4 The market for financial advice and primary underwriting of share issues

Contents

Page

4.1. This chapter describes the market in which firms obtain financial advice and underwriting in connection with share issues. It also considers certain features of the market for nil-paid rights.

The capital markets

4.2. Money is raised for investment in the capital markets which may be classified in a number of ways including:

(a) by the identity of the issuer/borrower: Governmental or non-Governmental;

(b) by whether or not securities are issued in exchange for the money raised (bank borrowing is not securitized);

(c) by the type of security that is issued: equity, preference shares, equity-linked (for example, convertibles) or debt; and

(d) by the extent to which any security issued can be traded and the individual exchange on which it is traded.

Capital market activity includes both the primary issue of new securities and secondary sales of securities that have already been issued.

4.3. Our terms of reference limit our area of interest to offers of shares thus excluding bank borrowing and all Governmental issues. Table 4.1 shows the level of capital issues by UK companies and financial institutions, excluding bank borrowing (the table covers all stock exchanges but the bulk of issues by UK companies are on the LSE). The table shows that the amount of money raised by share issues has fluctuated markedly from year to year. The amount raised from share issues over the last three years has been slightly less than the net amount raised from debt issues (loan stocks, bonds and notes) over the comparable period. The amount raised in rights issues was particularly low in 1997 and this low level of issuance has continued into 1998.

TABLE 4.1 **Capital issues by UK companies and financial institutions (inflation adjusted)**

£ million

	Ordinary shares		*Preference shares*	*Loan stocks, bonds and notes*		
	Total	*Rights issues*	*Total*	*Total*	*Sterling*	*Other currencies*
Gross issues						
1988	8,605	6,056	1,725	16,412	15,063	1,349
1989	8,396	4,002	1,486	20,300	17,736	2,565
1990	5,458	3,861	935	15,248	12,792	2,456
1991	13,050	10,694	1,351	15,584	13,797	1,786
1992	7,237	3,840	883	15,120	11,686	3,435
1993	18,532	12,136	2,028	25,221	19,888	5,332
1994	15,856	5,377	1,023	23,646	16,180	7,466
1995	10,292	4,745	3,017	14,012	8,485	5,527
1996	10,930	3,978	1,271	27,078	16,892	10,186
1997	8,459	1,960	793	28,696	15,767	12,929
Net issues (gross issues less redemptions)						
1988	8,445		1,308	14,609	13,715	894
1989	4,819		1,441	17,328	15,171	2,158
1990	4,331		903	12,433	10,335	2,098
1991	12,892		1,332	12,927	12,011	916
1992	7,202		705	10,315	8,251	2,064
1993	18,532		2,012	12,526	11,062	1,464
1994	15,853		652	10,338	6,376	3,962
1995	10,254		3,015	3,076	48	3,028
1996	10,521		727	13,567	6,534	7,034
1997	8,459		–883	15,802	6,699	9,103
Net issues by UK industrial and commercial companies						
1988	6,366		895	4,504	4,027	477
1989	2,555		1,379	6,150	5,286	864
1990	3,536		639	3,483	2,773	711
1991	11,435		562	5,122	4,967	155
1992	5,933		28	3,696	3,737	–41
1993	14,256		655	3,636	2,881	755
1994	10,795		502	3,170	2,920	251
1995	8,024		1,402	7,252	3,926	3,327
1996	7,803		–162	5,878	3,903	1,976
1997	5,354		–347	11,712	5,675	6,037

Source: Financial Statistics (Table 6.2A *Capital issues and redemptions by UK borrowers*), various issues.

Note: Figures for individual years are adjusted to 1997 prices using the retail price index. Data for 1988 to 1992 may be less reliable. Only issues for cash are included: bonus issues, exchanges of one type of security for another, for example during takeover, and issues for consideration other than cash are excluded. Sales of shares or bonds by the Government where no new money is raised for the companies concerned are also excluded. Other IPOs are included. Includes issues on all stock exchanges. Convertible loan stock is included under loan stocks, bonds and notes. Redemptions of ordinary shares do not include company share buy-backs.

4.4. Companies have a general requirement for specialist financial advice regarding their involvement in the capital market. This financial advice relates to a number of different aspects:

(a) raising capital through new issues of securities and sales on the secondary market of any shares that are held in other companies;

(b) bringing companies to the market for the first time;

(c) returning capital to shareholders, for example through share buy-backs;

(d) takeover of other listed companies (also defence against unwanted takeover bids) and acquisitions of unlisted businesses; and

(e) relations between the company, its shareholders and the LSE.

Listed UK companies have traditionally retained a financial adviser and a corporate broker to fulfil these functions. The distinction between the roles is less clear than formerly but *(e)* above would be dealt with by the corporate broker, while *(a)* to *(d)* would involve input from both financial adviser and corporate broker.

