

7 Views of third parties

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Companies which made share issues in the period 1995 to 1997

A large company

7.1. A large company which submitted evidence noted that companies undertaking rights issues inevitably needed to have such an issue underwritten to guarantee the level of funds. This guarantee was required not only by the vendor of the assets (if bank facilities were not sufficient), but also to satisfy the working capital sufficiency test required by the LSE Yellow Book. In effect, a company had no choice but to underwrite an issue; deep discounting was not acceptable.

7.2. The standard underwriting fee of 2 per cent was well known. With a 'trombone' issue (see paragraph 3.34) a further fee was applicable, supposedly to reflect additional risk on the second instalment, amounting to 0.375 per cent on the second instalment. However, under the terms of the underwriting agreements for a 'trombone' rights issue, there was no additional risk to the underwriter than with a normal rights issue, as the second instalment was the liability of the holder of the partly-paid stock and not the underwriter. In effect, the additional premium was normal City practice, with little obvious rationale as regards risk.

7.3. The company said that perhaps the most interesting aspect of underwriting related to the price of the shares being issued. Merchant banks, together with brokers, supported companies throughout the process of the transaction until the final hour when the pricing of the issue was decided. At that point, the merchant banks and the brokers had a vested interest to widen the discount of the rights issue to guarantee a successful issue. Effectively, they were minimizing the risk of the underwriting through the discount. Ultimately, the client's only choice was to agree to this or the underwriting would not be undertaken by the merchant bank. Although the argument that the absolute discount was irrelevant in accounting terms was broadly true, the widening of the discount reduced the equity funds available to the company, thereby increasing debt. Alternatively, a company must issue more shares, if the advisers agreed, at the lower price. The issue of dividends then became important.

7.4. The company said that with dividends the advisers could utilize the dividend stream as a further method to reduce risk. Not only did advisers want to see a 'good' dividend increase, often ignoring the 'adjustment factor' of the rights issue, but also all new shares ranking for dividends going forward; this was a real cost to the company.

7.5. Merchant banks would only enter into an underwriting agreement if there had been a successful pre-marketing exercise with significant uptake of the sub-underwriting. Without this comfort, merchant banks would not undertake the underwriting. Again, merchant banks and brokers were effectively mitigating the risk.

7.6. The company added that for a public company to change advisers at the time of a major transaction was extremely difficult for a number of reasons. It was therefore almost impossible to create a competitive situation between advisers, not least because of the confidentiality of such a process. Accordingly, any change to the standard underwriting fee might possibly result in an increase in the advisory fee payable to merchant banks and brokers.

Advent Limited

7.7. Advent Limited (the manager of Advent VCT plc) said that it had floated a considerable number of its investments in the UK and the USA. In nearly every case it had achieved a sufficient underwriting of the issue although it had experienced very different conditions when comparing the UK and the USA. It felt that the benefit of the US system had been the introduction of a much broader range of shareholders in the newly-issued company stocks; this had proved beneficial to subsequent liquidity.

Barratt Developments PLC

7.8. Barratt Developments PLC said that underwriting fees appeared to be so consistent that they did not fully reflect the varying degree of risk assumed by underwriters in relation to individual issues. Moreover, the ongoing relationships between brokers and institutions meant that the vast majority of commitment was effectively secured prior to any formal issue.

Berisford plc

7.9. Berisford plc (Berisford) believed that the current system of equity fundraising in the UK was efficient and should be retained. It said that well-managed UK companies should be aware of the evolving competitive practices in underwriting and should be able to negotiate these with their underwriter. The highest issue price was not always the most sensible goal to seek, and commissions (a direct cost to the company and shareholders) might sensibly be 'traded off' against a wider discount in which the pre-emption system allowed all shareholders to benefit.

7.10. Berisford made a number of observations:

- (a) In its experience, fundraising was not hide-bound by convention, and well-thought-out financing structures (as used in its Welbilt acquisition) could be successfully promoted even though they were unusual.
- (b) The pre-emption system ensured that existing shareholders would benefit from any discount in issue price, whether or not they took up the issue.
- (c) International commission structures (not unusually twice the level of those in the UK at 4 to 5 per cent) would inevitably come to the UK if the system were to change. This would be a direct cost to shareholders. Competition, even in the US domestic market, had not significantly reduced costs; there was no reason to believe it would do so in the UK.
- (d) Changing the structure would reduce competition, since the issuing business would become concentrated in the hands of heavily-capitalized distribution houses. At present, a far wider choice was available.
- (e) Berisford had access to significant innovation in the current market place. Its own financial advisers had introduced a success-based commission structure as long ago as July 1995.

(f) Tendering in rights issues was available where requested.

Bodycote International plc

7.11. Bodycote said that it had decided to use the deep-discounting method for its most recent rights issue in December 1997 because it gave substantial savings to the company and to its shareholders. It had initially considered financing the acquisition by borrowing, but decided against this course of action because it felt that gearing levels would become unacceptably high. As a result, a rights issue was decided upon, even though it had had a rights issue, in which 50 per cent of the sub-underwriting had been tendered, in December 1996. It said that the issue had been well received while preserving shareholders' pre-emptive rights. An estimated £2 million had been saved on underwriting compared with what would have been the cost under the conventional method.

7.12. Bodycote said that some city institutions had misunderstood the implications of deep discounting because they thought that earnings per share would be diluted; in fact they would be adjusted to take account of the scrip element. Generally, there was some suspicion of the deep-discounted method.

7.13. Bodycote had expanded rapidly over the last five years, both by acquisition and internal growth, and was experienced in mergers and finance; that, together with its successful track record, had put it in a position to be innovative.

7.14. On possible conflicts of interest between the financial adviser and the lead underwriter, Bodycote said that, in practice, the 'Chinese walls' which existed between the different functions were very carefully observed. It believed that the cost of the UK system of issuing equity compared well with the rest of Europe and the USA, but the traditional 2 per cent underwriting fee did not, in its view, give value for money.

Capital and Regional Properties plc

7.15. Capital and Regional Properties plc (CRP) submitted evidence and attended a hearing. It was concerned that the existence of pre-emption rights was a huge cost to companies when raising capital. The institutions claimed that these rights protected existing investors, but CRP believed there were other reasons why institutions wished to preserve the restriction on raising new equity. The effect of non-take-up by other existing shareholders enabled those institutions, which were sub-underwriting the issue at a substantial discount, to buy shares at a considerably lower price than they would otherwise have to pay—in addition to receiving their sub-underwriting fees. This materially enhanced their funds' performance at the cost of other shareholders. CRP therefore concluded that whilst underwritten issues gave companies certainty, the application of pre-emption rights could destroy shareholder value. CRP believed the Government should insist that pre-emption rights be abolished if UK companies wishing to raise capital were to compete successfully, for example, with those based in the USA.

7.16. CRP was of the view that a different fee structure should be introduced to reflect the amount actually taken on risk by brokers to that which was sub-underwritten. It said that sub-underwriting fees were not a major concern; the issue price was a more important consideration. CRP did not think that mandatory tendering for sub-underwriting would reduce costs significantly.

Capital Shopping Centres PLC

7.17. Capital Shopping Centres PLC (Capital) welcomed the decision to investigate the supply of underwriting services. It strongly held the view that the practice of charging standard fees operated against the interests of major companies wishing to access capital markets on a regular basis in the course of financing the expansion of their businesses.

7.18. Capital said that charging a standard fee for underwriting and sub-underwriting discouraged competition between individual investment banks and promoted inefficiencies in the new issues market. In a freely competitive market, underwriting commissions should reflect the pricing and covenant strength of the issuer, and therefore properly differentiate the cost of an issue between large and small companies and those with varying balance sheet gearing ratios.

7.19. Capital believed that the abolition of fixed fees would enable investment banks to be remunerated on a one-to-one negotiated basis. Whilst this might result in a modest consolidation of the industry, long-term benefits would ensue from a market free from artificial constraints.

Cordiant plc

7.20. Mr C J Bunton gave evidence and attended a hearing in his capacity as consultant to the three successor companies of Cordiant plc, following its demerger in December 1997. He considered that the market for equity capital in the UK was restricted because of the requirement to offer equity sold for cash first to existing shareholders. The existence of such restrictions made it more difficult to construct an open market for underwriting fees than if there were free competition for equity capital. On at least one occasion in the early 1990s Cordiant plc had identified with reasonable confidence potential overseas providers of equity but was unable to complete the transaction because of the constraints of pre-emption rights.

7.21. Mr Bunton believed that the structure of the underwriting process was such that risk was limited. The issue price was generally set at a level which made it unlikely that securities would not be sold. He understood that sub-underwriters generally agreed to participate in the underwriting of issues on the basis that they were fully sub-underwritten and therefore there was an implicit assurance that a high proportion of the shareholders who would receive the rights would take them up. In cases where there was any doubt, it was usual to conduct (sometimes extensive) pre-marketing and the launch was conditional on a successful outcome to that pre-marketing. Such pre-marketing did not tend to reduce the level of underwriting fees.

7.22. As regards deep discounting, Mr Bunton said that there were good reasons why it was not a popular alternative. There tended to be a stigma attached to it; there were tax disadvantages for shareholders and it lacked the certainty of underwriting. In the UK market for underwriting, the penalties for failed issues were far greater than in other markets where such underwriting was not normal practice.

7.23. Mr Bunton said that the UK market for equity capital was more constrained than in certain overseas markets. Based on his limited experience, he shared the view that excess returns existed in sub-underwriting. It was undoubtedly the case that the UK equity market offered certainty for rights issues through its unconditional underwriting feature, and at a level of cost which was extremely low.

