advisers and brokers used by respondent companies had served for a period of five years or less. Responses to our questionnaire to investment banks and brokers (see Appendix 2.3) also suggested a fair degree of turnover of clients. We also found that larger companies often had more than one adviser. We were told that increasingly companies would engage a particular financial adviser for a specific transaction, frequently in addition to their normal financial advisers.

2.52. 70 per cent of respondents to our questionnaire for companies said that it was not difficult to change financial advisers and brokers, although some of these also said that care needed to be taken over the market reaction to a change. We think an adverse market reaction is more likely to be a problem for smaller companies than for large ones with well-established reputations. Market reaction apart, none of those giving us evidence identified significant switching costs.

2.53. Financial advisers themselves thought that companies could normally replace them with impunity provided they were not in the middle of a transaction at the time. We were told that to change a financial adviser during a transaction would normally be difficult. This suggests to us that although competition to become a financial adviser may be vigorous in normal circumstances, it is likely to be more muted in the critical period when underwriting fees are being settled. However, the point should not be over-stressed; financial advisers are sometimes changed when plans for a share issue are well advanced. This occurred during our inquiry in the Monument Oil and Gas plc (Monument) rights issue. In other cases a change may be necessary because the financial adviser is faced with a conflict of interest, for example in a takeover situation.

2.54. We also considered the extent to which companies were dependent on their financial advisers. It was put to us that for most companies a share issue was a rare or very rare event and that finance directors might therefore believe themselves to be in a weak position

to argue with their advisers. Again, we thought this was likely to be a problem primarily for smaller companies. Some 85 per cent of respondents to our questionnaire for companies said that they were reliant on their financial adviser/broker for the method, pricing and other aspects of a share issue. However, most also said that they sought advice from a variety of other sources including non-executive directors, accountants and lawyers. It was also put to us that as companies frequently employed separate financial advisers and brokers, they had in effect two independent sources of financial advice.

Corporate brokers

2.55. The role of the broker in the provision of underwriting services is to procure sub-underwriters on behalf of the lead underwriter. This represents only a small part of their total business. The main brokers engaged in providing underwriting services are listed in paragraph 4.28 and market shares in 1995 to 1997 are shown in Table 4.8.

2.56. The competitive position among brokers appeared to us to be broadly similar to that among financial advisers: indeed, very often the same firms are involved. In many cases the foreign banks which have entered the UK financial advisory market in recent years have also entered the corporate broking market. In addition, Schroders, a traditional name in UK merchant banking and financial advice, has recently developed a broking business. Most of the comments made by respondents to our questionnaire for companies about financial advisers also applied to brokers. 58 per cent of them had experienced competition among brokers. However, some respondents suggested that finding brokers to act for small companies was even more difficult than finding financial advisers, which suggests that there is less competition for the broking business of smaller companies. Unlike financial advisers, brokers were rarely engaged only for a specific transaction.

2.57. For their role in the underwriting process, brokers need to establish a relationship with institutional investors, who provide the great majority of sub-underwriting (see paragraph 2.60). We asked various parties, both brokers and institutional investors, whether a new entrant broker would find it difficult to win underwriting business because it lacked the necessary relationships with institutional investors. The general view was that this was not a major barrier to entry. Nevertheless we note that some brokers are very unwilling to reveal their sub-underwriting lists because they consider them to be commercially confidential. We were told that the information contained in such lists was a source of competitive advantage. To the extent that this is true, new entrants would be at a disadvantage.

2.58. We also considered whether the relationship between brokers and institutional investors was one of mutual favours, with brokers giving sub-underwriting opportunities preferentially to those institutional investors who put most business their way. Some brokers agreed that they preferred to offer sub-underwriting to their own institutional clients but said that this was in everyone's interests. A broker would be more likely to get an issue successfully sub-underwritten if it dealt with its own clients; failure to have its issue underwritten was bad news for the company. About 95 per cent of respondents to our questionnaire for fund managers (see Appendix 2.4) said that they would expect to have regular business dealings (other than sub-underwriting) with brokers who offered them the opportunity to sub-underwrite.

2.59. The relationship between brokers and institutional investors could restrict competition between brokers if it were exclusive, that is if an institutional investor on one broker's sub-underwriting list would not take sub-underwriting from any other broker. We saw no evidence of this occurring. Institutions typically accept sub-underwriting from many different brokers. Although it is the case that companies such as Morgan Stanley (which

entered the UK market without buying an existing UK broker) do little traditional underwriting business and are critical of the way the UK share-issuing process works, the basis of their criticism concerns pre-emption rights (discussed in paragraphs 2.70 to 2.76). It appears that they have made little effort to break into the traditional underwriting market, rather than that they have been prevented from doing so.

Sub-underwriters

2.60. The great majority of sub-underwriting is undertaken by institutional shareholders such as pension funds, life assurance companies, unit trusts and the like. Many of the funds are managed by fund managers who accept sub-underwriting on behalf of their clients in accordance with the terms of a formal mandate. Fund managers may apply to their regulator, the Investment Management Regulatory Organisation Limited (IMRO), for permission to sub-underwrite on their own account. Very few such applications are made. IMRO told us that out of a total of 293 IMRO-regulated firms with permission to conduct underwriting or sub-underwriting, only 14 had permission to do so on their own account.

2.61. The largest fund managers and the value of the UK equities they managed on 31 December 1997 are shown in Table 5.1. Sub-underwriting market shares in 1995 to 1997 are shown in Table 5.2.

2.62. Procedures employed in the sub-underwriting market underwent important changes during the 1995 to 1997 period, following pressure by the DGFT (see paragraphs 2.2 to 2.4). Prior to October 1996, brokers (acting on behalf of lead underwriters) normally offered sub-underwriting to institutions for the standard fee. In October 1996 Schroders sought tenders for part of the sub-underwriting for a rights issue by Stakis. Since this innovation, tendering for at least part of the sub-underwriting has become common for larger rights issues. In all cases any reduction in the sub-underwriting fees achieved has been passed on by the lead underwriter to the issuing company. Details of the tendering process are described in paragraphs 5.23 to 5.29; we discuss its impact in paragraphs 2.101 to 2.107.

2.63. Before the introduction of tendering, entry into the sub-underwriting market was in principle constrained by the fact that sub-underwriting could be obtained only through an invitation from a broker. Tendering has changed this situation only to a limited extent. A few tenders (notably that for the Berkeley Group plc (Berkeley) issue in October 1997) were open to a wider range of financial organizations; but most tenders have involved brokers inviting traditional sub-underwriters to bid.

2.64. In practice this constraint does not appear to have constituted a serious barrier to entry. None of those who replied to our questionnaire for fund managers said that they had been prevented from sub-underwriting. One of them (a US company with a London office) said that when it began to develop a UK client base it had obtained sub-underwriting for its clients after notifying brokers of its wish to do so. We were also told about a self-managed pension fund located outside London that had been able to obtain sub-underwriting by approaching brokers even though it had not previously been on their sub-underwriting lists. We have received no complaints from any other organization about exclusion from the market. Those tenders which were opened up more widely attracted few bids from organizations other than traditional sub-underwriters.

2.65. Brokers told us that in general they welcomed an enlargement of the group of potential sub-underwriters, because that made their job of arranging the sub-underwriting easier. However, they did mention some restrictions they would want to apply, the most

important of these being that any potential sub-underwriter should be someone who could be relied upon to meet their obligations in the event of being required to take up shares. Many brokers also mentioned a preference for giving sub-underwriting to 'natural holders' of the shares in question, to avoid the problem of sub-underwriting stick being dumped on the market at the earliest possible opportunity to the detriment of the share price.

2.66. The fact that sub-underwriting is normally obtained by invitation from brokers means that the opportunity to sub-underwrite, even with most tenders, is not widely canvassed (although tenders are often announced on the Regulatory News Service of the LSE). Thus there is an information barrier to entry by non-traditional sub-underwriters although, as we have said, we have not identified anyone who believes they have been adversely affected by this. A more serious barrier is the legal and regulatory constraints on overseas institutions. For example, US pension funds and some mutual funds are prevented, by US law, from engaging in sub-underwriting.

2.67. It is clear that before the introduction of tendering there was almost no competition between sub-underwriters over the level of fee, although there were occasional examples of sub-underwriters offering their services for less than the standard fee. For example, in June 1996 Mercury Asset Management (MAM) arranged on behalf of a number of its clients the sub-underwriting of an entire issue by Cairn Energy for a fee of 0.5 per cent. Such offers were not always accepted. We were told that MAM and PPM had together offered both a reduction in the sub-underwriting fee and a reduction in the issue price discount for an issue in mid-1996 but that their offer had not been accepted by the broker. These exceptions apart, we cannot discern any form of competition between sub-underwriters in the period before tendering and the majority of respondents to our questionnaire for fund managers took the same view.

2.68. Tendering has changed this position. Since the Stakis issue in October 1996 there has been fee competition for most of the larger issues, albeit constrained by the way that tenders have been organized. For example, for most of them only part of the sub-underwriting has been offered for tender and in no case has there been an opportunity to bid for a fee higher than the standard rate.