Share offers relevant to this inquiry

4.5. In this inquiry, our interest is primarily in the first of these aspects and is limited to offers of shares. Such offers may be divided into one of two broad categories:

(a) pre-emptive-type issues (including rights issues and open offers) and any other offers where the price is decided at the start of a formal offer period (cash underpinnings and fixed price offers for sale and subscription); and

(b) non-pre-emptive offers where the price is decided towards the end of the period between announcement and payment (IPOs by placings and other primary or secondary book-built offerings) or where there is no formal offer period (cash placings by already listed companies).

In the first category, there is a period of at least three weeks between the date at which the price is decided and the close of the offer period. This adds to the risk involved in underwriting.

4.6. In both categories of issue, there is usually some form of primary underwriting under which one or more financial institution agrees to purchase the shares if they are not taken up in the offer. However, only underwriting in the first category of share offers comes within the complex monopoly situations. (Underwriting in the second category of share offers only provides protection against counterparty/settlement risk and not price risk, tends to be done only after demand for the shares has been revealed through contact with potential purchasers, and often covers a period of a few days only.)

4.7. We obtained details of share offers over the three years 1995 to 1997 from banks and brokers. We did not find any evidence of continued use of underwritten offers for sale/subscription, and therefore we confined our attention to rights issues, open offers and cash underpinnings. Table 4.2 summarizes data obtained on these offers.

TABLE 4.2 **Underwritten share offers, 1995 to 1997**

	Number	*Underwritten amount** *£m*	*Underwriting fees†* *£m*
Rights issues	205	10,049	211
Open offers	202	3,290	58
Cash underpinnings	52	9,507	169
Total	459	22,846	439

Source: MMC survey.

*For all offers including those that did not proceed.

†Lead underwriter's plus broker's plus sub-underwriters' commissions. Fee information was unavailable for some offers.

Note: Total underwriting fees does not reflect sum of constituent figures shown due to rounding errors.

4.8. An important feature of these share issues is that the lead underwriter often charges a standard underwriting commission of 2 per cent for periods up to 30 days plus a further 0.125 per cent for each additional seven-day period (or part of it). The lead underwriter always seeks to lay off all or almost all of the risk to sub-underwriters who are usually institutional investors. The lead underwriter then pays a standard fee of 1.25 per cent plus a further 0.125 per cent for each additional seven days to the sub-underwriters and 0.25 per cent to the broker who arranges the sub-underwriting, retaining 0.5 per cent.

4.9. Table 4.3 shows the number of lead underwriters using standard fees in offers accounting for over 25 per cent of their underwriting fees and also the percentage of underwriting fees accounted for by these lead underwriters. Figures are shown separately for the period after the introduction of tendering of sub-underwriting.

TABLE 4.3 **Lead underwriters using standard fees**

	1995 to 1997	*31.10.96 to end-1997*
Number of lead underwriters:		
– With standard fees*	38	22
– Without standard fees†	13	17
– No fee information‡	11	4
– Total	62	43
Underwriting fees paid to lead underwriters (£m):		
– With standard fees	390	36
– Without standard fees	49	43
– Total	439	79

Source: MMC.

*Offers with standard fees accounted for more than 25 per cent of fees received by the lead underwriter. Fees include broker's and sub-underwriters' fees.

†Offers with standard fees accounted for less than 25 per cent of fees received by the lead underwriter.

‡These lead underwriters provided no information on fees received. Offers by these lead underwriters were mostly small and would have little impact on the percentage of total fees paid to lead underwriters with standard fees.

4.10. The information in Table 4.3 was compiled from lead underwriters' responses to questions whether standard fees were paid to the lead underwriter, to the broker and to the sub-underwriters. A share offer was considered to be at standard fees only if standard fees were paid to all three participants. In some cases, information was incomplete: if information was missing for any one of the three participants, the offer was considered to be not at standard fees. For this reason there may be some underestimation of offers at standard fees in Table 4.3.

The economic market

4.11. A company which needs to raise money externally has a number of alternatives available including raising debt, either by bank borrowing or a bond or convertible bond issue; internal finance which could be made available by asset disposals or cutting the dividend; and the two types of share issue mentioned in paragraph 4.5. We consider the extent to which each of these are substitutes for the types of underwritten offer (rights issues, open offers, cash underpinnings) included in our terms of reference.

4.12. Debt financing benefits from a significant tax advantage compared with equity financing as subsequent interest payments are deducted in calculating profits on which corporation tax is payable, but dividends are not tax-deductible. On the other hand, debt has a disadvantage in that it increases the risk of financial distress. These considerations suggest that companies prefer debt finance up to a certain level of gearing and/or interest cover and beyond that prefer equity finance, hence that there is an optimal level of gearing. Companies would be likely to come into one of three categories: those with gearing below the optimum, which would prefer debt finance; those with gearing above the optimum which would prefer equity finance (or in more extreme cases would be required to raise equity); those with gearing at about the optimum which would ideally prefer a mixture of debt and equity. When raising fresh capital, companies with gearing at about the optimum would be in a position to consider all-debt and all-equity options as well as a mixture of the two but it is unlikely that the availability of debt as an alternative would prevent a small but non-transitory increase in the cost of raising equity. In recent years there has been a trend for companies to increase debt and reduce equity by buying back shares or paying special dividends. The reasons for this trend are likely to include increased pressure from shareholders to move towards an optimal gearing ratio. It should be noted that the existence of this trend does not imply that debt is a close substitute for a share issue as a source of funds for a major capital project or acquisition.