7.24. However, there was no reason why the UK market should have to choose between one system or another. In markets for other products and services, different types of product co-existed and competed with each other.

FI Group PLC

7.25. FI Group PLC said that, in its experience, negotiating underwriting agreements with financial advisers was at best difficult. Generally there was extreme reluctance on their part to depart from established market practice.

Magnum Power PLC

7.26. Magnum Power PLC drew our attention to its recent fundraising exercise on the AIM which incorporated elements of a firm placing and a rights issue. The firm placing was fully underwritten, whilst the rights issue was only partially so. The company said that it felt relaxed about the exercise

because of the pre-commitment of shareholders in terms of irrevocable undertakings. It had made significant savings in the fees payable to lead underwriters and sub-underwriters.

Northumbrian Fine Foods PLC

7.27. Northumbrian Fine Foods PLC (Northumbrian), commenting in its capacity as a small listed company, expressed concern about the way in which the corporate finance and underwriting markets operated. It believed that the fees charged by the various financial advisers in relation to transactions which involved the issue of shares were unrealistically high given the nature of the work normally undertaken, which was largely administrative in nature. It was often extremely difficult to have any influence over the level of fees charged and, given the size of the company and the transactions concerned, most financial advisers' minimum fees were still prohibitive.

7.28. Northumbrian believed that underwriting fees were no longer representative of the risk which underwriters accepted in the event that an issue did not succeed, but instead it had become almost a discount paid to so-called underwriters and sub-underwriters for taking allocations of shares which they wanted to hold in the first place. It was rare, if ever, that underwriting agreements were signed before all the shares were, in principle, taken up.

7.29. A consequence of this practice was that, instead of the underwriter forming his own view as to the value of the stock and pricing it accordingly, he in fact conducted what amounted to an auction among his contacts. As a result, the underwriter invariably presented the company, in the final hours of a transaction, with a choice of either reducing the price at which its shares would be issued (below what it had been led to expect) or of aborting the transaction.

7.30. Northumbrian welcomed the investigation which, it hoped, would lead to increased competition resulting in more realistic levels of fees. It also hoped to see greater flexibility in the market place where smaller companies were able to gain better and more cost-effective access to the capital markets, thereby generating more transactions and creating greater shareholder value.

Parkwood Holdings plc

7.31. Parkwood Holdings plc said that the process of its listing on the LSE in December 1996 was expensive. In particular, it questioned the need for companies to have to pay the fees of the broker's lawyers (as well as its own); the need for extremely detailed verification documentation; and the various accountants' reports needed to meet LSE requirements.

Pemberstone PLC

7.32. Pemberstone PLC (Pemberstone) submitted evidence and attended a hearing. It said that charging standard underwriting fees might appear to be anti-competitive but, in its view, any intervention by the Government to change the system could be detrimental to the public interest. Any change could well lead to larger, stronger companies enjoying reduced costs, whilst smaller companies could find the cost of underwriting increasing, assuming that underwriting was still available to them. Even if underwriting were available, it might be at such a cost that it made the raising of new underwritten equity prohibitively costly; underwriting was often an essential ingredient of any share issue.

7.33. Companies generally issued equity because they had either a present or future perceived need for capital, often for reasons of expansion. It was rare for small companies to stand still in operating terms; they either declined or grew. In terms of the UK domestic economy, growth should be healthy and in the public interest. Growth could often result in the provision of additional ranges of goods or services to the public, or the introduction to the market of goods and services that competed with existing providers. Many large companies were very concerned about their market share and often regarded new competitors entering their market as a threat (however small), and to which they needed to respond by improving their own service or by reducing prices, both of which were likely to be in the public interest and improve competition.

7.34. Pemberstone said that if access to underwritten equity became too expensive for small firms it might restrict the supply of equity capital to them, with the result that their ability to grow and expand would be severely restricted. Pemberstone felt that tendering for sub-underwriting was not a realistic option for smaller companies because of the limited number of institutions that were likely to be interested in doing it. In any case, it was unlikely that tendering would lead to lower fees; it was more likely that costs would increase as a result.

7.35. On the question of deep discounting, Pemberstone said that the market was suspicious because of the perception that companies which made deep-discounted rights issues were experiencing difficulties. There needed to be a culture shift over a long period before market makers and institutions accepted that there was nothing wrong with this method which, it believed, was actually far more effective than the conventional rights issue.

7.36. Asked about a possible relaxation of the pre-emption guidelines, Pemberstone said that it was difficult to see how the guidelines could be relaxed without institutions accepting that investee companies might take advantage of that relaxation. If investing institutions in practice did not like investee companies taking advantage of the relaxation, then this could have potential longer-term difficulties for the relationship between companies and investors. The existing pre-emption guidelines could have short-term frustrations for companies seeking to raise finance from new investors.

Scottish & Newcastle plc

7.37. Scottish & Newcastle plc (S&N) said that it was dissatisfied with the present system which, without question, did not result in a competitive environment at a time when companies wished to raise capital. On the two recent occasions when it raised capital from shareholders through rights issues the underwriting fees charged were based on the standard scale even though the risk being taken by the underwriters varied. It believed it was self-evident that there was insufficient competition in the setting of underwriting fees and no cognizance was taken of the risk profile of the transaction.

7.38. S&N said that without implying any criticism of its advisers in these transactions, it was inappropriate that the role of financial adviser and lead underwriter should be carried out by the same party. There was also no question that competition among brokers handling the underwriting would result in better deals for companies although there would be some loss of confidentiality.

7.39. S&N believed that there was merit in reviewing the current 5 per cent placing limit. An increase to between 10 and 15 per cent would provide a route which would enable companies to fund transactions of reasonable scale. There would also be merit in reviewing the current timetable for rights issues which seemed unnecessarily extended. Given the timescale allowed for new issues there seemed no reason why shareholders could not react more quickly than the current timetable, in, say, seven to eight days.

Silver Shield Group PLC

7.40. Silver Shield Group PLC (Silver Shield) believed that the current system provided a structure which generally benefited UK listed companies. With the UK still favouring the maintenance of pre-emption rights for existing shareholders, the rights issue had been maintained as the principal route for existing limited companies to raise new capital. When pricing a rights issue the risk factor had generally been dealt with through the size of the discount rather than the size of the underwriting fee.

7.41. Silver Shield said that any dismantling of this consensus, whilst allowing the principle of pre-emption to remain, would lead to a situation where smaller companies (which it defined as those capitalized at £500 million or less) would find it more difficult and more expensive to secure underwriting. Whilst it was possible that the very largest companies might benefit from a more flexible system, in practice the fee structures for underwriting in overseas markets suggested that over time even these companies would eventually have to pay higher fees.

7.42. Silver Shield said that, as had been evidenced by the larger privatization issues, it had always been possible for the very largest companies to agree their own terms for underwriting. For the rest of the market the existence of a general agreement had benefited small and medium-sized public companies seeking capital for expansion. Silver Shield believed that any changes which did away with the present system would, in time, lead to higher underwriting costs and would tend to discriminate against smaller listed companies seeking capital growth.

Springwood PLC

7.43. Springwood PLC (Springwood) was concerned that a monopoly situation existed and that it was used to the disadvantage of shareholders. In its view, the situation had arisen largely through self-regulation and the tacit protection of vested interests by the self-appointed regulatory authorities. Springwood believed that it required experienced commercial judgment to set the price of an issue fairly. However, this expertise and knowledge should not then be used to control all other aspects of the issue. It should be possible to devise a system which allowed the widest participation in offers and a degree of flexibility in setting a price within a prescribed range. Existing shareholders could be offered better options, including priority participation.

7.44. Springwood identified a number of weaknesses in the present system, including: large discounts on current market prices; underwriting being restricted to 'friends' of the issuing houses; major shareholders not being allowed to participate in underwriting; underwriters making quick profits by selling the shares they had just underwritten; company directors being too acquiescent in allowing their advisers to charge exorbitant fees; and generally offering poor value to shareholders.

7.45. Springwood said that smaller companies needed greater protection and more equality in the market place. For smaller issues possible remedies might include deep discounting, or the creation of a register of prospective underwriters who would bid in an open market within an offered price range.

Stagecoach Holdings plc

7.46. Stagecoach Holdings plc provided us with details of its 1996 rights issue. It said that in considering the whole aspect of corporate finance, it would be wrong to look at the sponsors' costs as a percentage of the capital raised in isolation. From its point of view, the overall pricing of an issue and the subsequent after-market were clearly very important. It said that it was definitely unusual in having significant board shareholdings. This meant that it was less keen to accept unnecessary dilution through underpricing, while at the same time it saw the dangers in terms of having a weak after-market following an overpriced issue.

Stakis PLC

7.47. Stakis attended a hearing. It had made a rights issue in November 1996 to finance its acquisition of Metropole Hotels. Its financial adviser, Schroders, had arranged for a third of the sub-underwriting to be tendered, which gave the company a saving of £400,000 in underwriting fees. Stakis had been concerned about the level of underwriting fees charged in earlier transactions and it had wanted to find a cheaper way of raising capital. It said that sub-underwriting could now be priced on the basis of the risk associated with deals and it was in companies' hands to take advantage of this. There were, however, some imperfections with the system and a number of improvements could be made to make the process work better.

7.48. Stakis believed that there was competition between merchant banks for their services as advisers to companies, and that it was easy for companies to change advisers if they wished. It also believed that a good relationship with an adviser was more beneficial to a company than if it were a purely deal-driven arrangement. The whole point about a relationship was that confrontation did not arise; there was a commonality of interest between the company and the merchant bank as to what they both wanted to achieve.