Conclusions on the extent of competition

2.69. On the basis of the evidence considered in paragraphs 2.48 to 2.59, it is our view that competition among financial advisers and among brokers is reasonably vigorous, although less strong for smaller companies and when a transaction is taking place. Before the introduction of tendering there was little discernible competition among sub-underwriters. Nevertheless there is no indication that there is a significant group of potential sub-underwriters which has been prevented from entering the market.

Pre-emption rights

2.70. Pre-emption rights condition the way in which shares are issued by listed companies in the UK and hence influence the market for underwriting services. They have proved to be by far the most controversial aspect of our inquiry. In this section we describe pre-emption and the views of its defenders and critics. In paragraphs 2.134 to 2.137 we consider the public interest aspects, in so far as they relate to our terms of reference, and in paragraphs 2.161 to 2.165 we discuss a possible remedy involving changes to the application of pre-emption rights.

2.71. Pre-emption rights require that existing shareholders be offered new shares in a company before they are allotted to anyone else. This principle is enshrined in the Companies Act 1985 (the Companies Act), section 89(1), and in EC law (Second Company Law Directive). Pre-emption rights may be waived either in the articles of association or by a special resolution of shareholders requiring a 75 per cent majority. Such waivers may be for a particular share issue or generally for all issues. The maximum period for which they may be granted is five years.

2.72. A body called the Pre-emption Group (see paragraph 3.14), which includes representatives of institutional investors, companies and investment banks, issues guidelines ('the pre-emption guidelines') about the disapplication of pre-emption rights. Its main points are:

(a) Shareholders should agree to a general waiver of their pre-emption rights provided that the amount to be issued non-pre-emptively does not exceed 5 per cent of issued share capital in any one year or 7.5 per cent over a rolling three-year period.

(b) The discount for a non-pre-emptive share issue should not exceed 5 per cent.

These guidelines, which are set out in full in Appendix 3.1, have no legal force but are nevertheless generally followed.

2.73. Defenders of pre-emption rights see them as a fundamental right of ownership. They point out that, in their absence, company management would be able to dilute both the wealth and the control over the company of existing owners by issuing shares to third parties at a discount to the market price. Most critics do not object to the rights in themselves but believe that the guidelines are too restrictive.

2.74. The pre-emption guidelines are strongly supported by most institutional investors, their associations and representatives of small shareholders. Financial advisers and brokers are strongly divided in their views. Some firmly support the guidelines; others, particularly some US investment banks, are fiercely critical. The views of companies are mixed. The Confederation of British Industry (CBI) told us that there was a strong case for an increase in the 5 per cent limit, whereas the Association of Corporate Treasurers (ACT) supported the existing guidelines. We received relatively few submissions from individual companies actively pressing for a loosening of the guidelines but when we asked in our questionnaire for companies whether it would matter if the guidelines were loosened, 67 per cent of respondents said that it would not and a further 23 per cent said that loosening would be beneficial.

2.75. Towards the end of our inquiry Morgan Stanley drew our attention to the results of a MORI poll that it had jointly commissioned with The General Electric Company plc of the views of the Finance Directors of the 1,000 largest UK companies. In response to a question whether the pre-emption guidelines were a restriction on their choice of action, 78 per cent of respondents said that they were, although 36 per cent said that the restriction was a minor one. 71 per cent agreed that their choice of share-issuing options should be less restricted than at present.

2.76. The typical method used by listed companies to issue new shares in the UK is the rights issue, and the effect of the guidelines is to make it difficult for companies to use other methods except for relatively small issues. Defenders of the guidelines argue that rights issues are cheap by international standards (see paragraph 3.61 for issuing costs in other countries), effective, and, of course, fair to existing shareholders. Most critics acknowledge

that rights issues are beneficial in some circumstances but say that the pre-emption guidelines reduce choice and flexibility by pushing companies into making rights issues when another issuing method could be more appropriate.

2.77. Morgan Stanley put to us a particularly thoroughgoing critique of the UK share-issuing process. Its main lines were as follows (a more detailed account is given in paragraphs 6.277 to 6.296):

(a) The investor base in the UK was highly concentrated, facilitating a degree of communication between institutional investors and co-ordination of their interests to a greater extent than in other countries.

(b) Over half of the UK market by value was accounted for by pension funds and insurance companies for which solvency was an overriding imperative. This contrasted with the US market, where individuals accounted for a much larger share.

(c) UK institutions had a high ratio of equity to debt in their portfolios, leading them to look to dividends to provide an income stream. This created a bias in favour of investments which produced dividends over those which produced capital growth.

(d) Because of the way that pre-emption rights were applied, companies were tied to their existing shareholder base. This suppressed competition for the provision of capital and denied companies access to alternative investors with a greater growth orientation who might therefore put a higher value on longer-term, higher-risk growth opportunities.

(e) Claims that rights issues were cheap failed to take account of the cost of the discount. This was a real cost because dividends were not usually adjusted to take account of the scrip element of the issue (indeed institutions discouraged companies from making such adjustments) and because shareholders who sold their rights did not receive anything like their full value. Other share-issuing methods, particularly book building, achieved much lower levels of discount.

(f) It was illogical to insist that shareholders be consulted about issues for cash of over 5 per cent of equity when companies could issue shares up to 25 per cent for acquisitions without consulting shareholders.

Much of this case goes well beyond our terms of reference but the arguments about pre-emption rights are in line with what some other parties told us. We return to them in paragraphs 2.161 to 2.165.

Public interest questions

2.78. As we have concluded that two complex monopoly situations exist and identified the persons in whose favour they exist, our terms of reference direct us to answer the following three questions:

(a) whether any steps (by way of uncompetitive practices or otherwise) are being taken by those persons in whose favour the monopoly situation exists for the purposes of

exploiting or maintaining the monopoly situation and, if so, by what uncompetitive practices or any other way;

(b) whether any action or omission on the part of those persons is attributable to the existence of the monopoly situation and, if so, what action or omission and in what way it is so attributable; and

(c) whether any facts found by us operate, or may be expected to operate, against the public interest.

Fees of lead underwriters and brokers

2.79. The first complex monopoly situation we found to exist involved the charging of a standard fee by lead underwriters. The fee concerned is the 2 per cent commission (for 30 days) that lead underwriters charge issuing companies. As described in paragraph 2.12, this fee is divided up by lead underwriters according to a formula: 0.5 per cent is retained by the lead underwriter itself; 0.25 per cent is paid to the broker; and 1.25 per cent is paid to the sub-underwriters. We conclude that these payments are actions by the lead underwriter (being a person in whose favour the first complex monopoly situation exists) attributable to the existence of the monopoly situation in that the lead underwriter charges the 2 per cent fee with the intention of so dividing it up.

2.80. In the remainder of this section we consider whether there are any facts relating to the lead underwriter's own share of the fee and to the broker's share of the fee which operate against the public interest. In the next section we do the same for the sub-underwriters' fee.

2.81. During our inquiry we considered whether the lead underwriter's and broker's fees were higher than they would have been if standard fees did not exist. We found it hard to answer this question directly for two reasons:

(a) Financial advisers who act as lead underwriters and brokers do not treat the underwriting services they provide as a separate business for accounting purposes and do not attempt to allocate costs to this activity. Hence it is impossible to say what part of the overall profits of financial advisers and brokers are attributable to the provision of underwriting services.

(b) Both fees may cover a range of different services which differ from case to case. The lead underwriter's fee will always cover the element of underwriting risk borne by the lead underwriter set out in paragraph 2.13. It may also cover documentation and advice in connection with the share issue and even general advice provided by the financial adviser over a long period which has not been separately charged. The broker's fee will always cover the arrangement of sub-underwriting but may cover other broking activities not separately charged.

2.82. It appears that the standard fees retained by lead underwriters and paid to brokers are artificial constructs. We were told that financial advisers and brokers usually take a view on the cost of all the work they have done for their company and negotiate with the company about fees on that basis. The standard underwriting fees are treated as contributions to total remuneration. Where a share issue is not accompanied by another transaction (for example, an acquisition) and the company concerned does not need much advice, the standard underwriting fees may be all that are charged. But in more complex cases or with an inexperienced company that required a lot of help, advisory or other fees are often charged in addition.

2.83. We have already looked at competition between financial advisers and between brokers (see paragraphs 2.48 to 2.59), and reached the view that it is reasonably vigorous. That being so, we see no grounds to conclude that the underwriting fees earned by lead underwriters and brokers (ie 0.5 per cent and 0.25 per cent respectively) are higher than they would be in the absence of standard fees.

2.84. We looked at the more readily available data on share-issuing fees in other countries. In the USA, for which we have the most data, issuing costs averaged 4.1 per cent, against 2.8 per cent for UK rights issues in our sample (that is, the total cost including sub-underwriting and financial advice). International comparisons need to be treated with a great deal of caution because of the special features of the various markets involved, but we take a little comfort from the fact that fees in the UK are not high compared with those elsewhere (see paragraphs 3.58 to 3.61).