4.13. Companies could increase the internal finance available by asset disposals or reducing the dividend but neither is likely to be a close substitute for share issues. The potential for asset disposals depends on the company's commercial strategy and it is unlikely to be attractive to alter the volume of asset sales in response to small changes in the cost of share issues. Cutting the dividend would usually raise a relatively small amount (net dividend yields currently average about 3 per cent and were about 2.6 to 3.6 per cent during the period 1995 to 1997) and would tend to have an adverse impact on investor confidence, making other forms of capital-raising more difficult.

4.14. Other types of share issue may also be a substitute for those in our terms of reference. However, the use of cash placings is limited by the pre-emption guidelines to cases where the money raised is less than 5 per cent of market capitalization and 7.5 per cent over three years, while vendor placings without clawback are limited to 10 per cent of market capitalization (the maximum discount is also limited to 5 per cent including commission).[1] The responses to our questionnaire to investment banks and brokers (see Appendix 2.3) indicated that a cash or vendor placing is usually preferred if it comes within the guidelines and rights issues, open offers and cash underpinnings used only when a cash or vendor placing is unlikely to be approved by shareholders at an EGM. Cash and vendor placings do not therefore appear to be a close substitute for the types of offer covered by our terms of reference.

4.15. Non-underwritten (deep-discounted) rights may be a substitute for an underwritten rights issue where absolute certainty of proceeds is not required.

4.16. The primary underwriting of share issues is closely linked with financial advice on the share issues. The lead underwriters must assess the company's plans regarding its use of the money raised, as must the financial adviser. A lead underwriter which underwrote without assessing the issuing company's plan would find itself underwriting bad deals: if it did this repeatedly, it would be unable to obtain sub-underwriters, would incur losses as the risk it assumed would exceed the fees charged and would ultimately go out of business. Lead underwriters do almost always provide financial advice to companies, although companies may also pay for additional advice. In total, there was at least one financial adviser which was not a lead underwriter in 54 of the offers (out of 416 for which information was available) over the period 1995 to 1997, accounting for 9 per cent of underwritten proceeds during that period. There were 24 further offers, accounting for 6 per cent of underwritten proceeds where the financial adviser to the offer was not the company's usual financial adviser: it is likely that in these cases, independent advice was available from the usual financial adviser. Companies may also obtain independent advice from the corporate broker.

4.17. In some cases, the corporate broker may act also as financial adviser and lead underwriter, with the consequence that the company has no other source of specialist advice, although we found that they do also obtain advice from non-executive directors, accountants and lawyers. There has in recent years been an increasing tendency for financial advice and corporate broking to be provided on an integrated basis. Table 4.4 shows that offers where there was only one adviser accounted for about one-third of total underwritten proceeds over the period 1995 to 1997.

---

[1]See Table 3.1.

TABLE 4.4 **Number of advisers used by issuing companies, 1995 to 1997**

Gross underwritten proceeds of offer £m	*Underwritten proceeds as a percentage of total for offers in size range*				
	1 adviser	*2 advisers*	*3 or more advisers*	*No information*	*Total*
0–10	47	45	1	6	100
10–50	34	56	6	4	100
50 and over	33	27	39	0	100
All offers	34	32	34	1	100

Source: MMC.

Note: Rows may not sum to 100 due to rounding errors.

4.18. Although all lead underwriters provide financial advice, it is not the case that all financial advisers act as lead underwriters. In particular, the corporate finance departments of accountancy firms provide financial advice and may act as issue sponsors but do not underwrite for regulatory or other reasons. Responses to our survey showed that accountancy firms were financial advisers to four rights issues and five open offers during 1995 to 1997.

4.19. Taking into account the points made in paragraphs 4.11 to 4.18, the relevant economic market would appear to be that of financial advice and primary underwriting supplied to companies in connection with rights issues, open offers and cash underpinnings. This overall market includes a large number of individual services which may be classified as follows:

(a) services provided by the lead underwriter and financial adviser to the issuing company, including: advice about issue structure; project management; insurance against share price falls during the period between issue announcement and the time the offer closes; documentation and satisfying LSE and other regulatory requirements; and

(b) services provided by the corporate broker, including advice about issue pricing and market reaction to the issue; satisfying LSE requirements; marketing the issue to institutional investors; also distribution of sub-underwriting and, in rights issues, the placing of any unsubscribed-for shares (the rump).