7.49. On possible conflicts of interest, it was not concerned that its largest shareholder also acted as both financial adviser and lead underwriter; there were 'Chinese walls' within the organization to deal with any conflicts that might arise. Stakis said that if it were required to split the role of adviser between two firms there would be no advantage to the company as it would have to pay double the amount in fees.

7.50. Stakis felt that deep discounting of rights issues in order to avoid underwriting was flawed in terms of what it tried to achieve. There was a great deal of misunderstanding surrounding deep discounting and a lot of ill-informed comment about it, and it made no difference whatsoever to shareholders' wealth. Stakis was against the way deep discounting operated and felt that company directors were taking too much on themselves in making shareholders' decisions for them.

7.51. Stakis believed that pre-emption rights were important to smaller shareholders and that any relaxation or abandoning of them should be a matter for shareholders to decide.

The Berkeley Group plc

7.52. Berkeley had, for some time, been concerned that raising new equity by way of rights issues could be achieved only at a standard cost. It said that the cost of underwriting in particular did not appear to take into account the quality of the company seeking the underwriting, nor indeed the reasons for it.

7.53. Its most recent rights issue was achieved by setting a more deeply-discounted price for the new shares and then inviting the sub-underwriters to tender both for the numbers of shares that they were underwriting and the commission level they were seeking. This had proved to be extremely successful and, broadly speaking, it believed that the total cost of the exercise was roughly 50 per cent of what it would have been had it pursued the traditional route.

7.54. Berkeley doubted that a monopoly situation existed, but believed that there were various arrangements relating to the pricing of underwriting which could work against the interests of those seeking to raise new capital. The most fundamental change to the present system would be to organize it so that those raising new equity did not necessarily need to underwrite it. This could be achieved, for instance, where the new equity was raised at a very significant discount to the prevailing share price. There could, however, be significant CGT disadvantages for large shareholders in this arrangement. The current rules were that provided a sale was defined as a *de minimis* sale, then the shareholder was not taxed. However, the more deeply discounted the rights issue, the more likely it was that the *de minimis* rule was breached and the shareholder was thus taxed—to his disadvantage. This could be overcome by appropriate adjustments being made to the tax rules by, for example, a widening of the *de minimis* arrangements. Berkeley itself had avoided a rights issue discounted so deeply as to require underwriting because of the potential CGT effects on directors.

The Character Group plc

7.55. The Character Group plc (Character) said that larger companies could be reasonably certain that, provided they priced the issue appropriately, they would be able to achieve a successful rights issue or placing and therefore the question of costs to those companies became paramount. For companies of Character's size (capitalized at less than £100 million), the real question was whether or not they would be able to get a rights issue away, and therefore the question of cost became very much a secondary consideration. Finding underwriters to take on the responsibility of rights issues for small companies was difficult in itself, but to do so while trying to negotiate reduced rates would be almost impossible.

7.56. Character said that it would like to see charges reduced as much as possible, but its primary concern was getting the job done. It was prepared to pay a reasonable rate in order to obtain the peace of mind that underwriting brought to a deal, especially if it was done at an early stage of the procedure.

The Scottish Oriental Smaller Companies Trust PLC

7.57. The Scottish Oriental Smaller Companies Trust PLC was launched in March 1995. It said that because of the high levels of fees charged, many similar trust launches at the time had resulted in shareholders' assets representing about only 96 per cent of the proceeds of the issue. It had felt that this was unacceptable and the expense of the placing was therefore limited to 1 per cent of the gross proceeds of the placing. The placing was not underwritten, partly because it was felt that the level of underwriting fees then prevailing would have led to an unacceptable and immediate reduction in the assets attributable to the new shareholders.

Other companies

A large company

7.58. A large company said that something of a closed shop existed in equity underwriting, and that this applied not only to straightforward equity issues, but also to convertible debt issues, where a standard 2.5 per cent fee appeared to be applied. It seemed that the major banks competed on service and market knowledge, but not on price.

Another large company

7.59. Another large company made the following comments:

- (a) The costs of raising equity finance in the UK appeared to be high compared with international standards.
- (b) Attempts to negotiate lower costs had, in its experience, always been met with a response from the sponsoring merchant bank that it was what the market demanded and it was not negotiable. Also, the level of discount that normally applied when issuing shares seemed excessive compared with the risk which underwriters took when they were left with shares.
- (c) It believed that the pre-emption rights of existing shareholders under UK company law and the relatively small number of 'major institutions' seemed to act together to curtail competition. It also believed that little would be achieved in terms of lower costs unless pre-emption rights were weakened, or unless major existing shareholders could be forced towards wanting the equity-issuing company to minimize costs rather than maximizing their own underwriting income.
- (d) The company said that, from the economic viewpoint of small shareholders, underwriting costs should be minimized. The current arrangements acted as a subsidy from small shareholders to the major institutions. It wondered whether there was any merit in not allowing existing large shareholders to participate in underwriting or sub-underwriting while not losing their pre-emption rights. This should lead the major investing institutions to change their attitude towards the equity-issuing company achieving the lowest cost of underwriting in general. There was then the problem as to who would provide the underwriting in these circumstances and whether it would be cheaper.

Allied Domecq PLC

7.60. Allied Domecq PLC welcomed any measures that would increase competition in underwriting. From its observations, the raising of capital was invariably at a substantial discount to the market thus resulting in little risk to the underwriter. The remuneration for underwriting fees seemed to be out of proportion to the risks involved.

BG plc

7.61. BG plc said that the provision of financial advice was a well-populated and competitive market and it should therefore be possible to obtain impartial advice. It added that payment of underwriting fees for rights issues was voluntary. Deep-discounted issues were possible and therefore the need for underwriting could be avoided.

Cadbury Schweppes PLC

7.62. Cadbury Schweppes PLC (Cadbury Schweppes), which made rights issues in 1993 and 1995, submitted evidence and attended a hearing. It considered that the standard fee was far too high in relation to the risks accepted by underwriters. Since its incorporation in 1969 no shares issued by it had ever been left with underwriters.

7.63. It felt that, in common with most other issuers of equity, it had been constrained by a number of circumstances which, together, made it impractical to break free from the established standard terms for underwriting. These were:

- (a) Share issue timetables had been inseparable from acquisition timetables.
- (b) There was a need for strict confidentiality; both acquisitions and share issues were price sensitive.
- (c) Despite being in £ million, underwriting commissions were always, by their nature, very much less than the cost of an acquisition. Management's priorities were always to negotiate an acquisition at a satisfactory price and to ensure that sufficient finance was available at reasonable terms; negotiating underwriting terms was a lower priority.
- (d) There was no precedent in the company for seeking better underwriting terms and so no knowledge as to whether it might be worthwhile.
- (e) Even standard terms were available only if the advisers were content with key parameters, namely: size of issue, discount percentage and recent share price stability or volatility.

7.64. Thus, hitherto, Cadbury Schweppes had not considered it practicable to shop around for lower rates.

7.65. As regards possible alternatives to the present system, Cadbury Schweppes made the following comments:

- (a) It had always rejected the idea of making an issue at a conventional discount but without any underwriting. There was always the risk that not getting sufficient cash could force a second issue at a lower price which, in turn, could upset those shareholders which did subscribe to the initial issue.
- (b) Although making an issue at a deep discount with no underwriting was fine in theory, there was a risk that many shareholders would not understand and they might conclude that management considered the shares to have been overpriced at the current (pre-rights) price, thus provoking a reduction in market capitalization.
- (c) A book-building approach would ensure a competitive market if it could be adapted to comply with the pre-emption principle embodied in UK company law.
- (d) Inviting competitive quotes for underwriting at a conventional discount was a consideration for future issues.

7.66. Cadbury Schweppes would be reluctant to be the first to depart from the current accepted practice. However, if bodies such as the LSE, the ABI or the NAPF were to state that they considered it good practice for companies contemplating underwriting arrangements to obtain written quotations

of terms from at least three independent sources, and to disclose such quotations (possibly without attribution) in relevant circulars, then a more competitive market should emerge fairly rapidly although with concerns about transaction security in some cases. It considered that tendering for sub-underwriting was a positive development because of the very substantial cost savings to companies. However, it was against mandatory tendering, preferring instead a more flexible approach.

Caledonia Investments PLC

7.67. Caledonia Investments PLC was concerned that any change to the present underwriting system might lead to higher charges. It noted that the cost of raising capital was substantially higher in the USA, and it believed that companies in the UK were being encouraged by the investment banking community (now largely US-dominated) to move towards the US system with higher costs being imposed on the UK corporate sector for the benefit of investment banks. The company believed there were growing signs that investment banks in the UK were now beginning to put forward innovative ways of reducing standard fees. It also believed strongly that the pre-emption rights of shareholders should be maintained.

Ladbroke Group PLC

7.68. Ladbroke Group PLC (Ladbroke) said that it had made a number of conventional rights issues since it first came to the market in 1967. In relation to the more recent issues it understood that fee negotiations resulted in merchant banks bearing only some of the incidental costs (for example, printing) which would not be reflected in disclosed fee percentages. The banks, therefore, would not be seen to be 'breaking rank'. It believed a perception existed that the level of discount had some reflection on the general confidence in a company's share price, and that such a perception would not encourage the use of deep-discounted rights issues.

7.69. Ladbroke had a number of observations to make on conventional rights issues. These were:

- (a) The reliance on an issue being underwritten severely limited a company's negotiating position. Any reduction in the level of underwriting fees would not be material in the context of the overall event and, therefore, was not a factor in any decision whether or not to proceed.
- (b) Negotiation of fees could detract from determining an appropriate level of discount.
- (c) The separation of adviser and underwriter would complicate an already pressurized process which, by adding extra cost, only diluted the benefit of any fee reduction obtained.
- (d) Any involvement of further parties was a serious concern to companies seeking to avoid any 'leak' of price-sensitive information.
- (e) Reference to a market norm allowed companies to justify the amount of fees paid, thereby perpetuating the level. Moreover, sub-underwriters were likely to be the companies' major shareholders.
- (f) Unless the level of discount was agreed in advance, it would not be feasible to do so in respect of fees.