2.85. Given the difficulty that we had in linking services provided to fee charged, we considered whether the lead underwriting fee was unnecessarily opaque and whether this operated against the public interest. Some lead underwriters insisted that their clients knew exactly what they were paying for but we do not find this convincing, at least as a general proposition. When we asked lead underwriters what services their fee covered, the answers we received were varied and often vague.

2.86. However, although we think that these fees should be more transparent, it does not follow that the present arrangements operate against the public interest. The customers involved in these transactions are not naive consumers. Negotiating prices for services is a normal business activity and if companies believe that they need more information in order to get a good price, we would expect them to demand it. 68 per cent of respondents to our questionnaire for companies believed that the fees they had paid represented value for money. In the responses to our questionnaire for companies, we received many more adverse comments about the fees of lawyers and accountants (in connection with share issues) than we did about underwriting fees.

Sub-underwriting fees

2.87. Concern that sub-underwriting fees were too high was one of the principal reasons why the DGFT referred underwriting services to us. In this section we discuss first the evidence about the level of sub-underwriting fees, then consider whether the introduction of tendering has removed any adverse effects of the traditional arrangements, and finally examine any benefits that the use of standard fees might provide.

The level of standard fees

2.88. There are three sources of evidence relevant to the question whether the use of standard fees results in sub-underwriting costs being higher than they otherwise would be: *ex-ante* calculations based on the use of the Black-Scholes formula; data on the actual returns of sub-underwriters; and the results of tendering. We deal with each in turn.

2.89. Professor Marsh treated sub-underwriting as a put option and used the Black-Scholes formula to value it in his work on sub-underwriting returns referred to in paragraph 2.2. A summary of his findings and of the criticisms of his methodology is given in paragraphs 5.49 to 5.68. The most radical criticism of Professor Marsh's work was that the Black-Scholes formula could not be applied to sub-underwriting because it assumed that the

transaction costs of a put option were negligible whereas in fact the cost of hedging sub-underwriting risk would be very high indeed as a result of the large volume of shares involved. This criticism took it as axiomatic that the application of the Black-Scholes formula required hedging costs to be taken into account. Professor Marsh denied this assumption. He observed that sub-underwriters did not hedge their risk in practice and claimed that it was therefore unnecessary to take account of hedging costs. In his view the Black-Scholes formula could be treated as a valuation method and its validity did not depend upon assumptions about hedging.

2.90. Professor Marsh's view seems a reasonable one if the Black-Scholes formula is treated as a method by which a company could estimate the value of sub-underwriting to its shareholders and compare it with the underwriting fees being charged by its investment bank. The net cost of the sub-underwriting (amount charged less Black-Scholes value) could then be compared with the benefits of underwriting such as the certainty provided. This use of Black-Scholes is comparable with the use of discounted cash flow to value projects. Professor Marsh put the formula to a different use, however, namely to estimate the profits of sub-underwriting. This raises the question of the costs incurred in carrying out sub-underwriting. Professor Marsh assumed that they were zero but this is most unlikely to be correct, a point which he accepted in relation to operational costs.

2.91. The costs may include:

(a) operational costs incurred in sub-underwriting (see paragraphs 5.32 to 5.34); and

(b) larger underwriting losses than would otherwise be expected, due to underwriters being less well informed about the issuing company than the company's managers (asymmetric information).

A study by Francis Breedon and Ian Twinn[1] treated the bid-ask spread on traded options as a proxy for these costs. Using this method (together with some other changes to the approach taken by Professor Marsh) they concluded that sub-underwriters made excess returns but that the value of the excess was appreciably smaller than that calculated by Professor Marsh. However, as there have been only a small number of rights issues by companies for which there are traded options, the available evidence is very limited.

2.92. Critics of the use of the Black-Scholes formula to calculate sub-underwriting returns argued that Breedon and Twinn had taken inadequate account of the large size of sub-underwriters' commitments compared with option trades and thus had understated the necessary adjustment. On the other hand, Professor Marsh argued that it was inappropriate to apply bid-ask spreads for traded options to sub-underwriting as sub-underwriters did not face the same sort of information asymmetry as market makers in traded options.

2.93. Other criticisms have been made of Professor Marsh's *ex-ante* calculations, of which two are of particular importance. The first concerns the assumption underlying the Black-Scholes formula that returns on shares are distributed normally around the mean return. In fact large movements in share prices occur more frequently than is compatible with this assumption. This implies that the effect on sub-underwriters of events like the 1987 crash are not adequately reflected in estimates of the value of sub-underwriting derived from Black-Scholes. Professor Marsh accepted this criticism but he dealt with it only by pointing to *ex-post* estimates of sub-underwriting losses.

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[1]F Breedon and I Twinn, 'The valuation of sub-underwriting agreements for UK rights issues', *Bank of England Quarterly Bulletin*, May 1996.

2.94. The other major criticism concerns the assumptions about the volatility of returns on shares used by Professor Marsh. He used the monthly volatility in the 60 months prior to the rights issue as a proxy for the volatility during the rights period and gave evidence to show that this estimate is on average greater than actual daily volatility in the rights period. However, the position for individual shares varied considerably: in some cases issue-period volatility was much higher than the 60-month historical volatility. This has two consequences:

(a) As there is a non-linear relationship between volatility and Black-Scholes option value, strictly no conclusions can be drawn from a comparison of average volatility. However, Professor Marsh told us that further analysis of his data showed that substituting the measured volatility during the issue period for the 60-month historical average made only a small difference to the results (see paragraph 5.67*(a)*).

(b) Sub-underwriters face additional risk (about volatility over the issue period), the costs of which are not included in Black-Scholes option values.

2.95. The logic of Professor Marsh's approach is that the additional risk referred to at *(b)* is not costly because it is 'non-systematic', ie not correlated to market risk and hence diversifiable. The critics of Professor Marsh maintained that in practical situations such as underwriting a rights issue, investors were concerned about all types of risk and that the cost could be established only if the cost of hedging against all risk could be measured.

2.96. The problems with Professor Marsh's *ex-ante* approach are such that his conclusions about the excess returns earned by sub-underwriters must, in our view, be treated with caution. One of us thought the balance of argument was in favour of his findings but the majority of us did not.

2.97. The data relevant to actual sub-underwriting returns are set out in paragraphs 5.35 to 5.48. Professor Marsh has calculated that in the 1986 to 1996 period (including the 1987 crash) underwriters received fees equal to 1.43 per cent of issue costs and sustained losses of 0.53 per cent, giving them a margin of 0.9 per cent. Critics have reduced this figure by identifying sub-underwriting costs not included by Professor Marsh in his calculations. In particular, some sub-underwriters argued that these costs should include an equity risk premium, reflecting the additional return that could be earned through the underwriting period on equities as compared to cash. Against this it could be argued that sub-underwriters did not need to cover their underwriting commitment with cash so the size of the premium was not relevant. The equity risk premium over the period 1986 to 1996 was somewhat uncertain but its inclusion might reduce excess returns by 0.3 to 0.5 per cent. In addition, it was put to us that operational costs, possible tax payments and risk compensation for crashes should also be included in the calculation.

2.98. Interpretation of the actual returns therefore depends critically on the view that is taken of risk compensation. If it is thought that funds engaged in sub-underwriting require cash to be held against underwriting commitments and also require extra compensation for the risk of large underwriting losses at the time of stock market crashes, then the level of actual returns could appear reasonable. If one or other of these factors is not accepted, some element of excess returns remains likely. We think the balance of probability is that some excess returns were earned in 1986 to 1996. Since late 1996 (that is, since the introduction of tendering for sub-underwriting) there have been too few issues on which to base an *ex-post* assessment of whether or not excess returns continue to be earned.

2.99. Our third source of evidence about whether standard fees led to the cost of underwriting being higher than it otherwise would be is the results of tendering between October 1996 and the end of 1997. The figures show (see Appendix 5.1) that the actual sub-underwriting costs for 27 tendered issues within that period were 1.21 per cent; had standard fees been charged the cost would have been 1.42 per cent. This appears to show that the introduction of competition in the sub-underwriting has produced significant savings, though not on the scale implied by Professor Marsh's *ex-ante* calculations. However, the following points were put to us:

(a) Only the stronger issues were tendered. Over 30 rights issues in the same period were not tendered and they were generally those of smaller companies for whom the underwriting risk was greater.

(b) The market conditions in this period were favourable. (These favourable conditions continued in the first half of 1998, when we collected most of our evidence, but in the second half the market became volatile and bearish. There were several examples of underwriting stick.)

(c) The reduced fees for the tendered issues reflected deeper discounts for these issues.