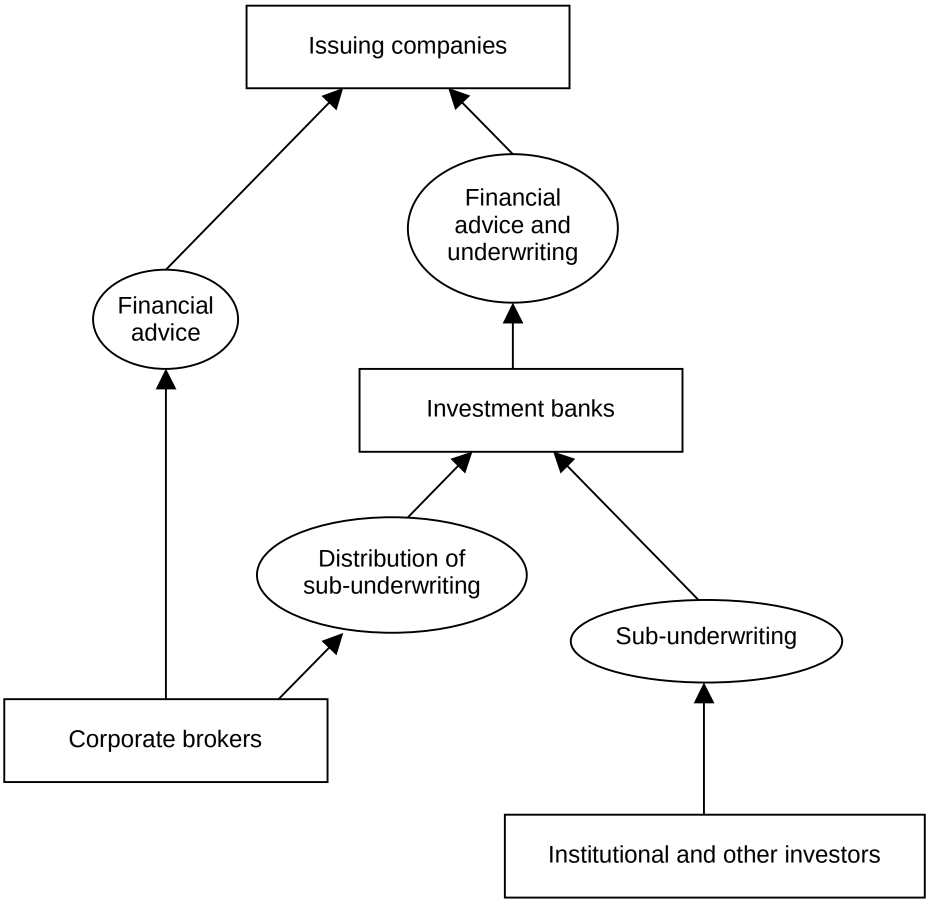
As mentioned previously, the lead underwriter lays off the underwriting risk by purchasing sub-underwriting from institutional investors. We have treated this as a separate market (dealt with in Chapter 5) where effectively the service purchased is insurance against share price falls: this is an input into the service provided by the lead underwriter. We have treated the services provided to issuing companies by lead underwriters and brokers as part of the same market because the main service (financial advice) is supplied by both lead underwriters and brokers and is distinct from the pure insurance provided by sub-underwriters. Figure 4.1 illustrates the market.

Fees

4.20. Sub-underwriting is provided by sub-underwriters to the lead underwriter and the sub-underwriting fees are reflected in the overall underwriting fee charges by the lead underwriter to the company. This is true also of the broker’s fee for distributing the sub-underwriting on behalf of the lead underwriter although the broker also usually charges an advisory fee direct to the issuing company.

FIGURE 4.1

Commercial relationships involved in a share-issuing transaction



Source: MMC.

Note: Rectangular boxes show institutions supplying and receiving relevant services. Oval boxes show services supplied. Arrow shows receiver of service. Payment flows in the reverse direction to that shown.

4.21. Table 4.5 and Figure 4.2 summarize total fees charged for underwriting and financial advice on the offer. Fees paid for financial advice/primary underwriting and for broking services as a percentage of money raised decline as the amount of money raised increases. This is likely to reflect economies of scale in the provision of advice.