7.70. Ladbroke said that clearly from a company's perspective it would be desirable to have a generally accepted process for rights issues which made underwriting fees more competitive, which at the same time avoided any conflict of interest; a process which did not detract energies from the overall project, did not require the involvement of additional parties, but ensured certainty of proceeds and would enable the pre-selection of advisers.

7.71. Accordingly, Ladbroke favoured any extension of tendering for sub-underwriting; a sliding scale of commission dependent on the level of discount; and any mechanism which would result in a rebate on a maximum fee calculated by reference to actual take-up levels, the level of the issue's dis-

count and historic returns earned by underwriters (such bases of calculation would be published by all those offering underwriting services).

7.72. Ladbroke added that other more cost-effective arrangements for raising new equity (which included a more widespread use of deep-discounted rights issues) would be welcome.

Marks & Spencer plc

7.73. Marks & Spencer plc said that it seldom had recourse to the capital markets but firmly believed in the merits of organic growth methods. Whilst it welcomed any move towards greater competition, it was concerned that the current process could be replaced by something worse. It pointed out that the cost of raising equity capital in the USA was much greater than in the UK, and the methodology had tended to put investment banks in an overly powerful position. It also believed, however, that growing competition would, over time, generate a greater variation in fees than had been seen in the past, reflecting specific circumstances and risks.

Monument Oil and Gas plc

7.74. Monument launched a rights issue in April 1998 to provide funding for the group's investment plans. It changed its financial adviser at the end of March 1998 (at short notice), appointing Schroders because of its perceived success at innovating, and willingness to innovate, in equity capital-raising in the UK. The issue was structured so that a number of the company's major shareholders, representing 54 per cent of the issue, undertook to take up their rights and to enter into a tender to underwrite the remaining 46 per cent. The only variation in the tender was the level of commission bid, and this was subject to a maximum. The tender itself was open to the market as a whole and not just the shareholders who had committed to enter it.

7.75. Monument was concerned that there should be as low a discount as possible so as to minimize the initial value of nil-paid rights. This was because it was concerned that if the share price were to rise after the issue was launched, the value of the nil-paid rights would have a value in excess of 5 per cent of the original holding and thereby become subject to CGT for individual shareholders who were unable, or did not want, to subscribe for their entitlement under the rights.

7.76. Monument therefore decided against a non-underwritten deep-discounted rights issue simply because the necessary discount level would have triggered—for some, very substantial—CGT bills for individual shareholders who were unable or unwilling to subscribe. The company had many loyal individual shareholders, including virtually all its staff. It was therefore not considered acceptable to choose a structure which would adversely affect these shareholders.

SmithKline Beecham plc

7.77. SmithKline Beecham plc (SB) made the following observations:

- (a) It believed that historically there had been a complex monopoly in the supply of underwriting services in the UK that had led to standard levels of underwriting fees which were anti-competitive and operated against the public interest.
- (b) It said that there had been a recent trend towards competitive tendering for all or part of sub-underwriting which had led to a reduction in the level of underwriting fees. It was not sure to what extent this trend was due to market forces as opposed to a response to heightened scrutiny by the UK competition and other regulatory authorities, and the fear of change in practices being imposed by law or regulation. It was also unclear whether the current trend would continue and if it would lead to further reductions in underwriting fees as a result of increased competition.

- (c) If SB were to undertake a rights issue it thought it very likely that it would follow a competitive tendering process for sub-underwriting, in the expectation that it would achieve a level of underwriting fee that was lower than the standard 2 per cent.
- (d) SB would also review possible alternative methods of equity-raising. It believed that, as a large global company, it had sufficient depth and expertise internally to assess whether it received impartial advice from external financial advisers and to ensure that any decision it made was on a properly informed basis.

7.78. From this, it believed that the current trend adequately addressed concerns about anti-competitive practices, at least for large listed companies such as itself. Provided this trend continued, it would not request legislative or regulatory measures. However, it believed that if continued progress was to be made towards a more competitive market in underwriting fees, the situation should continue to be monitored and further steps considered.

Smith & Nephew plc

7.79. Smith & Nephew plc (Smith & Nephew) said that it endorsed the process of opening up underwriting to competition by tender. Rights issues were a highly effective way of raising equity both for healthy expanding businesses, large or small, and those in trouble. However, for many years corporate users had found that the process was 'not negotiable' with the City. The situation had changed in that banks and brokers were now prepared to invite tenders for underwriting, but their roles still remained 'tied'. However, the viability of tendered underwriting had yet to be fully tested as no really large rights issues had been conducted in this way.

7.80. A criticism of the tendered underwriting approach was that it discriminated against the smaller, riskier issues in that it led to higher underwriting fees and deeper discounting. Smith & Nephew disagreed with this view stating that the larger, more stable issues should not subsidize those which were smaller and riskier.

7.81. Smith & Nephew said that a significant factor in the process was the insistence of investment institutions on shareholder pre-emption rights. This had encouraged a fail-safe 'club' approach to underwriting, which in turn had encouraged the preservation of the status quo among banks and brokers. The corollary of this was that US investment banks saw the UK rights issues market as a source of rich pickings for their public offer approach. However, Smith & Nephew shared the general consensus that this seemed to be a less effective approach than a rights issue for general secondary equity-raising, and was more expensive.

7.82. Smith & Nephew questioned whether pre-emption rights were too restrictive and whether companies should be allowed greater freedom to issue equity directly. If they were, it would enable competitive alternatives to be assessed.

7.83. Smith & Nephew believed that financial advisers should not automatically be appointed as lead underwriters. In their role as lead underwriter financial advisers were not necessarily free to give companies the independent advice which they sought. Corporate brokers should be able to fulfil the role of lead underwriter.

Tarmac plc

7.84. Tarmac plc (Tarmac) said that recent rights issues had demonstrated that the City was capable of finding innovative and more cost-effective ways of raising equity, but it had yet to be convinced that fundamental change would be driven from within. It had also to be convinced whether change could be driven by individual companies seeking new equity. Whilst issuing companies were now more alert to the possibilities of cheaper underwriting through the use of auctions and competitive tenders, and could thus begin to exert more pressure for change, the considerable constraints placed

upon the fundraising process by the LSE rules should not be underestimated as a barrier to truly competitive behaviour.

7.85. Tarmac said that the importance of relationships between issuing companies and their advisers, and the impact of these on competitive behaviour, should not be underestimated either. The long-term nature of these relationships tended to give advisers a degree of monopoly power, which was further heightened by the stigma attached to frequent changes of adviser.

7.86. As regards alternatives to underwriting, Tarmac was of the view that non-underwritten deep-discounted rights issues remained unpopular due to misplaced perceptions among issuing companies. It believed that a programme of education was required if deep discounting was to become an effective substitute and thus reduce the cost of underwriting.

7.87. Tarmac believed it was difficult to determine whether market behaviour with regard to the provision of underwriting services was deliberately anti-competitive as there were many factors, some intangible, which affected market behaviour. However, Tarmac was of the view that it was highly unlikely that competition would work more effectively without some degree of external intervention.

The Royal Bank of Scotland plc

7.88. The Royal Bank of Scotland plc shared the concern that there was insufficient competition in the market for underwriting services. It did, however, recognize that the scope for increasing competition was limited, bearing in mind the restraints, financial and otherwise, on entry by other parties. It believed that these constraints were likely to become greater as the financial services market continued to consolidate, both in the UK and globally

7.89. As regards other options for raising equity, it said that, until recently, this had tended to be the preserve of the financial services sector. However, there was now a greater awareness of the alternatives for raising capital available to companies, and it believed that more use of these alternatives to rights and general equity issues would continue to grow. It said that, in many respects, the opening up of capital markets might be the way in which a greater degree of competition was introduced to the underwriting market.

7.90. Whilst the bank believed that it was well placed to vet and select brokers for its capital transactions, it appreciated that other companies were less so. A means of differentiating between underwriters and brokers was to prevent standard fees being charged, with each party having to justify their fees in terms of the specific work undertaken by them; this would be part of the tendering process.

Unilever PLC

7.91. Unilever PLC said that, in relation to the transactions market as a whole, a situation similar to that which prevailed in the New York market was developing in London; there was an effective scale of fees prevalent in the industry, generally based on the size of the transaction. This was of particular relevance given the increasing concentration of the investment banking and financial services industry in London and the involvement here of major New York banks.

7.92. Whilst banks were happy to compete on the basis of their respective skill base, experience and global positioning, they were less amenable to negotiate on price. If this was the experience of a major listed company such as itself it was likely that it was also the experience of other major companies, and indeed accentuated in the case of smaller companies.

7.93. Unilever PLC said that industry would welcome any encouragement that could be given to price competition in the transactions market generally.

United Biscuits (Holdings) plc

7.94. United Biscuits (Holdings) plc believed that the justification by the financial community for having a fixed rate was perhaps valid in the past when the form of remuneration was seen as reward for other 'free' advice and assistance given. However, specific fees for projects were now usually agreed. Accordingly, it was of the opinion that fees should be related to time, expertise and risk involved, rather than a flat rate based on the amount of cash generated from a share issue.

Wassall PLC

7.95. Wassall PLC said that the fixed commission structure for rights issues was a travesty, which had resulted in a misallocation of resources and good credits subsidizing bad ones.