2.100. The third of these claims was not supported by the evidence. The average discount for the tendered issues was 11.7 per cent which is not more than the average discount for issues sub-underwritten at standard fees. The other two points might have some validity but even if they do, the outcome of tendering still indicates that for many companies in the right market conditions, the use of standard fees results in sub-underwriting costs being higher than they otherwise would be. We conclude that, at any rate up to October 1996, the use of standard fees resulted in sub-underwriting fees in many cases being higher than they would have been with greater competition.

Effects of tendering

2.101. Between the end of October 1996, when tendering of sub-underwriting was first tried, and the end of 1997, there were 28 tendered rights issues, of which 27 reached completion. Although there were more non-tendered rights issues, the latter were on average substantially smaller, so that 78 per cent of sub-underwriting fees for rights issues were on a non-standard basis, mainly as a result of tendering (see Table 5.3). In all but three of the tendered issues, tendering was not for the whole of the sub-underwriting: on average, over all 27 completed issues, the tendered proportion was 53 per cent. Further details of tendering are given in paragraphs 5.25 to 5.29 and Appendix 5.1.

2.102. It has been put to us strongly that whatever view one took about the merits of the old system of standard fees, it had now gone for good. The tendering of sub-underwriting was irrevocable and would develop without further action by the competition authorities partly because of competition between financial advisers and partly because companies would insist that their financial adviser discussed with them alternatives to paying standard fees.

2.103. We are not convinced by this argument for the following reasons:

(a) The use of standard fees has a long history. No one we asked was quite sure when it began but the general view was that it dated back at least as far as the early 1970s. It

seems premature to conclude that such a long-standing practice has now gone for good.

(b) Where tendering has been used for part of the sub-underwriting, standard fees have been used for the remainder, suggesting a continued predisposition to use these fees on the part of lead underwriters.

(c) There has been only a limited number of cases of tendering so far, partly reflecting the relatively few rights issues since October 1996. Moreover, as many parties have pointed out to us, market conditions were favourable in the October 1996 to December 1997 period. We do not believe that this limited number of cases provides sufficient evidence of a permanent change of practice.

(d) Experience in the first half of 1998 (when market conditions continued to be benign) suggests that it would be wrong to be complacent about the continued use of tendering. In that period, slightly under half of the money raised in rights issues was from issues in which the sub-underwriting was non-standard (reflecting the use of tendering or other unconventional methods—see Appendix 5.2), a substantially smaller proportion than that for the October 1996 to December 1997 period.

(e) The introduction of tendering, it seems to us, required a good deal of pressure from the DGFT notwithstanding the competition between financial advisers and the desire of companies to get the best deal. The behaviour of lead underwriters since tendering was first introduced had been influenced initially by the threat and subsequently by the existence of an MMC investigation. As standard fees benefit lead underwriters by making it easier for them to procure sub-underwriting, we believe that in the absence of this pressure, unless other action is taken, standard fees will be used in cases where the use of tendering would produce lower fees.

(f) In several of the cases in which sub-underwriting fees were only partially tendered, bids at below standard rates were received for more than the amount put out to tender. This indicates that in these cases a higher proportion of tendered sub-underwriting would probably have produced lower fees, and suggests that the use of tendering has been cautious.

(g) There have been other aspects of tendering which appear to restrict its scope; in particular, most tenders have only been open to a relatively limited range of bidders. We doubt whether this will change without some external encouragement, given brokers' traditional preference for sub-underwriters they know (see paragraph 2.58).

2.104. In paragraph 2.100 we concluded that, at any rate up to October 1996, the use of standard fees resulted in sub-underwriting fees being higher than they would have been with greater competition. We now consider whether it results or might be expected to result in higher fees when subsequent events are taken into account.

2.105. We are in no doubt that prior to October 1996 there was a practice of using standard fees in the great majority of cases and that it clearly had effects that were against the public interest. Under pressure from the OFT, the industry then introduced a tendering system. But the practice of charging standard fees (without any element of tendering) has continued since October 1996. Only 28 out of over 60 sub-underwritten issues were tendered between October 1996 and December 1997 (and 5 out of 19 in the first half of 1998). Many members of the group we have identified have not used the tendering system at all or even been involved in underwriting since October 1996. Where tendering has been used, in all

but a few cases it has only been partial and invitations to bid have been restricted. Under partial tendering the overall fee is based partly on standard fees and we believe that this has led to fees being higher in some cases than they would have been had more of the sub-underwriting been tendered. Thus tendering has not so far opened sub-underwriting to full competition and we believe that fees have not been as low as they would have been had there been greater competition.

2.106. We also believe that, in the absence of further action, there will be times in the future when standard fees will be used for all of the sub-underwriting in cases where tendering would result in lower fees or for too large a part of the sub-underwriting in cases where tendering of a greater proportion would result in lower fees. The proportion of such cases may be expected to rise in the absence of pressures such as the existence of our inquiry. In the circumstances, we do not accept that the use since October 1996 of partial tendering for some issues prevents us finding that the practice of using standard fees has or may be expected to have effects adverse to the public interest.

2.107. We therefore conclude that:

(a) the group we have identified have a practice of using standard fees for all or some of the sub-underwriting for an issue; and

(b) that fact has or may be expected to have effects adverse to the public interest in that it results in some issuing companies being charged higher underwriting fees than would otherwise have been the case.

2.108. We now consider whether the use of standard fees has any benefits that outweigh these adverse effects.

Benefits of standard fees

2.109. It was put to us that standard fees had substantial practical benefits: they were simple, cheap and quick to administer, and they provided certainty, that is they enabled the issuing company to know exactly what it would have to pay and hence what net proceeds it would receive from its issue. The experience of the tendering process suggests that some of these benefits are more apparent than real; tendering has not in practice proved to be particularly costly or slow.

2.110. The benefit of standard fees in giving certainty to a company seems to us to be overstated. Provided a company knows in advance the maximum it will have to pay for its issue, it can be certain about the proceeds of the issue whether or not the fees charged are at a standard level. In all tenders so far (except for the Berkeley issue), standard fees have acted as a cap on the cost of sub-underwriting. In the absence of this cap, however, either the issuing company would not be sure of the maximum fee it would have to pay or this maximum would have to be guaranteed by the lead underwriter (ie the lead underwriter would have to take the risk of high bids by sub-underwriters) which would presumably increase the fee it charged for its own services.

2.111. It has also been put to us that standard fees have the considerable merit of having actually worked, that is they have delivered underwriting for issues of a wide range of riskiness in a wide range of market condition. The absence of standard fees could induce sub-underwriters to leave the underwriting market when conditions became adverse. We think that the problem of finding sub-underwriters in adverse market conditions is unlikely to be a serious one provided that discounts are deep enough to take account of greater market volatility.

2.112. A further possible benefit of standard fees is that they are helpful to small companies. Some parties put it to us that the system of standard fees had led, in effect, to a cross-subsidization of small companies by large ones, with the latter paying more for sub-underwriting than it was really worth to them and the former paying less. We have not seen convincing evidence that such cross-subsidization occurs and if it did its economic justification would be debatable. Nevertheless, we recognize that many small companies and their advisers do feel that standard fees give them some protection from having to pay more to raise capital.

2.113. Overall we think that the benefits of the practice of using standard fees are not sufficient to outweigh the adverse effects we identified.

Conclusions on sub-underwriting fees

2.114. We have found that the practice of using standard fees has effects adverse to the public interest (see paragraph 2.107). We have also found that those adverse effects are not outweighed by the benefits of the practice (see paragraph 2.113). We therefore conclude that:

(a) the group we have identified have the practice of using standard fees for all or some of the sub-underwriting for an issue; and

(b) that fact operates against the public interest in that it results or may be expected to result in some issuing companies being charged higher underwriting fees than would otherwise be the case.

Conflicts of interest

Possible conflicts of interest over share-issuing methods

2.115. One of the concerns expressed by the DGFT in his 1995 report was that financial advisers who also acted as lead underwriters had a conflict of interest. The financial adviser might be disposed to recommend the use of a share-issuing method involving underwriting in order that it could earn the lead underwriter's fee, when it would be in the best interests of the company to use some other issuing method. Relating this issue to our terms of reference we have first to decide:

(a) whether the recommendation by a lead underwriter in favour of the use of an issuing method involving standard fees (for example, an underwritten rights issue or open offer) is a step taken for the purposes of exploiting or maintaining the first complex monopoly situation; and

(b) whether such a recommendation is an action or omission on the part of the lead underwriter attributable to the existence of this monopoly situation.

2.116. To address these questions we considered first whether there was evidence to suggest that companies were, on the advice of their financial advisers, using conventionally underwritten share-issuing methods when alternative methods would be more beneficial to them; and second, whether financial advisers were gaining from their advice.

Deep discounting

2.117. The clearest example of an issuing method that appears on the face of it to have benefits for companies but is in practice rarely used is the non-underwritten deep-discounted rights issue. This involves setting the share issue price at such a deep discount to the market price that take-up of the issue by shareholders is virtually assured, making underwriting unnecessary and thus saving the issuing company the cost of the underwriting fees.