TABLE 4.5 **Fees charged for share issues, 1995 to 1997**

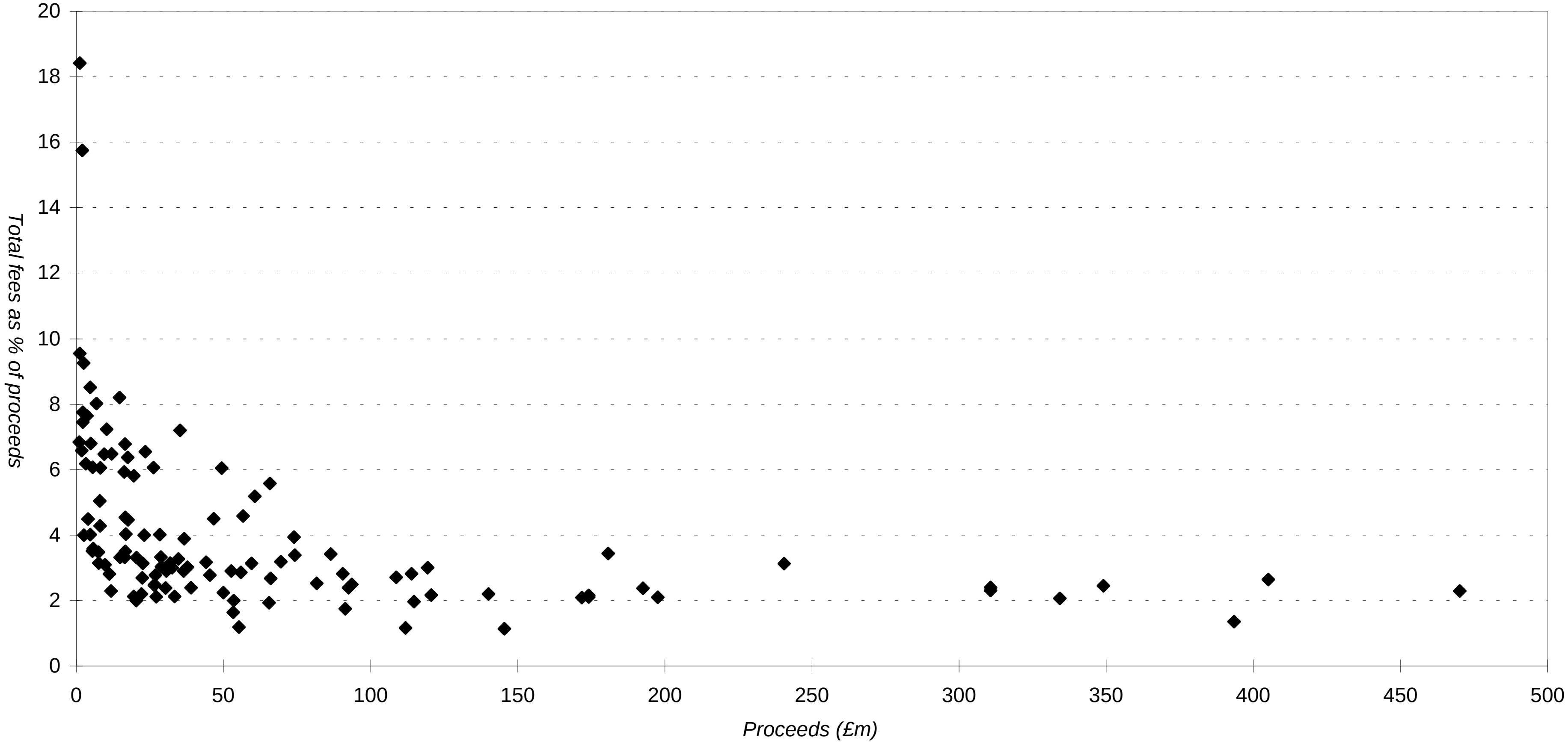
	Fees as a percentage of underwritten proceeds			
Gross underwritten proceeds of offer £m	*Lead underwriter and financial adviser*	*Broker*	*Sub-underwriters*	*Total*
0–10	2.5	1.4	1.3	5.1
10–50	1.4	0.9	1.3	3.6
50–100	1.0	0.5	1.4	2.9
100 and over	1.0	0.4	1.2	2.5
All offers	1.1	0.5	1.3	2.8

Source: MMC.

Note: Rights issues only. The sample size was 117 due to incomplete information especially on broker's advisory fee. Totals do not necessarily reflect constituent figures shown due to rounding errors.

FIGURE 4.2

Total (advisory and underwriting) fees in rights issues



Source: MMC.

4.22. Fees are settled at an early stage in the transaction and are stated in the terms of engagement letter which is provided by the adviser to the issuing company. The level of fees is usually settled after negotiation between adviser and issuing company, which would take into account both underwriting and advisory fees. At the time that fees are negotiated, the company has the option of appointing a different financial adviser if the fees demanded are too high, while the adviser can resign if the offered fees are too low. Some aspects of the issue, including the issue price and the percentage (if any) of the sub-underwriting to be tendered, are settled only immediately prior to the issue announcement but affect the risk borne by the lead underwriter and hence the appropriate level of fees. The comments of issuing companies suggest that, at this stage, there is an imbalance of bargaining power as companies frequently need the money to complete a transaction and would find it difficult to change advisers. The imbalance of bargaining power is clearly greater where the company does not have independent financial advice available (for example, when the company's broker is also acting as lead underwriter and financial adviser). The comments of financial advisers suggested that their reputation for competence and integrity was at stake and that it would not therefore be in their interests to give companies a bad deal.