Associations

Association of Investment Trust Companies

7.96. The Association of Investment Trust Companies (AITC) is a trade association representing 95 per cent by number and value of funds under management of all the approved investment trust companies (ITCs) listed on the LSE. At the end of 1997 there were 314 ITCs which are members of the AITC and between them they managed funds of around £60 billion.

7.97. The AITC said that the principal business of the ITCs was the investment of their funds in equities. As a consequence of Inland Revenue requirements, ITCs tended to spread their risk by having a large number of small investments. ITCs were also restricted in the level of income they could earn from underwriting and related activities. Consequently, they had little or no engagement in lead underwriting, although they did participate in sub-underwriting.

7.98. The dominant business of ITCs was investment in shares and securities. Whilst they were very interested in efficient raising of capital, this should not be at the expense of surrendering pre-emption rights. Pre-emption rights were regarded as an integral part of ownership rights; their existence correctly ensured that all shareholders had the right to participate in any capital-raising exercise and, in addition, ensured that no dilution of their interest took place. The AITC believed that it must remain both easy and cheap for companies to access the equity market and meet the requirement for LSE quotation.

7.99. In principle, the AITC was opposed to any changes which could lead to concentration of power in the hands of increasingly fewer institutions, or changes which would not demonstrably reduce the costs and complexities of raising equity funds. It believed that the present system, where underwriting and sub-underwriting was widely distributed, was effective and low-cost, although it would like to see greater use of tender arrangements and deep-discount rights issues.

7.100. The continuing process of merger and amalgamation among investment banks, the elimination of independent market makers, and the dominance of overseas firms in investment banking had meant that underwriting was already concentrated within fewer institutions. By seeking to change the system radically in the search for even lower costs there was a danger that, as a consequence, there would be a greater concentration of underwriting in fewer hands.

7.101. In addition, the consequence of further radical change could lead to higher overall costs or to a two-tier system where smaller companies found the raising of equity more difficult and costly; the AITC believed that either would be undesirable.

The Association of Private Client Investment Managers and Stockbrokers

7.102. The Association of Private Client Investment Managers and Stockbrokers (APCIMS) is the representative body for firms offering financial services in equities to private investors. It believed that it was important that any proposals did not have a detrimental effect on the likely success or cost of any share issue as this was likely to be borne not only on the company concerned, but also by private shareholders who might suffer from a falling share price as a result.

7.103. On the possible remedy to reduce the length of the 21-day offer period in rights issues, the APCIMS said that, whilst reducing the minimum offer period would arguably reduce exposure to market risk of any potential share issue, and could therefore also reduce the costs of underwriting, it would not expect there to be a significant reduction in costs between a 21- and 14-day notice period. Reducing the period, say, to 14 days could also work against private investors who, for example, might be on holiday for such a period and could potentially miss out on a share offer.

7.104. Whilst the APCIMS was not against such a proposal, it agreed that if companies were allowed to reduce the minimum offer period, they would need to justify it to their shareholders, for example at the AGM or an EGM. It could be a requirement for the relevant underwriters, brokers or financial advisers to attend such meetings to address any specific concerns.

7.105. Careful consideration would need to be given to new issues, where it was not possible to seek existing shareholders' views. New issues tended to be for smaller companies and it was important to ensure that the success of a share offer for a small company was not jeopardized by allowing a shorter offer period without any justification. Whilst it might not be necessary to exclude all new issues from having the option of a shorter offer period, the broker, financial adviser or underwriter should be required to clearly set out the reasons why they were recommending a shorter period for a new issue.

7.106. As an alternative option to a shorter offer period, the APCIMS raised the question of whether an offer needed to be underwritten at all. It said that it might be in a company's best interests to issue an offer at a significant discount rather than having the issue underwritten.

Association of Unit Trusts and Investment Funds

7.107. The Association of Unit Trusts and Investment Funds (AUTIF) represents approximately 98 per cent of the investment fund industry in the UK, with funds under management of some £158 billion at the end of 1997. Its members supported the existing system of capital-raising in the UK but welcomed the more flexible approach to sub-underwriting commission which had been adopted in some recent rights issues. It said that sub-underwriting fees accrued to the underlying unit trusts and were for the benefit of the unit holders and not the management companies.

7.108. The AUTIF said that there appeared to have been a significant reduction in the number of rights issues in recent years, which was probably attributable to greater liquidity in balance sheets, together with some tendency to reduce the proportion of equity to debt in order to optimize the overall cost of capital. It was possible that because of the comparative paucity of share issues there had been less opportunity to consider tendering as a means of raising capital.

7.109. Many recent issues were for smaller companies which were below the threshold for inclusion in the FTSE 350 index. In these cases the management concerned often preferred the certainty of a sub-underwritten issue because the main alternative, a tender with book building, might have to be abandoned due to unstable market conditions and was therefore regarded as inappropriate. For larger companies with more flexible financing arrangements, the tendering system's relative unpredictability was less of a concern.

7.110. The AUTIF added that raising equity capital in the USA was more expensive than in the UK, and there was no certainty that an issue would proceed because of the dependence of book building on market conditions.

CISCO

7.111. CISCO, which represents the smaller quoted company sector, submitted evidence and attended hearings. It is a non-profit-making association and is funded by membership subscriptions. It currently has around 220 members, over half of which are smaller quoted companies. Smaller companies, which are those listed outside the FTSE 350 and including AIM stocks, represent around 85 per cent of companies quoted on the LSE by number. CISCO said it was vital that their viewpoint was represented, as any change to the present system could fundamentally affect the climate for raising capital for these companies.

7.112. Its members used the equity capital market as an important source of funds to strengthen their balance sheets; to fund and provide resources for growth; and to make acquisitions. The key concerns for members in their quest for equity funds were accessibility, an easily comprehensible and manageable process, and low cost.

7.113. CISCO expressed concerns that:

- there should be a level playing field between large and small companies;
- there should be no ‘one cap fits all’ solution: the system should maintain flexibility, simplicity and choice; and
- there must be no increase in the cost of raising capital for smaller companies.

7.114. CISCO said that the main costs to companies of raising capital by way of rights issues were the professional fees and commissions. The rights issue discount was not a cost; however, it was the important adjusting mechanism which could take account of risk. An issue perceived as carrying a higher risk level (or open for a longer period) tended to be priced and underwritten at a greater discount to the prevailing price.

7.115. Smaller quoted companies by their nature were perceived by investors as carrying a higher investment risk compared with larger companies. This was the result of being generally narrower businesses, more vulnerable to economic downturns, and with poor liquidity in their shares. It was also the case that the cost of capital for them was generally higher. As a result of their higher risk profile, smaller quoted companies were more exhaustively pre-marketed. The relatively small number of institutions which invested in smaller companies’ stocks and the higher frequency of large institutional stakes (over 10 per cent) meant that pre-marketing or ‘soundings’ of anchor shareholders were normal and almost always essential. These shareholders, which also often acted as sub-underwriters, were taking an investment view of the stock, willing to make the investment if the issue was left with the underwriters.

7.116. The most difficult issues to sell were those which carried a higher level of risk; the effort to sell them was greater, the process was more laborious for management and their advisers, and this was often reflected in proportionately higher advisory fees.

7.117. Smaller companies found it more difficult than larger companies to procure appropriate financial advice. In addition brokers did not provide analyses of many smaller companies making it harder to stimulate interest in their issues.

7.118. In February 1998 CISCO consulted its members for their views as part of this inquiry. There was a clear preference for the certainty attached to underwritten issues rather than deep discounting. Furthermore, the fact that an issue was underwritten was a helpful expression of support. Whilst companies should be aware of the full range of alternatives available for raising equity capital—and deep discounting considered more often—it was thought unlikely that it would become more prevalent because of the importance attached to certainty of receiving the proceeds.

7.119. In CISCO’s view, smaller quoted companies were not yet sufficiently aware of the alternatives to standard underwriting commissions. Competitive tendering for sub-underwriting had been tried successfully but was not widespread for smaller issues. The choice of competitive tendering was easier when the issues were made by highly-rated companies which were likely to be well supported.

7.120. CISCO members which acted as advisers were very much in agreement that abolishing standard fees would lead to higher overall costs for smaller companies. The current practice of charging standard fees appeared to provide a cap on underwriting costs for smaller companies, and without it these costs could increase. Among the reasons given for charging standard fees were that they were established and understood, simple and quick to administer, and the debate about adjusting for risk was therefore over the pricing discount.

7.121. The combined role of adviser and underwriter was not seen as a significant problem; removing potential conflicts of interest was desirable in principle, but some respondents saw this role as a positive advantage. It also made for a simpler process, and any separation of the roles was likely to lead to duplication in certain areas and therefore to higher costs.

7.122. CISCO believed that the present system offered sufficient choice and therefore there was no need for radical change. However, it noted that much more information and advice should be made available to smaller companies as to the various alternatives available; advisers should explain the alternatives and encourage innovation. Non-executive directors also had a role to play in that many had backgrounds in the City or larger companies, and were in a position to give valuable insights into the process.

7.123. CISCO was concerned that some of the possible remedies had the potential to increase the cost of raising capital for smaller quoted companies and this was not in the public interest. It made the following comments:

- (a) Mandatory tendering for sub-underwriting was, it believed, capable of both increasing and decreasing commissions and this in effect would increase costs overall for many smaller quoted companies, both in the process of tendering and in terms of the outcome.
- (b) It was against compulsory competitive tendering for the appointment of lead underwriters and brokers as this would operate against the best interests of many smaller quoted companies. In its view, it would damage companies because the extended process and the risk to confidentiality of price-sensitive information would make raising capital much more difficult. Moreover, the parties approached would not be closely familiar with the issuing company's circumstances and this would result in an increase in costs.
- (c) CISCO did not accept that combining the roles of financial adviser and lead underwriter was problematic. It did, however, agree that there was a potential conflict of interest but this was negated by the presentational advantages because the financial adviser was seen to be supporting the company financially. Any forced separation of the roles would lead to higher costs for smaller quoted companies.