2.118. A variety of reasons were put to us why deep discounting was used relatively rarely. The main ones are as follows:

(a) A non-underwritten issue, however deeply discounted, did not give a company absolute certainty of proceeds. Where certainty was a primary requirement, as for example when the proceeds of the issue were to fund an acquisition, underwriting was often a more satisfactory way of guaranteeing the availability of funds than the alternatives, such as a bank facility.

(b) The market reacted adversely to deep-discounted issues because it took them as a signal that the company was unsure of the strength of its case, an association reinforced by the use of deep discounting for rescue rights issues.

(c) As a general rule companies wanted as small a discount as possible as they disliked seeing their share price fall more than was absolutely necessary.

(d) Companies were frequently unwilling to reduce their dividend per share to take account of the scrip element of a rights issue; with a deeply-discounted issue, failure to adjust dividends significantly increased the cost of raising equity.

(e) Deep-discounted issues put undue pressure on shareholders to take up their rights, because if they did not their ownership stake in the company would be materially diluted. They would also face the risk of losing wealth by being unable to sell their rights not taken up for their full value, because of imperfections in the market for these rights.

(f) Deep discounting posed a particular problem for major shareholders who did not want to take up their rights. If they tried to sell their rights after the start of official trading they would depress the share price but if they placed them before official trading started, then under LSE listing rules they were not permitted to receive more than half of the difference between the offer price and the theoretical ex-rights price.

(g) Shareholders who sold their rights could face a capital gains tax (CGT) charge on the proceeds, which would be larger with a deep discount.

2.119. Some of these objections to deep discounting seemed to us to lack cogency. A rights issue (at any level of discount) may be viewed as an issue of shares at the market price plus a scrip or bonus issue. With a deep-discounted issue the latter element is relatively larger. As scrip issues have no effect on the value of a company, some of the concerns about the impact of deep discounting on the share price seem misplaced.

2.120. Several of the objections to deep discounting concern its impact on shareholders. The evidence we received suggested that most shareholders were relaxed or even positive about the use of this method. The ABI and the NAPF have said that they welcome the wider

use of deep discounting and, in answer to our questionnaire for fund managers, 64 per cent of respondents expressed a favourable attitude towards it (20 per cent said that they did not favour it and the rest were neutral). The UK Shareholders' Association (UKSA), representing small shareholders, was also positive and although it mentioned the CGT issue, it did not see it as a major problem.

2.121. Clearly deep discounting is no panacea and there will be many occasions when a company is best served by having an underwritten issue. But the balance of advantage between these alternatives seems to us to be such that we would expect deep discounting to be used rather more than it actually is. A critical question for us is whether the main cause of its relative neglect is self-interested advice by financial advisers looking to pick up the lead underwriter's fee, or the preferences of company management.

2.122. On the whole, the evidence we have received points to the latter. There is no doubt that underwriting provides a level of certainty for companies which cannot be matched by any non-underwritten method. 82 per cent of respondents to our questionnaire for companies said that certainty was a very important factor in their choice of share-issuing method. No other factor was given anything like this level of importance. 62 per cent of respondents who had made rights issues in the 1995 to 1997 period said that their reason for having the issue underwritten was because they wanted certainty of proceeds.

2.123. Managers were also concerned about the level of discount for their rights issue, notwithstanding the fact that this should be a matter of indifference for their shareholders because they have the right to buy the new shares at the discounted price. 89 per cent of respondents to our questionnaire for companies said that they expressed a view to their financial advisers about the level of discount. Although many of these respondents gave no further details, those that did made it clear that they had argued for a smaller discount. Whether or not there are sound reasons for this view (it was put to us that small discounts benefited companies by signalling to the market that they had strong shareholder support), it is clear that it is a powerful psychological factor influencing company management and disposing them against deep discounting.

2.124. There is also a small but sometimes influential group of shareholders for whom deep discounting is unattractive. For example, individuals holding a sizeable proportion of the shares of the issuing company who do not want or cannot afford to take up their rights may be unable to sell them for their full value (for the reason given in paragraph 2.118*(f)*) and may be faced with CGT payments, even if they use the whole of the proceeds from selling some of their rights to take up the remainder (see paragraphs 2.171 to 2.174). Where such individuals are on the board of the issuing company (for example, as founder-directors) they are likely to be particularly influential in determining the share-issuing method.

2.125. Not unexpectedly, financial advisers denied that it was in order to earn lead underwriters' fees that they encouraged their clients to have their share issues underwritten. It was put to us that a financial adviser's reputation for offering good advice was far more valuable to it than any additional underwriting fees it might earn. It would not put this reputation at risk by offering self-serving advice. Given the extent of competition between financial advisers, we think that this is a fair point. If demand by companies for non-underwritten issues had been suppressed by self-serving advice from financial advisers, there would be an opportunity for a competitor (perhaps a financial adviser without a lead underwriting capacity) to expand its business by providing better advice and helping companies to save on underwriting fees. We have seen no evidence that this is happening.

2.126. Financial advisers are regulated by the Securities and Futures Authority Limited (SFA) whose rules require that a firm facing a conflict of interest may not provide advice on the transaction in question unless it takes reasonable steps to ensure fair treatment for its customer. The SFA told us that it had received no complaints about failure to comply with its conflict of interest rules in connection with advice about share issues.

2.127. It is far from clear that financial advisers would in fact lose a great deal if fewer issues were underwritten. We described in paragraphs 2.81 and 2.82 how various services could be remunerated by the lead underwriter's fee and how this fee was treated as a part of total remuneration. To the extent that this fee covers the cost of work other than underwriting, it is reasonable to suppose that in its absence, the relevant costs will be recovered by an increased advisory fee. While it is true that the charge for underwriting proper would be lost, it is unclear to us (and we suspect to lead underwriters themselves) just how profitable this is on its own.

Other issuing methods not involving standard fees

2.128. We considered whether there were issuing methods not involving standard fees, other than deep discounting, which might in principle be under-utilized as a result of actions attributable to the complex monopoly situations. We identified placing (without clawback) as a possible example, both in its traditional form, in which the issue price is predetermined, and in its book-building variant in which the issue price is determined following bids by potential placees. Both these methods require shareholders to waive their pre-emption rights and by far the most important reason why they are not used more frequently is that such waivers above the 5 per cent level specified in the pre-emption guidelines are either not sought or are refused. We consider the effect of the pre-emption guidelines in the next section.

2.129. Pre-emption rights aside, we can find no evidence to suggest that the use of traditional placing and book building is influenced by a preference for standard fees. Financial advisers have no interest in advising companies against using placing or book building. With traditional placings the fee earned by the lead underwriter (as distinct from the sub-underwriter) appears to be no less than that earned in rights issues and open offers. Relatively few book-built issues by listed companies have yet taken place (though book-built IPOs are now quite common) but the general market perception is that book building is more remunerative for lead underwriters than traditional rights issues.

2.130. We conclude that advice by lead underwriters in favour of the use of an issuing method involving standard fees is not a step taken for the purposes of exploiting or maintaining the first complex monopoly situation or an action attributable to the existence of that situation.

Possible conflicts of interest over issue pricing

2.131. A further conflict of interest between the roles of financial adviser and lead underwriter was brought to our attention. As we have noted already (see paragraph 2.118*(c)*), companies often want as small an issue price discount as possible. However, the smaller the discount, the greater the risk for underwriters that there will be a stick, hence the more difficult it will be to secure sub-underwriting for any given standard fee. It is therefore in the interest of lead underwriters to press for a deeper discount. We were told by some

companies that their financial advisers ceased to support them and 'crossed to the other side of the table' when the issue price was discussed.

2.132. A major reason why lead underwriters will be concerned about the level of discount is that when underwriting fees are fixed, the discount is the only variable that can take account of differential risk. Consequently, we conclude that proposals by lead underwriters that companies increase the issue discount are actions by these lead underwriters attributable to the existence of the first complex monopoly situation.

2.133. For share issues not involving pre-emption, for example IPOs, a lower issue price is clearly a cost to existing shareholders. But we have found that standard fees are now rarely used for non-pre-emptive issues. It has been put to us that the discount is also a cost in a pre-emptive issue but, as our comments on deep discounting imply, we are not convinced by this. It appears to us very questionable whether there would be any benefits to the public interest if discounts for pre-emptive issues were smaller. Consequently we do not believe that the conflict of interest faced by lead underwriters over the discount for these issues operates or may be expected to operate against the public interest.

Pre-emption guidelines

2.134. We have already referred to the pre-emption guidelines and their critics (see paragraphs 2.70 to 2.77). Although the latter are more concerned about choice, flexibility and the overall cost of capital than they are about underwriting costs, there is an argument for saying that the guidelines push up the cost of issuing shares by requiring companies to make rights issues or open offers when a traditional placing would be cheaper (because it would avoid sub-underwriting fees).