4.23. As discussed above, standard underwriting fees continue to be charged by many underwriters. Table 4.6 shows the number of offers at standard fees and the percentage of underwriting fees paid on those offers. Offers where standard fees were paid to lead underwriter, broker and sub-underwriters accounted for about 60 per cent of total underwriting fees over the period 1995 to 1997. The comparable figure for offers where the standard fee was paid to the lead underwriter (but not necessarily broker or sub-underwriters) was 78 per cent and to the broker was 82 per cent. Following the introduction of tendering at the end of October 1996, the percentage of fees accounted for by offers at standard fees fell substantially (the lead underwriter's fee was affected as in many tendered issues the lead underwriter agreed to reduce it pro rata with the results of the tender). The table excludes advisory fees paid to lead underwriters and brokers; there is no evidence of standard rates being paid on these advisory fees. Consequently, the standard fee paid to lead underwriters and brokers does not necessarily determine their total remuneration.

TABLE 4.6 **Use of standard underwriting fees**

	Total underwriting fee	*Lead under-writer's fee*	*Broker's under-writing fee*
1995 to 1997			
Offers at standard fees (number)	219	289	279
Offers not at standard fees (number)	127	82	88
Inadequate information (number of offers)*	113	88	92
Total (number)	459	459	459
Standard fees received (£m)	261	96	47
Non-standard fees received (£m)	160	25	10
Inadequate information (£m)	18	2	0
Total fees (£m)	439	123	57
Percentage standard	60	78	82
31 October 1996 to end-1997			
Offers at standard fees (number)	62	93	94
Offers not at standard fees* (number)	66	45	41
Inadequate information (number of offers)*	32	22	25
Total (number)	160	160	160
Standard fees received (£m)	20	7	7
Non-standard fees received (£m)	54	13	5
Inadequate information (£m)	5	1	0
Total fees (£m)	79	21	13
Percentage standard	26	35	58

Source: MMC.

*Includes offers where no fee information was available and also those where there was inadequate information to determine whether standard or non-standard fees were paid.

Note: Total fees and percentage at standard fees do not necessarily reflect constituent figures shown due to rounding errors. Sub-underwriting fees are shown in Table 5.3.

4.24. We asked investment banks whether they thought the underwriting fee retained by lead underwriters purely compensated for risk or whether it also remunerated other services provided by the lead underwriter. We received a variety of responses: 13 respondents indicated that the lead underwriter's fee was primarily compensation for risk and 24 respondents clearly indicated that other services were remunerated by the fee as well. Among the services mentioned as being covered by the lead underwriter's fee were advisory work, documentation, project management and marketing. None of the lead underwriters and brokers who responded to our questionnaire (see Appendix 2.3) treated underwriting as a separate profit centre and we were unable to obtain useful information relating to costs incurred or profits earned in supplying services in this market. The available data related to all corporate finance activities and seemed of little value to our inquiry.

4.25. Advisers are often remunerated on a transaction-related basis. Consequently, no fee may be received for advice which does not lead to a transaction and fees associated with the transactions, including share issues, that do occur are higher than they otherwise would be. An advantage of this method is that it incentivizes the adviser to provide useful advice. A disadvantage is that fees may be less transparent. Corporate broking services appear to be less often remunerated on a transaction-related basis than financial advice, with annual fees for work done between transactions being more common.

Market shares

4.26. We have calculated the share of lead underwriting fees received by each lead underwriter over the 1995 to 1997 period. Financial advisory fees were not included due to incomplete information: allowance for advisory fees would tend to increase the share of the smaller firms who tend to advise on smaller issues. It should also be noted that computed fee shares depend heavily on the largest share issues, of which there were only a small number in the period 1995 to 1997 (there were 12 underwritten offerings over £350 million).

4.27. Table 4.7 summarizes the shares of lead underwriting fees. No firm had a share of over 20 per cent and there were ten lead underwriters with a fee share of over 5 per cent. These were (in alphabetical order): Baring Brothers International Limited (Barings), BZW (the relevant parts of which were subsequently acquired from Barclays plc by Credit Suisse First Boston (CSFB), Deutsche Morgan Grenfell, DrKB, Hoare Govett Limited (Hoare Govett), Lazard Brothers & Co Limited (Lazards), NatWest Markets (the relevant parts of which were subsequently acquired by Bankers Trust and renamed BT Alex Brown), SBC Warburg Dillon Read (now Warburg Dillon Read), Schroders and UBS Limited (part of the Union Bank of Switzerland Group). SBC and UBS subsequently merged and the combined investment banking business is known as Warburg Dillon Read.

TABLE 4.7 **Market shares of lead underwriters, 1995 to 1997**

Share of fees	*Number of lead underwriters*	*Total share of fees*
Over 10%	2	25
5% to 10%	8	57
Up to 5%	52	18
Total	62	100

Source: MMC analysis of lead underwriters' fees.

4.28. Table 4.8 similarly summarizes the shares of brokers' underwriting fees (again excluding advisory fees due to incomplete information). No firm had a market share of over 20 per cent and there were seven firms with a fee share of over 5 per cent. These were (again in alphabetical order): BZW, Cazenove, DrKB, Hoare Govett, HSBC Investment Bank plc (HSBC), SBC Warburg Dillon Read and UBS.