7.124. CISCO was supportive of possible remedies which would encourage and require greater information and disclosure on the alternative methods of raising equity capital and on underwriting costs.

Confederation of British Industry

7.125. The CBI submitted evidence and attended a hearing. It said that the great majority of its members considered that the existing underwriting system in the UK had generally worked well for companies wishing to raise new capital, and that it had served well the interests of all parties. The system was considered efficient and generally appeared cheaper and more certain than the US system of book building. It had enabled both large and small companies to raise new funds in good times and bad. The price paid by some companies may have had the beneficial result of enabling others to raise money on the same terms. In particular, large issuers may have effectively subsidized smaller ones.

7.126. In addition, alternative underwriting arrangements were gradually being introduced, and it should be noted that during the period of the OFT's review of market practices relatively few cash-raising issues had taken place; many companies did not have a need to raise new capital. On the contrary, there seemed to have been as many, if not more, instances of companies returning cash to shareholders through share buy-backs and special dividends.

7.127. The CBI referred to a number of innovative underwriting arrangements which had taken place in the last couple of years. Significant savings appeared to have been available for the best quality issues. In one particular case shareholders' pre-emption rights were retained, and in another the issue was deep discounted.

7.128. By contrast, the US-style book-building system seemed generally to involve higher fees of between 4 and 8 per cent. Costs had to be balanced against whether a higher strike price for a new issue was achieved compared with the discount normally made on a rights issue, although a discount should not prejudice shareholders if their pre-emption rights were preserved. Furthermore, companies should adjust the dividend per share to allow for the discount where appropriate, although companies often did not do this perhaps because there could be a mistaken belief that it would imply a cut in the dividend, but often because companies could afford to and wished to increase the rate of dividend in any event.

7.129. The CBI said that the issue of pre-emption rights was clearly an important one, and in essence it supported the principle. The CBI understood from the ABI and the NAPF that they were normally flexible in the operation of their guidelines so that companies were able to issue shares on a non-pre-emptive basis in excess of the 5 per cent limit in the guidelines, although the circumstances leading to this flexibility were not made transparent. The CBI would support a formal recognition of this by an amendment to the guidelines with an appropriate increase in the 5 per cent limit and greater transparency. If a company wished to introduce new outside investors who were willing to subscribe at a certain price, or for a new class of share, the company should offer clawback to existing shareholders on the same terms. This would normally provide the flexibility to introduce new outside investors whilst protecting the legitimate interests of existing shareholders.

7.130. The CBI said that there was a minority view among its members (principally from potentially larger issuers) that the book-building system generally used in the USA had its advantages. There was a philosophical view fairly widely held that mandatory and restrictive practices inhibited innovation and prevented the proper working of a free market. In essence, the argument was that the introduction of new systems (involving the relaxation of any current restrictions) did not, and should not, require the removal of the existing fixed rate rights offering; rather, it should provide choice for corporate issuers who could then make rational market decisions, reporting and explaining them to their shareholders.

7.131. The CBI questioned the timing of this investigation given both the innovations seen recently (during a period of infrequent issues) and the willingness expressed by the ABI and the NAPF on behalf of institutional investors to see a book-build issue with pro rata entitlement operated on an experimental basis.

7.132. Ultimately it was a matter for each individual company and its directors and shareholders so that a company wishing to raise new capital did so in the most efficient manner and on the most appropriate terms for its purposes. Many companies were satisfied that the existing underwriting system provided certainty in their fundraising, and certainty alone had a value.

7.133. The CBI was therefore of the view that the fixed fee system, particularly if the overall level did not exceed 2 per cent, should be allowed to continue, and as far as possible should be available generally to all companies which wished to take advantage of it. At the same time, as was currently the case, if individual companies were able to make alternative or cheaper arrangements that should equally be encouraged. Whether pre-emption rights were respected or waived, these alternatives could include different offer structures such as book building.

7.134. The CBI considered that the traditional fixed fee system had been broken and that the current underwriting market in the UK was not anti-competitive and should be given time to develop further. It believed that there was sufficient competition in underwriting for competitive pressures and innovation to flourish without further regulation.

Institute of Actuaries

7.135. The Institute of Actuaries suggested that in future rights issues should not be underwritten, but rather made at a very substantial discount without underwriting. Possible exceptions to this might be large rescue or project financings where the ratio of new to existing shares was unusually high.

7.136. The Institute highlighted one of the problems associated with non-underwritten issues, which concerned the treatment of holders of rights not taken up. This could easily be overcome by ensuring that those shares not taken up, but sold in the market, were only of such a quantity as was sufficient to provide the issuing company (beyond the proceeds of rights taken up) of its planned receipt from the issue.

7.137. The Institute said that provision should be made for the tax treatment of both the holders of shares not taken up and the issuing company to be the same as for normal scrip issues; and that shares be allowed to be issued at below par value in these particular circumstances.

Investor Relations Society

7.138. The Investor Relations Society is a professional body whose members are practitioners in investor relations and include representatives from the majority of the FTSE 100 companies. In its evidence, it made the following points:

- (a) The present system of underwriting had been tried and tested over time; it worked well and there was no reason to change the concept. However, significant problems had arisen in practice.
- (b) Companies had to ensure that share issues were fully subscribed to generate the capital required. They had little control over the vagaries of the market and could only guarantee success through underwriting. There was no realistic alternative and underwriters therefore had a captive market.
- (c) Merchant banks and brokers, with whom companies already had an established relationship, were in the best position to offer guidance on equity issues or the merits of alternative ways of raising funds. Unfortunately, this created a conflict of interest because the advisers also benefited as underwriters. As a result, companies did not feel that they always received truly independent advice and found that charges were often made which did not clearly distinguish between the cost of advice and underwriting.
- (d) The system of scale fees was inflexible; it resulted in charges which did not reflect the varying degrees of risk inherent in underwriting. Moreover, in practice, shares were seldom left with the underwriters because they were offered at a sufficient discount which ensured success and thus reflected favourably on the reputation of all concerned. Companies took the view that in the majority of cases scale fees represented an unreasonably high level of income for the limited amount of work involved and the minimal risk carried by both lead and sub-underwriters.

7.139. Pre-emption rights limited the freedom of companies to issue shares to investors other than their own shareholders. Alternatives to conventional rights issues might increase competition for new shares, enhance the price and reduce the traditional cost of underwriting.

Securities Institute

7.140. The Securities Institute is the major examining body for the securities and derivatives industry and provides a wide range of industry qualifications which attract over 26,000 entries each year. The Institute is also a substantial provider of training courses and of relevant publications.

Unlike the regulatory bodies and trade associations, it is focused on individuals. Its prime purpose is to set and maintain professional standards and promote excellence in matters of integrity, skill and competence. With 12,000 members in 1,800 firms, the Institute's additional purposes are to promote, for the public benefit, the advancement of knowledge in the field of securities and investments and to consult and research in matters of public interest concerning investment in securities.

7.141. In general terms the Institute believed that the public interest was well served under the present system. The advantages of standard fees were:

- (a) that companies with more difficult issues to organize could do so at a more reasonable price than if the issue were priced according to the perceived risk;
- (b) that these were firm costs which were known at the outset; and
- (c) the speed of agreement to underwrite (the standard fee removed one of the uncertainties and speeded up decision-making).

The Institute accepted, however, that this might involve some element of cross-subsidy, which in purist terms was a disadvantage. In any event, standard fees appeared to be eroding with the development of tendering facilities.

7.142. The Institute said that evidence from the pre-emption group suggested that the introduction of tendering for sub-underwriting had reduced fees in this area, and that there was now a greater awareness of costs associated with rights issues by corporate treasurers. The combination of the increased use of tendering and the greater awareness by companies suggested that this development was likely to continue to drive fees down, especially on large and popular issues.

7.143. Deep-discounted issues were unattractive to investors because they were unusual and misunderstood and because of the CGT uncertainty which surrounded them. For example, investors unable to subscribe additional funds but wishing to sell sufficient nil-paid rights to take up the balance might find themselves liable for CGT even though they had not realized any cash. If deep-discounted issues were to be stimulated, the Inland Revenue should be encouraged to make it clear that 'sell-and-take-up' transactions would not incur an immediate charge to CGT.

7.144. The Institute said that, in general, the trading market for rights not taken up appeared to work well. It was a long-standing arrangement and well understood by participants.

7.145. In recent years new methods of raising money, other than traditional rights issues, had been developed. In particular the book-building exercise had been introduced, but the evidence to date suggested that costs associated with this system were considerably higher than those for an underwritten rights issue. The advantage of a book build was that there could be a shorter time frame for the capital to be raised and therefore the period at which a company was at risk of a falling market was reduced. However, the arrangement prevented many existing shareholders from participating.

7.146. The Institute said that the pre-emption guidelines were an important element of investor protection. The pre-emption rules, allied with the ability to trade rights in nil-paid form in the market, were as important, if not more important, for private investors than they were for the investing institutions, who themselves could take advantage of new issues made in any other way.

7.147. On possible conflicts of interest, the Institute accepted that the interests of shareholders, who wanted as small a discount as possible, and those of the underwriters, for whom a larger discount meant less risk for them, might conflict. However, in practice both parties wanted the issue to succeed and the theoretical conflict of interest was not a practical problem.