2.135. But this argument, whatever its validity, is not the issue we have to address under our terms of reference. We have to decide whether adherence to the pre-emption guidelines is a step taken by sub-underwriters for the purpose of exploiting or maintaining standard sub-underwriting fees (the basis of the second complex monopoly situation); or whether adherence to the guidelines is an action on the part of sub-underwriters attributable to the existence of standard fees. On the basis of the evidence we have received, we do not believe that we could reasonably answer yes to either of these questions.

2.136. Institutional investors (who provide virtually all sub-underwriting) and their associations have made it abundantly clear to us that they adhere to the pre-emption guidelines because they see this as the best way of protecting pre-emption rights, which they value highly. They would continue to follow the pre-emption guidelines if standard fees and, indeed, sub-underwriting itself were to disappear entirely. We find this entirely plausible for the following reasons:

(a) Sub-underwriters as a whole defend their adherence to the pre-emption guidelines strongly but standard fees only weakly, if at all.

(b) The introduction of tendering for sub-underwriting has reduced the importance of standard fees but this has had no impact on adherence to the guidelines.

(c) Sub-underwriting is a relatively minor and marginal part of the income of institutional investors (see paragraph 5.12), whereas the institutions see pre-emption rights as fundamental to their core interests.

2.137. We conclude that adherence to the pre-emption guidelines by sub-underwriters is not a step taken for the purpose of exploiting or maintaining the second complex monopoly situation, nor is it an action attributable to the existence of that situation. That being so we can make no public interest findings about the pre-emption guidelines. However, we consider in paragraphs 2.161 to 2.165 whether a relaxation of the guidelines might be a remedy for the adverse effect of the standard sub-underwriting fee being too high.

Conclusions on public interest questions

2.138. We summarize our conclusions on the public interest questions in our terms of reference as follows:

(a) The retention by lead underwriters of a standard underwriting fee of 0.5 per cent and the payment of standard fees of 0.25 per cent to brokers and 1.25 per cent (plus a further 0.125 per cent for each seven-day period above 30 days) to sub-underwriters are actions on the part of lead underwriters attributable to the existence of the first complex monopoly situation.

(b) The standard fees retained by lead underwriters and paid to brokers do not operate and may be expected not to operate against the public interest.

(c) Conversely, the use of standard fees for sub-underwriting operates against the public interest in that it results or may be expected to result in some issuing companies being charged higher underwriting fees than would otherwise be the case.

(d) Recommendations by lead underwriters in favour of using issuing methods involving the use of standard fees are not steps taken for the purposes of exploiting or maintaining the complex monopoly situations; nor are they actions attributable to the existence of these monopoly situations.

(e) Adherence to the pre-emption guidelines is not a step taken by sub-underwriters for the purposes of exploiting or maintaining the second complex monopoly situation; nor is it an action attributable to the existence of that situation.

Recommendations

2.139. Before we had reached our public interest conclusions, we set out a series of hypothetical remedies to deal with possible adverse effects of the existing underwriting arrangements, and we invited the comments of interested parties on these suggestions. These hypothetical remedies were set out in our letter of 11 May 1998, reproduced at Appendix 2.1. Some of these remedies sought to deal with adverse effects which, in the event, do not form part of our public interest conclusions. We will say no more about these. The remainder are discussed below together with another remedy we have identified since our 11 May letter.

Tendering

2.140. In our public interest conclusions, we have identified just one adverse effect which needs to be remedied, namely that in some cases the use of standard fees makes the cost of sub-underwriting higher than it would otherwise be. We believe that greater use of tendering will help to remove this adverse effect, and one group of alternative remedies we

considered involves making tendering mandatory. This suggestion received support from a few parties, notably the UKSA (representing small shareholders), but the great majority of those who commented on it felt that it would harm the interests of companies.

2.141. Many parties had a general objection to mandatory requirements on the grounds that they reduced the flexibility and responsiveness of the market and left less scope for innovation. It was also put to us that there were always likely to be some circumstances in which a fixed fee would have greater benefits for a company than a tendered one and that it would be wrong to deny companies the opportunity to make this choice. A particular concern, expressed by several parties but put particularly strongly by CISCO, was that mandatory tendering would be detrimental to the interests of smaller companies. We were told that brokers did not provide regular analyses of many smaller companies, making it harder to stimulate interest in their issues. It was argued that if they were obliged to tender they would frequently end up paying higher underwriting fees than they do under the present arrangements.

2.142. We think these arguments are strong ones. We recognize that smaller companies have particular problems in capital-raising and we do not wish to make their task any more difficult. In principle this concern could be dealt with by limiting mandatory tendering to companies over a specified size but, apart from the problem of finding a suitable cut-off point, we are persuaded that the benefits of flexibility and choice for companies of all sizes are greater than any that might be obtained by making tendering mandatory. Moreover, the hypothetical remedy rested on the assumption that companies needed support to defend their own interests in the underwriting market. This is least likely to be the case with larger companies.

2.143. We considered whether putting a cap on the maximum fee that could be offered in a tender would secure the advantages of greater tendering without losing the possible benefits of standard fees for smaller companies. We concluded that it would not, partly because it too would restrict flexibility and partly because it would reduce the number of institutions willing to underwrite except at a substantial discount.

2.144. A variant of our mandatory tendering suggestion was that companies should be permitted to choose whether to tender or not, but where a fixed fee route was chosen, the maximum sub-underwriting fee that could be paid should be capped at a level substantially below the current 1.25 per cent. Against this it was argued that such a cap would make it very difficult for many companies, particularly small ones, to find willing underwriters, so that in practice they would be forced to tender whether or not that was to their advantage. We accept that argument.

2.145. Another variant of the mandatory tendering remedy was that the OFT should continue to monitor the use of tendering for a further two years and if tendering were not widespread by the end of that period it should be made mandatory. Few parties had serious objections to continued OFT monitoring (though some thought that two years would not be sufficient) but many pointed out that, given the disadvantages of mandatory tendering, it would be unattractive even as a fall-back position after two years. We accept the logic of that. We believe that the other remedies we have suggested in paragraphs 2.151 to 2.160, in conjunction with market forces, would be sufficient to ensure that tendering would normally be used when it was appropriate. Companies which think they have been given bad advice by their financial advisers or brokers on the opportunities for tendering can complain to the SFA.

2.146. When we examined the form of tenders for sub-underwriting undertaken so far, we noted that many of them were for less than 100 per cent of the total sub-underwriting and that in most cases only traditional sub-underwriters had been invited to bid. We thought that tendering the whole of the sub-underwriting and opening it to as wide a group of potential sub-underwriters as possible would be more likely to drive down sub-underwriting fees and one of our hypothetical remedies was that tenders should be so constructed. We did not say that this should be a mandatory requirement but many parties who commented assumed that that was our intention and objected to the remedy accordingly.

2.147. That point aside, response to our suggestion was mixed. For example, the ACT agreed with both proposals provided they were not mandatory but some other parties objected to them. It was put to us that tendering the whole of the sub-underwriting would be risky unless it had been initially allocated at the standard fee, as a fall-back in the event of an unsuccessful tender. But sub-underwriters might be unwilling to accept such an initial allocation because they would receive no sub-underwriting if the tender were completely successful and their full allocation if it were unsuccessful; in other words, they would only get the least attractive sub-underwriting.

2.148. Several brokers expressed doubts about widening the population of potential sub-underwriters. They were concerned not to have sub-underwriters who could not be trusted to meet their obligations in the event of a stick or who might be expected to sell any stick they received immediately, to the detriment of the issuing company's share price.

2.149. We agree that making the form of tendering mandatory is open to the same objection as making tendering itself mandatory, namely that it reduces flexibility and choice. However, if our two suggestions are treated as guidance on good practice, we continue to think that they are useful. We accept that there is a risk in tendering the whole of the sub-underwriting but we think that the risk of being over-cautious and not tendering enough of it is greater in practice. We therefore believe that companies should be encouraged to tender as high a proportion as possible, while recognizing that they might in some circumstances prefer a more restricted tender.

2.150. Opening up tendering to as wide a group of potential sub-underwriters as possible does not necessarily mean that every bid made has to be accepted. It would be reasonable to exclude bidders about whose creditworthiness there were genuine doubts. But we are sceptical about other reasons for exclusion. We recognize that there do not currently appear to be many non-traditional sub-underwriters who are looking for an opportunity to tender, but as markets are dynamic, this situation will not necessarily last. We return to the issue of guidance on good practice in paragraphs 2.156 to 2.160.

Transparency

2.151. It seems likely to us that one of the reasons why sub-underwriting fees are too high is information asymmetry: as a general rule companies can be expected to know less about the share-issuing and underwriting process than underwriters themselves. We therefore considered possible remedies to increase transparency or otherwise to improve companies' knowledge of the process.

2.152. In our 11 May letter we suggested that the underwriter should be required to inform issuing companies of the Black-Scholes 'fair value' of underwriting for a particular issue. Most parties who commented said that such information would be positively misleading as the Black-Scholes formula is not suitable for this task. We agree. We have already noted the difficulties of applying Black-Scholes to sub-underwriting as a whole (see

paragraphs 2.89 to 2.96). Applying it to individual cases is even more problematic, in particular because of the uncertainties about what measure of volatility to use in the formula.