TABLE 4.8 **Market shares of brokers, 1995 to 1997**

Share of fees	*Number of brokers*	*Total share of fees*
Over 10%	4	58
5% to 10%	3	23
Up to 5%	36	19
Total	43	100

Source: MMC analysis of brokers' fees.

Entry requirements

4.29. The main requirement for entry as a financial adviser is a reputation for giving good advice, including the necessary skill and knowledge base. 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. A new entrant might be able to establish a reputation rapidly by recruiting experienced individuals. In advising the largest companies, an international presence also appears to be of importance.

4.30. The position for brokers appears to be similar, except that there may be a greater need for staff with specific skills and experience in areas such as distribution capability, research and sales, and competence in the interpretation and application of the listing rules of the LSE. This may imply that entry has to be on a larger scale than for financial advisers.

4.31. Entrants must also satisfy all relevant regulatory requirements. A firm acting as a lead underwriter would require authorization and would have to meet capital adequacy requirements. More generally, a lead underwriter requires sufficient financial capital to have credibility with issuing companies.

4.32. There is evidence of significant entry and exit in the market:

(a) There has been entry by US investment banks, including Merrill Lynch International (Merrill Lynch), Goldman Sachs, Morgan Stanley, Lehman Brothers, J P Morgan Securities Ltd; and also the Japanese firm, Nomura International plc. All of these firms appear to compete in the market for advice. Some of them are also active as brokers, although it should be noted that Merrill Lynch acquired Smith New Court, an existing market maker and broker. None of these entrants had a significant share of lead underwriting of rights issues, open offers and cash underpinnings during the period 1995 to 1997 but this may reflect their concentrating on advice to the largest companies which have carried out very few of these types of issue in recent years.

(b) Exit has occurred most notably by Barclays plc and NatWest, which during 1997/98 sold parts of their investment banking business. The parts of the business sold included the main parts providing advice and lead underwriting on equity issues.

Competition between advisers

4.33. We asked companies which had made a share issue about some aspects of competition between advisers (see Appendix 2.2). The main points emerging were:

(a) 64 per cent of those responding thought there was at least some competition between financial advisers and 58 per cent thought this for brokers.

(b) About 75 per cent of advisers used by companies had served for a period of five years or less (15 per cent for one year or less).

(c) About 30 per cent of companies had just one adviser (a corporate broker) and about 25 per cent had three or more (typically one financial adviser and two brokers).

(d) Around 70 per cent of those responding said that it was not difficult to change advisers while 30 per cent saw some difficulty (these figures excluded around 25 per cent who did not respond to this question).

(e) Some 85 per cent of those responding said that they were reliant on their advisers for the method, pricing and other aspects of a share issue. However, most also said that they had access to advice from a variety of other sources including non-executive directors, accountants and lawyers.

(f) As shown in Table 4.9, the majority of those responding thought there was competition between advisers on both price (ie fees charged) and quality of service.

TABLE 4.9 **Bases of competition between financial advisers and brokers**

	Price (mainly)	*Quality (mainly)*	*Both*	*Other*	*No reply or not known*
Financial advisers					
Number of companies	3	74	130	22	61
Percentage of responses	1	32	57	10	
Corporate brokers					
Number of companies	1	82	117	31	66
Percentage of responses	0	35	51	13	

Source: MMC's questionnaire to companies.

Note: Percentages may not sum to 100 due to rounding errors.

4.34. Several small companies told us that it was difficult to find an adviser. This appears to reflect economies of scale in providing advice: the smaller the company (as measured by profits and market capitalization) the higher the cost of advice relative to the company's profits. At some point it becomes very difficult for advisers to quote an affordable fee to small companies.

The market for nil-paid rights

4.35. In a rights issue, shareholders who do not wish to take up their rights can receive the value in the rights in one of two ways: either by selling their rights in nil-paid form or by doing nothing and receiving their share of the proceeds of the rump sale.

4.36. We asked banks and brokers about the efficiency of the market in nil-paid rights. A common response was that this depended on liquidity in the underlying shares: the market worked well when the market in the underlying shares was liquid but less well when the underlying market was illiquid. A number of respondents suggested that, when underlying liquidity was poor, the shares tended to trade down to a level close to the offer price. One commented that this illustrated the effect of dealings at the margin in securities which lack a natural two-way order flow.