7.148. The Institute believed that setting a maximum fee by way of regulation would not be helpful; it could possibly harm the interests of high-risk companies whose issues might simply not be possible. The Institute suggested that the OFT should continue to monitor the use of tendering for sub-underwriting for a further period. It believed that over time a system of tendering and other innovations would prove to be more effective than government regulation designed to stimulate competition. It also believed that, in the public interest, tendering for sub-underwriting should be

encouraged where appropriate. It would also be helpful if advisers were to advise their corporate clients of the alternatives to underwriting at standard fees. Requiring companies undertaking non-tendered issues to explain their reasons for doing so to shareholders would focus finance directors' attention.

7.149. The Institute supported the development of best practice in the new issue market for companies raising new capital by, for example, encouraging the use of tendering, highlighting the advantages of deep discounting and encouraging competition for financial advice. However, it believed that encouraging the marketing or pre-marketing of rights issues with the objective of securing firm commitments was not always practical in terms of the timetable for issues, which was already rather extended. On the other hand, truncating the period between the announcement of a rights issue and the final acceptance date would ignore the interests particularly of private investors and the brokers which served them. The present arrangements, whilst appearing to be drawn out, were as short as they could be in the interests of fairness for all investors.

7.150. In certain appropriate circumstances it might be possible to shorten the timetable by arranging a placing with clawback, which would enable the rights of those shareholders not included in the placing to be protected, since they were given the opportunity to claw back their entitlement at the placing price. The pre-emption guidelines provided the mechanism for this procedure (which reduced or avoided underwriting costs) by receiving prior clearance from institutional shareholders if a company so desired.

7.151. The Institute noted that the right of pre-emption was written into company law and the guidelines themselves sought to help companies by relaxing the strict operation of the law in this respect. It said that further relaxation should be a matter for the shareholders of individual companies to decide.

7.152. The Institute was in favour of the SFA rules being amended to include greater disclosure and transparency as regards underwriting requirements. It did not believe that brokers should be required to inform companies of the names of proposed sub-underwriters or of the level of sub-underwriting they were being offered.

The Association of Corporate Treasurers

7.153. The ACT submitted evidence and attended a hearing. It said that its 2,700 members were drawn from both the corporate and the banking world, from academia and from industry. Probably 95 per cent of the FTSE 100 companies had members in the ACT and 80 per cent of the FTSE 250 companies. Smaller companies' representation was rather less.

7.154. The view of the ACT's technical committee on issuing equity was that pre-emption rights should be substantially preserved—that is, material value should not be diverted to non-shareholders, nor should value be preferentially allocated among shareholders. The committee considered that equity issuance and repurchase should be cost-efficient, flexible and transparent with no tax disincentives. If underwriting was needed, it should be subject to competitive bidding, where possible by institutions that were existing shareholders. The ACT published a book in October 1998 on the raising of equity finance in which it indicated these views.

7.155. If it could be shown that the underwriting commission compensated the sub-underwriters for the risk that they were taking and no more, then the company and its shareholders would be getting value for the commission paid to non-existing shareholders. But it was uncertain whether this could be achieved. To the extent that underwriting was transferred to non-shareholders and therefore some value was transferred outside the company, the ACT believed that this transfer of value should be minimized.

7.156. The ACT drew attention to a hazard of competitive tendering of sub-underwriting, namely that certain sub-underwriters, if they had to dispose of the shares, might do so in a way which was less than convenient for the company. From the point of view of the broker and the primary underwriter, it was easier to get a sub-underwriting group together if a particular group of well-known sub-

underwriters were already in place. However, current arrangements were insufficiently transparent. It would be desirable to find a compromise solution which balanced the advantages of the current speedy, simple and administratively inexpensive processes against the advantages of tendering.

7.157. The ACT went on to say that the rights issue discount had no implications for the wealth of existing shareholders. It believed that comparative dividend and earnings data should be adjusted for the embedded scrip element in any rights issue, although this was not standard practice at the moment. Encouragement should be given to deep-discount non-underwritten rights issues. It might help to encourage adjustment of dividend data following rights issues if shareholders were informed what the equivalent scrip issue was and therefore the factor by which dividends and earnings needed to be adjusted.

7.158. Although the taxation of rights issues had been a disincentive to companies considering a deeply-discounted rights issue, the problem had now been significantly improved by the change in Inland Revenue practice introduced in 1997 whereby small proceeds could be defined as £3,000. The ACT believed that greater publicity should be given to this change and its implications for deep-discount rights issues.

7.159. The ACT's technical committee considered that companies should be allowed to hold treasury stock as a method of fine-tuning the cost of capital.

7.160. The ACT thought that book-building alternatives to rights issues should be examined carefully for their true cost to shareholders. There were a limited number of examples of book building in the UK but the US experience, with fees in the range of 4 to 8 per cent, seemed to suggest that such a fee might well erode any possible cost advantage over a conventional UK rights issue. On the other hand, net proceeds might be higher and new shareholders might be encouraged.

7.161. The ACT had a particular anxiety that UK finance directors might be misled into believing that because new shares were issued at only a small discount to the existing market price in a book-building exercise, compared with the discount on a rights issue, this more than offset the high initial fee. This argument was invalid because the discount on a rights issue was not a cost to existing shareholders. It should also be noted that one of the claimed advantages of the book-building method, namely that new shares were issued at a price very close to the price of existing shares, might be partly illusory. This was because the book-building process itself was likely to affect the price of existing shares before the price at which the new shares were to be issued was finalized.

7.162. However, the ACT believed there might be particular situations where a book-building exercise could be appropriate. These included the presence of one or more larger shareholders who were known not to wish to put up further capital, or a shareholding distribution which was in some way constricted (geographically or otherwise), where there might be benefit in bringing in new shareholders. A company considering book building to widen its shareholder base might also need to consider whether it would not be just as cost-effective to carry out a 'roadshow' to persuade potential new investors to buy shares in the secondary market.

7.163. The ACT considered that the nil-paid trading spreads and rump placement procedures should be more transparent and efficient. The rump placement, particularly in non-underwritten deep-discount rights issues, was an area of obscurity; arguably the company should have the obligation to dispose of the rump by the best possible method.

7.164. The ACT added that equity issuance should become more like debt issuance in its efficiency, frequency and cost. There were no fundamental problems with underwriting evident at present. However, it would be desirable for choice of methods of issuing equity to exist. The relative infrequency of equity issues meant that finance directors and treasurers were inevitably inexperienced. Financial advisers who were independent of the underwriters could be helpful.

7.165. On possible remedies, the ACT said that we should recommend initiatives that supported the continuing development of competition and innovation, but we should dismiss the belief that there was anything fundamentally wrong with raising money through a mechanism which protected shareholders' interests, namely, the traditional rights issue.

7.166. The ACT was concerned that some of the possible remedies could, by being mandatory, effectively prevent the efficient working of the market place. Whilst there were a number of valuable ways in which companies could be given encouragement, it did not support all of them being imposed by regulation. It was to some extent in companies' hands how they created competition, especially now that competitive tendering was becoming more established.

7.167. If tendering were to be made mandatory, it should be applied when the funds to be raised exceeded a percentage of existing equity, say 15 per cent, rather than an absolute value of £20 million. The ACT did not believe that sub-underwriting fees should be tendered on a mandatory basis, but rather that greater encouragement should be given.

7.168. The ACT would not wish to see a maximum figure imposed for sub-underwriting fees. This was because the size of the fee depended on a degree of discount and therefore the risk taken by the underwriter. If a limit were to be set, the sub-underwriter would respond by requiring the risk to be reduced through a greater discount on the issue. The present effective limits of 1.25 per cent should therefore be maintained.

7.169. The ACT did not agree with the possible remedy that the guidelines on the application of pre-emption rights should be relaxed to enable companies to issue up to 15 per cent of their share capital non-pre-emptively in any one year. It said that a change in the current pre-emption limits up to a maximum of 10 per cent would be acceptable to it. Otherwise it believed that the current pre-emption rights were sufficiently well established and the present system worked efficiently. In the absence of the ability to hold treasury stock, it believed that any relaxation should only apply to small companies with specific capital and shareholder structures, for example companies with large shareholders.

7.170. The ACT was generally in agreement with the remaining possible remedies.

The Hundred Group of Finance Directors

7.171. We held a hearing with Mr Christopher Pearce, Chairman of The Hundred Group of Finance Directors (The Hundred Group). The Hundred Group represents finance directors of the FTSE 100 companies; there are currently about 140 members.

7.172. Mr Pearce said that, as well as new equity by way of rights issues, what was of great importance to large companies was the underwriting of equity issues where the equity was being issued in an acquisition. The price at which the equity was underwritten in an acquisition was of critical importance commercially and financially to the companies concerned, and also to the public markets and the whole economic and commercial process.

7.173. Asked about the way in which companies chose their financial advisers, Mr Pearce said that generally competence was the deciding factor. A company's own assessment of competence was important, as was the public perception of confidence in a financial adviser who, when undertaking a transaction, was seen by the shareholders and other parties to be giving the company proper advice. Mr Pearce said that there was intense competition among merchant banks for their services as financial advisers to major companies.