2.153. We also suggested that financial advisers should be required to advise their clients who were considering share issues of alternatives to underwriting at standard fees. These alternatives would include tendering for sub-underwriting and non-underwritten deep-discounted issues. Many financial advisers who commented on this hypothetical remedy said that it was unnecessary because they were doing it anyway; other parties were generally in favour of it. We accept that many financial advisers would be giving this information to their clients but we would be surprised if the practice were universal. We think therefore that the remedy would be a helpful one. We recommend that the SFA should issue guidance to corporate financial advisers reminding them of the application of the principle of the Financial Services Authority (FSA) on information for customers, and recommending that they should advise their clients who are considering share issues of alternatives to underwriting at standard fees. The appropriate recognized professional bodies (RPBs—see paragraph 3.6) should issue similar guidance to accountants and solicitors acting as financial advisers. Companies which believe they have not received this advice should complain to the SFA (or the relevant RPB). The SFA told us that it would certainly look into such complaints.

2.154. A further suggestion along similar lines was that if a company made a sub-underwritten share issue not involving tendering, the directors should be required to explain to their shareholders why they had chosen this route. The purpose of the suggestion was to encourage companies to think carefully before deciding not to use what would in many circumstances be the cheapest way of securing underwriting.

2.155. Some financial advisers and brokers who commented objected to the remedy on the grounds that companies which did not choose tendering would normally be in a weak position and would not wish to advertise the fact. We do not find this objection convincing. We think that any material weakness in a company's position when it made a share issue would (and should) be known to the market. We doubt whether disclosure of reasons for not tendering would appreciably change the market perception of a company's strength. We therefore recommend that the offer document should give the reasons for a decision not to tender sub-underwriting. As a decision to tender might be overtaken by events after the offer document had been published, the reasons for not tendering should also be given in the directors' annual report. Given the prevalence of partial tendering, we further recommend that an explanation should be given if less than two-thirds of the sub-underwriting is to be tendered. In our view these recommendations would be most appropriately implemented by means of an amendment to the listing rules.

Good practice guidance

2.156. To assist companies to make more informed choices about share-issuing methods, in the belief that this would help to reduce the cost of underwriting, we put forward the hypothetical remedy that information on best practice should be made available. We suggested that this guidance should encourage the use of tendering; explain the advantages of deep-discounted rights issues and recommend that the scrip element of such issues should always be made explicit; encourage the marketing or pre-marketing of rights issues; and encourage companies to seek financial advice from more than one source, wherever possible separating the roles of financial adviser and lead underwriter.

2.157. Some parties welcomed this suggestion, others were unenthusiastic, but no one had any serious objections to the general idea. There were, however, some adverse comments on some of these specific points we thought should be included in the guidance.

In particular, several financial advisers and brokers were critical of the idea of separating the financial adviser and lead underwriter roles which they said would increase costs significantly. The purpose of this hypothetical remedy was to deal with possible conflicts of interest but as we have made no public interest findings on this point, the remedy ceases to be relevant.

2.158. The notion of 'best practice' may appear to imply that there is one right way to go about issuing equity, whereas several parties pointed out that different circumstances may call for different approaches. We accept that point. We see the guidance not as a blueprint but more as a checklist of points for companies to consider and questions for them to put to their financial advisers and brokers which would encourage them to think positively about tendering and deep discounting while recognizing that these will not necessarily be the most appropriate methods in all circumstances. The guidance on tendering should pick up the points referred to in paragraphs 2.146 to 2.149 about tendering for the whole of the sub-underwriting and opening the tender to as wide a group of potential sub-underwriters as practicable. Several of the points we would like to see more widely publicized were included in a recent book on equity finance by the ACT.[1]

2.159. It was put to us that the guidance we were proposing was already available. That may be so, but it appears that many companies are taking insufficient notice of it. We noted with some concern in our inquiry that too many companies seemed not to be demanding customers of underwriting services, and that that was one explanation of why standard fees had persisted for so long. In our view it would help to change this situation if appropriate guidance were to be brought together and promulgated by an authoritative and neutral source. We thought that either the Bank of England (the Bank) or the LSE might take this role. The LSE told us that it did not have the necessary degree of expertise or the resources, but the Bank said that it was willing in principle to consider the role we proposed.

2.160. We recommend that the compilation of the guidance should be co-ordinated by the Bank in consultation with all those who could usefully contribute. In our list of hypothetical remedies we suggested that endorsement of the guidance should come from the CBI, the ABI and the NAPF. It was suggested to us that endorsement by the IFMA, the CISCO, the ACT and The Hundred Group of Finance Directors would also be valuable. We agree. We think that each of these organizations should take part in the preparation of the guidance and should subsequently promote it actively to their members.

Pre-emption guidelines

2.161. The most controversial of our hypothetical remedies was that the pre-emption guidelines should be relaxed to enable companies to issue up to 15 per cent of their share capital non-pre-emptively in any one year, either for all companies or only for companies with a market capitalization of over £50 million. Our reason for making this suggestion was that if companies were able to issue a higher proportion of equity non-pre-emptively, this would probably result in more placings (without clawback) and fewer rights issues. As placing does not normally involve sub-underwriting such a change would provide a partial remedy to the adverse effect of sub-underwriting fees being too high.

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[1]R Hinkley, D Hunter, M Whittell and M Ziff: *Current Issues in Equity Finance*, The Association of Corporate Treasurers, 1998; Chapter 4.

2.162. Most parties rejected this hypothetical remedy. Those who supported it had a range of views about the extent to which the guidelines should be relaxed. For example, Morgan Stanley thought that 25 per cent (the figure which triggers Super Class 1 transactions under the listing rules—see paragraph 3.24*(g)*) would make more sense than 15 per cent. Williams de Bröe plc suggested that the higher limit of 15 per cent should only apply to issues of up to £5 million. Several parties commented that the guidelines were more of a constraint for smaller companies.

2.163. Reactions to the remedy depended on the position which parties took in the wider debate about pre-emption rights, to which we referred in paragraphs 2.70 to 2.77. Critics of the existing system put the following arguments to us:

(a) It was desirable to maximize flexibility and the choice available to companies when raising capital; the pre-emption guidelines reduced them.

(b) Companies which wanted to raise capital ought to justify their need for it. There was no time to do this in an underwritten rights issue, with the result that easy-to-understand transactions, such as acquisitions, tended to be preferred to investments involving organic growth.

(c) Investors ought to compete to provide capital to companies. Such competition would have a positive effect on the share price of strong companies and would reduce their cost of capital.

(d) It was frequently beneficial to companies to widen their shareholder base, both to increase the liquidity of their shares and to enable new shareholders, who might value the company more than the existing ones, to be brought in.

(e) For each of the previous three reasons, it was desirable to market a new issue widely before its price was settled. This was rarely done with a rights issue.

(f) Although it was possible to waive pre-emption rights, it was difficult and time consuming (requiring a special resolution supported by 75 per cent of shareholders) and consequently rare.

(g) The value of rights to shareholders was exaggerated. Because of inefficiencies in the market for nil-paid rights, those who did not take up their rights were usually able to obtain only a fraction of their value. Such shareholders would be better off with a non-pre-emptive issue sold at a minimal discount.

(h) Rights issues were unfair to overseas shareholders, particularly those in the USA for whom there were regulatory barriers (in the USA) preventing them from taking up their rights (see paragraphs 3.52 to 3.55).

(i) Even if the pre-emption guidelines were less restrictive, management would still be restrained from using its ability to issue equity to the disadvantage of existing shareholders by the need to retain shareholder confidence. Shareholders did not suffer in the USA despite having no pre-emption rights.

2.164. Defenders of the pre-emption guidelines generally accepted that the guidelines reduced management flexibility but argued that this was necessary in the interests of protecting the rights of owners. They also made the following points:

(a) It was an exaggeration to say that sub-underwriters had to decide whether or not to support an issue without having time to understand the case. Sub-underwriters were

frequently major shareholders who already knew quite a lot about the company. For difficult issues or where companies were not well known, it was not uncommon for pre-marketing to take place.

(b) Arguments about the cost of capital tended to confuse it with the cost of raising capital. The cost of capital itself was given by the risk-free interest rate plus an equity risk premium and was not determined by the method by which capital was raised. The cost of raising capital (underwriting fees and other expenses), on the other hand, was lower for rights issues than for many other types of issue, particularly those involving book building.

(c) It was unlikely that the marketing of a new issue served to increase a company's share price; the evidence from the USA did not indicate such an increase. (Our own figures show that for US new equity issues, excluding IPOs, in 1997, the issuing company's share price declined on average by 4 per cent between the date of announcement and the offer date, after adjusting for the change in the S&P 500 index—see Table 3.3.)

(d) If a company wanted to widen its shareholder base, it could do so perfectly well by conducting a marketing exercise and encouraging investors to buy its shares on the secondary market.