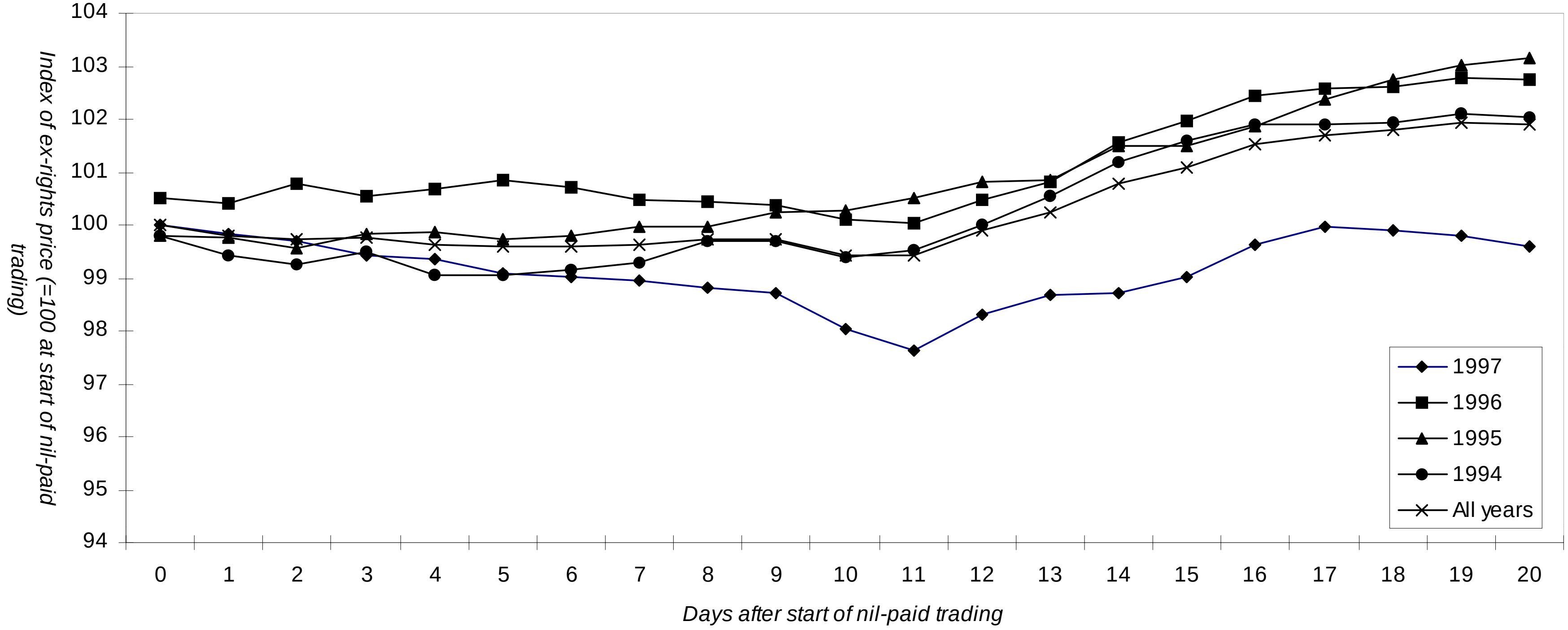
4.37. One respondent (CSFB) provided us with a study of the working of the nil-paid market (see Appendix 4.1). The main points emerging were:

(a) On average nil-paid rights tend to trade at a small discount compared with the difference between the ex-rights price and offer price in the rights issue.

(b) There was a tendency, as shown in Figure 4.3, for share prices to rise after the end of the nil-paid trading period (the last day of trading is shown as np + 13 on Figure 4.3). Figure 4.3 does not show any general tendency for the share price to underperform relative to the wider market during the period of nil-paid trading (rights issues in 1997 were an apparent exception).

FIGURE 4.3

Trend in average ex-rights price of companies (adjusted for changes in FTSE index) making a rights issue during the period of nil-paid trading



Source: CSFB.

Note: Based on unweighted average of ex-rights prices (adjusted for the FTSE index) of companies making a rights issue.

4.38. It should be noted that shareholders selling nil-paid rights may incur significant transaction costs as the bid to offer spread on the nil-paid is likely to be greater as a percentage of value than the spread on the fully-paid shares. For the small shareholder the proceeds of any sale of nil-paid are likely to be small and hence commission paid on the sale may also be relatively high as a percentage of value.

4.39. We sought data from lead underwriters on the price obtained in the sale of the rump. Satisfactory data were obtained for 68 rights issues between 1995 and 1997 and for these issues the price was on average 1 per cent below the closing mid-market price on the day the rights issue closed. The price obtained for the rump was on average 1.9 per cent below the closing mid-market price on the day after the rights issue closed (both the weighted and the unweighted averages were 1.9 per cent). The range was from 10.6 per cent below the closing mid-market price on the day after the rights issue closed to 1.1 per cent above. An execution-only broking commission of about 0.2 per cent would also be paid on the rump sale. On average (weighted) the rump accounted for 8 per cent of issue size. It should be noted that we also found evidence of a small increase in share prices relative to the FTSE All-Share Index between the announcement of the rights issue and the day after the rights issue closed: the unweighted average increase was 1.5 per cent; the average weighted by value of the rump was 1.2 per cent and the average weighted by amount underwritten was 0.4 per cent.