(e) Experience suggested that when the shares of UK companies were sold in the USA as part of a book-building exercise, they frequently flowed back to the UK.

(f) Shareholders were in practice willing to waive their pre-emption rights when a good case for doing so was put to them. (15 per cent of respondents to our questionnaire for companies said that they had sought permission from their shareholders to issue more than 5 per cent of share capital non-pre-emptively. Nearly all of these respondents either stated or implied that such permission had been granted.)

(g) Shareholders, large and small, valued their ability to sell rights they did not want to take up. The evidence did not indicate that the actual sale price was on average greatly below the theoretical price, though it could be so for rights on very illiquid shares.

(h) If companies wanted to conduct a book-building exercise, it was possible to do so while still preserving pre-emption rights. Credit Suisse First Boston told us about its system for combining pre-emption and book building (which, however, had not yet been used).

(i) US shareholders who wanted to take up UK rights issues could do so by arranging to have a UK presence.

2.165. As a Group, we had mixed views about the pre-emption guidelines. Some of us were sympathetic to several of the points made by critics of the existing arrangements, particularly in relation to smaller companies; others of us did not find their case a strong one. But whatever our views on the wider issue, we all agreed that it would not be right for us to recommend a change to the pre-emption guidelines, for the following reasons:

(a) Although relaxation of the pre-emption guidelines might reduce sub-underwriting costs, we do not believe that the wider costs of issuing shares would be lower, on average, for non-pre-emptive share issues. When shares are placed with non-share-

holders, the discount is a cost to existing shareholders, unlike with a rights issue. If companies were to try to minimize this discount by a book-building process, the fees they would have to pay the lead underwriter would almost certainly be greater than they are now.

(b) It is by no means certain that relaxing the guidelines would have the effect of making it easier for companies to issue shares non-pre-emptively. As shareholders in the UK are deeply committed to preserving their pre-emption rights, it is not unlikely that they would ignore any guidelines which suggested that they waive these rights in ways that they disagreed with.

(c) More fundamentally, we think that the guidelines, and pre-emption rights generally, are primarily a corporate governance question rather than a competition issue. We do not think it would be appropriate to introduce a fundamental change in current UK share-issuing practice on the back of a narrow and limited finding about the level of sub-underwriting fees. The treatment of pre-emption rights in the UK needs to be debated in a much wider context. The Department of Trade and Industry (DTI)'s present review of company law provides such a context.

Other remedies

2.166. We suggested that the Accounting Standards Board (ASB) should be asked to issue guidance about the adjustment of dividends per share to take account of the scrip element of a rights issue to match their existing guidance about the treatment of earnings per share. We consulted the ASB about this suggestion. It told us that it was in the process of revising its guidance on the computation and disclosure requirements in respect of earnings per share. The new requirements were published on 1 October 1998 as Financial Reporting Standard 14. We concluded that these new requirements met the point made in our hypothetical remedy.

2.167. We suggested that companies should be given the option to vary the period between the announcement of a rights issue and the final acceptance date for shareholders. As the risk borne by sub-underwriters is dependent on the length of the rights period, we thought that a shorter period (in combination with tendering) would have the effect of reducing sub-underwriting costs. The majority of parties who commented on our hypothetical remedies supported this suggestion but it was strongly opposed by ProShare (UK) Limited and the UKSA who believed it would damage the interests of small shareholders.

2.168. The current minimum rights period is 21 days. Since it was first introduced there has been an enormous development of electronic communications and we think it is reasonable to permit companies to shorten the period on occasions whilst still protecting the interests of small shareholders. The case for a shorter period seems particularly strong for issues which require an extraordinary general meeting to be held. In such cases shareholders know about the details of the rights issue at least two weeks before the start of the minimum period. We note that the EC's Second Company Law Directive specifies a minimum period of only 14 days.

2.169. Any reduction of the 21-day minimum period would require an amendment of section 90(6) of the Companies Act and of paragraph 4.21*(a)* of the listing rules. The LSE told us that it would wish to keep the period specified in the listing rules in line with the

equivalent period specified in legislation. We recommend that the DTI examine the scope for reducing the minimum rights period.

2.170. The final item on our original list of hypothetical remedies was the suggestion that brokers should be required to inform issuing companies who the proposed sub-underwriters were and how much sub-underwriting they would be offered. Many parties questioned the usefulness of this remedy. Some brokers told us that their list of potential sub-underwriters was commercially confidential information which they would not want to reveal. We do not think that this is a good reason for withholding information from issuing companies and we think that greater transparency throughout the share-issuing process is a valuable wider objective. However, we accept that our suggestion would be unlikely to remedy the adverse effect of sub-underwriting fees being too high and we do not therefore recommend it.

Changes to capital gains tax

2.171. We considered one remedy that was not on our original list. It concerned possible changes that might be made to CGT, with the object of removing disincentives to the use of deep discounting. We asked in our letter of 11 May 1998 whether the operation of CGT made deep-discounted issues unattractive to some shareholders. Many respondents to the letter claimed that it did though they were not generally able to provide much detail about the number of shareholders affected. The most convincing evidence came from Berkeley and Monument, both of which told us that they had avoided discounts which would have created significant CGT disadvantages for some of their individual shareholders.

2.172. 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 (see Appendix 3.2). 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. In addition the chargeable gain may be reduced by an indexation allowance or the new taper relief introduced in the 1998 budget and CGT is only payable if a taxpayer's total chargeable gains in any one year exceed the Annual Exempt Amount (currently £6,800).

2.173. 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. We accept this estimate but, as we said in paragraph 2.124, it seems to us that those who would be affected could include some large individual shareholders who are likely to be particularly influential when a board is considering whether or not to have a deep-discounted issue. In addition boards may be concerned not to disadvantage long-term private shareholders and employees with modest holdings which might nevertheless be large enough to yield proceeds from the sale of rights which were not small in CGT terms.

2.174. 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'). In our view there is no recognition of the fact that the reduction

in the value of a shareholding when rights are sold is not equal to the whole of the proceeds but to the proceeds less the value of any rights taken up. For rights issues with a relatively shallow discount, this will not normally have much effect, but with a deep-discounted issue, tailswallowing by some shareholders may lead to rights being taken up which have a substantial value.

2.175. As a possible remedy for this disincentive to engage in deep discounting, we suggested to the Inland Revenue that the CGT rules might be amended so that tax was not payable by shareholders who used all of the proceeds from the sale of some of their rights to finance the take-up of the remainder. The Inland Revenue pointed out that when a taxpayer sold shares and used the proceeds to buy other shares, there was no general roll-over relief from CGT. There would therefore need to be a policy justification for treating tailswallowing differently from other transactions and a sufficiently strong case for action.

2.176. This is of course a matter for the Chancellor of the Exchequer. But in our view the justification of special treatment for tailswallowing is that it would remove an identifiable distortion to the share-issuing process, namely the disincentive to engage in deep discounting, for what we believe would be a modest loss of revenue. The fact that we had evidence of two cases in which this disincentive influenced behaviour, and that the majority of parties who commented said that the CGT rules were one reason why deep discounting was rare, leads us to believe that this may be an important factor. In the absence of this disincentive it is likely that there would be more non-underwritten rights issues. These issues would be cheaper, to the benefit of all the shareholders of the company concerned who were not themselves underwriters, that is virtually all private shareholders.

2.177. It should not be difficult to restrict the concession to tailswallowing. It is an unusual transaction in that it involves shareholders merely in maintaining the value of their holding in a particular company in response to events over which they have no control in practice. We recommend that the Chancellor of the Exchequer should consider taking steps to amend the CGT rules so that tailswallowing is not treated as a disposal.

Summary of recommendations

2.178. We recommend the following action intended to reduce the cost of sub-underwriting fees:

(a) The SFA (and relevant RPBs) should issue guidance to corporate financial advisers reminding them of the application of the FSA's principle on information for customers and recommending that they should advise their clients who are considering share issues of alternatives to underwriting at standard fees.

(b) The LSE should amend the listing rules to the effect that, when companies undertake an underwritten share issue in which less than two-thirds of the sub-underwriting is to be offered for tender, the directors should be required to explain to their shareholders in the offer document and in their annual report why they have chosen this route.

(c) The Bank should publish guidance for companies on share-issuing good practice. It should take the form of points to consider and questions to ask advisers and should:

(i) encourage the use of tendering for sub-underwriting;

(ii) encourage the use of tenders which involve the whole of the sub-underwriting and which are open to as wide a group of potential sub-underwriters as practicable; and

(iii) explain when deep-discounted rights issues are likely to be advantageous and recommend that the scrip element of such issues should always be made explicit.

The guidance should be endorsed and promoted by the organizations named in paragraph 2.160.

(d) The DTI should examine the scope for reducing the minimum length of the rights period.

(e) The Chancellor of the Exchequer should consider taking steps to amend the CGT rules so that when shareholders sell some of their rights and use all of the proceeds to finance the take-up of the remainder, these proceeds should not be treated as arising from a disposal.