7.174. Mr Pearce said that companies were concerned about the cost and flexibility of underwriting and sub-underwriting. There had been some moves to more flexible and cheaper sub-underwriting but it was still concerned with the inflexibility of the system, particularly in relation to lead underwriting. In the Hundred Group's view there was a conflict of interest in that the financial adviser also acted as lead underwriter. Mr Pearce said that all conflicts of interest were complex; there were some advantages in having a joint involvement as well as disadvantages. The Hundred Group felt that its members could obtain more flexibility and savings on lead underwriting arrangements as a result of negotiations with the major underwriters and financial advisers, with particular emphasis on separating out the advice fee and the underwriting commission. With regard to flexibility, for example, Mr Pearce pointed out that on acquisition finance where the level of a public bid was improved (which was normal) companies had to pay two sets of underwriting commissions, even if the equity element were unchanged, which made transactions more expensive than they ought to be. He

thought that major companies would, if the system were more flexible, be able to make rights and other underwritings closer to the market price and for lower commission.

7.175. Mr Pearce said it was possible that larger companies subsidized smaller ones. He thought that research would show that the risk for smaller companies was greater and hence the percentage fees for larger companies should be at a lower level. At present, neither the commission nor the arrangements nor the general pricing of the discount of an underpinning or a rights issue seemed to reflect the variety of risks that existed between different types of company.

7.176. Asked why deep discounting was not used more frequently, Mr Pearce felt that it was mainly to do with tradition; companies did not want to upset the institutions and the market by departing from traditional methods. There was also the disturbance to the historic trend of the share price and dividend payments.

7.177. Mr Pearce felt that pre-emption rights were a legal right and he did not see them as necessarily a major barrier to raising capital. However, it would be more logical for institutions to allow the same percentage (25 per cent) for new issues for cash as was, effectively, allowed for new issues for acquisitions (rather than the present 5 per cent).

UK Shareholders' Association

7.178. The UKSA submitted evidence and attended a hearing. It is an independent body which represents private shareholders and it said that its primary concern in relation to the inquiry was to protect the interests of minority shareholders when new shares in listed companies are issued.

7.179. The UKSA said that pre-emption rights provided a fundamental protection for minority shareholders and should not be weakened in any way. Although their application was far from perfect, there was no better way of protecting the interests of those minority shareholders who wished to maintain a percentage interest in companies, and were prepared to pay their portion of any additional capital that a company was raising, or of those who were unable to provide additional capital.

7.180. There were conflicts of interest inherent in the present system and they played a major part in allowing underwriting fees to continue at their present level. These could be addressed in a number of ways, one of which was deep discounting. However, there were even greater conflicts of interest inherent in the alternative scheme, whereby shares were issued to third parties, resulting in a far greater real loss of value to existing minority shareholders. The excessive standard fee of 2 per cent was a small price to pay for a system which protected these shareholders from the alternative.

7.181. The UKSA said that deep-discounted rights issues were valuable because they allowed companies to dispense with underwriting fees, or at least to reduce them significantly, although deep discounting would not be suitable in every case. It shared the concern that deeply-discounted rights issues might result in private shareholders incurring greater CGT costs. However, it noted that, under the present CGT rules, this would only affect a small minority of shareholders and therefore it did not see it as a major problem.

7.182. In its response to our possible recommendations, the UKSA believed that the most effective way to resolve the problems associated with underwriting fees in general was to remove the various conflicts of interest that existed. The challenge was to do so in a way that did not make the process of raising capital excessively expensive or cumbersome.

7.183. The UKSA therefore supported in principle the following possible remedies:

- (a) The tendering of sub-underwriting fees should be mandatory, either for all share issues that are sub-underwritten or only for the larger ones, say those with a value of over £20 million.
- (b) The whole of the sub-underwriting should be tendered and the tender should be open to as wide a group of potential sub-underwriters as possible.

- (c) The appointment of lead underwriters and of brokers providing underwriting services for share issues should be on the basis of competitive tenders.

7.184. The UKSA said that the tendering procedures adopted should not result in excessive cost or delay. It was important also that they should not result in a number of privileged parties having inside information about a rights issue before it had been disclosed to the market. A practical way to overcome these problems might be for companies to announce a rights issue and invite underwriting tenders at the same time, using the Regulatory News Service. The UKSA would expect the rights issue to be conditional upon a successful early completion of the underwriting exercise, and it would not expect the overall timetable for the issue to be affected.

7.185. If mandatory tendering were considered impractical, the UKSA said that it would support the following alternative remedy: when sub-underwriting fees are not tendered, no sub-underwriter should receive a fee greater than some figure to be determined (say, 0.5 per cent of the value of the issue), either for all issues or only for those over £20 million.

7.186. The UKSA was strongly opposed to any relaxation of pre-emption rights that would allow companies to issue up to 15 per cent of their share capital non-pre-emptively in any one year. It was also opposed to the possible remedy that would give companies the option to vary the period between the announcement of a rights issue and the final acceptance date for shareholders because private shareholders whose shares were held in nominee accounts would not have time to be informed about the issue.

Other parties

Financial Services Authority

7.187. The FSA submitted evidence and attended a hearing with the SFA. In its written evidence it commented in particular on two of the possible remedies which related directly to the SFA's business rules. These concerned the handling of the conflict of interest in the financial adviser and lead underwriter roles being undertaken by the same organization; and the disclosure of charges for underwriting services as such.

7.188. The FSA drew our attention to the rules which currently bear on these matters. The Statements of Principle issued by the FSA were intended to form a universal statement of the standards expected of firms and applied directly to the conduct of investment business by all authorized persons. Two Principles were relevant in the present context:

- *Principle 5*, which requires a firm to take reasonable steps to give a customer it advises any information needed to enable the customer to make a balanced and informed decision; and
- *Principle 6*, which requires a firm to avoid conflicts of interest arising or, where conflicts arise, to ensure fair treatment to all its customers by disclosure, internal rules of confidentiality, declining to act or otherwise.

7.189. In addition, more detailed rules apply which set out in greater detail the standards expected of firms. For example, one of the rules in the SFA rule book provides that where a firm has a conflict of interest in relation to a transaction, it must not advise its customer in relation to that transaction unless it takes reasonable steps to ensure fair treatment for the customer. As for the disclosure of the firm's charges, another rule requires a firm, before it provides investment services to a private customer, to disclose to him the basis or amount of its charges for the provision of those services, and the nature or amount of any other remuneration receivable by it.

7.190. The FSA said that most companies to which underwriting services were supplied were non-private customers. The directors and executives of such organizations could, in its view, reasonably be expected to ensure that they got the best value possible from their advisers and brokers when seeking to raise capital in the market. In particular, the benefit to an investment bank of recommending an underwritten offer should be plain to such customers, who could similarly be expected to understand the implications of underwriting for the price of the services. Accordingly, the FSA did not see a case

for introducing further or more detailed regulations requiring authorized firms to do more by way of disclosure of conflicts, or specifying an obligatory template for provision of information on charges.

7.191. The FSA acknowledged that not all companies would have the same degree of experience of raising capital in the market. Smaller firms in particular might have a greater dependence on their adviser and in practical terms in the short run might have relatively little scope to make a change. In such cases, the general duties placed on authorized firms to manage conflicts properly implied a need for particular care in ensuring that their services were fully described, with a view to reaching a clear and early understanding about how charges would be structured. However, for the reasons given the FSA thought it would not be appropriate for the regulators to seek to address this by means of an elaboration of the rules. If, through the SFA's standing arrangements for surveillance of the corporate finance activities of authorized firms and/or from work on relevant customer complaints, it became aware of the problems with a particular firm's approach, then this would be taken up with management in the normal way.

7.192. The FSA said that the duties placed on directors in seeking to raise capital were onerous. It might be that there was a role for the CBI and/or the Institute of Directors, for example, to give companies guidance on how best to obtain competitive terms from advisers and underwriters, and advice on the range of means available.

7.193. The FSA added that in considering the issues we had raised (see Appendix 2.1) it had taken into account the fact that the SFA had not received any complaints from customers of the firms it regulated that current rules were inadequate or that there had been a failure to comply with them in connection with advice about share issues. It had also considered whether any of the rules currently in place might in some way be positively contributing to, or facilitating, uncompetitive behaviour. It saw no evidence that current regulatory requirements had that effect.

7.194. On the extent of underwriting by regulated firms, the FSA told us that out of some 1,100 IMRO-regulated firms, 293 had permission to conduct underwriting or sub-underwriting, of which 14 were permitted to sub-underwrite on their own account. Similarly, of some 1,300 SFA-regulated firms, 302 could undertake underwriting.

7.195. We asked the FSA at the hearing about the hypothetical remedy that it or the SFA might require financial advisers to advise companies on alternatives to underwriting at standard fees. The FSA said that it was generally enjoined to protect consumers' interests, but had to keep a proper balance between the benefits and burdens of regulation. Companies could complain to the SFA if they felt they were not getting the service they expected from their advisers. The SFA would certainly look into such complaints.

Mr Hugo Dixon, Financial Times

7.196. Mr Hugo Dixon, head of the Lex column, was invited to attend a hearing and give his views which, he said, were not necessarily those of the *Financial Times*. What was needed, he believed, was more flexibility in the market for raising equity. Companies should have a broader range of options available to them and they should be able to assess, on a case-by-case basis, the best way for them to proceed. There were already many ways of raising equity in the UK market, but the present system was, nevertheless, somewhat restricted. Both the pre-emption guidelines and City practice tended to channel companies towards the traditional underwritten rights issue. This was sometimes the best way forward, but not always. He did not think that the cost of underwriting per se was the major issue in the raising of capital.

7.197. Mr Dixon said that in addition to underwriting fees, there were two other points which were important. First, in the allocation of capital throughout the economy and the cost of capital for companies, one of the defects of the traditional underwritten rights issue seemed to be that it did not encourage companies to 'sing for their supper'. If companies wished to raise capital, or if they needed to do so through a rights issue, they were not encouraged to market it. It was common practice (although there were exceptions) to keep the whole process very much under wraps until it had been underwritten and it was then presented as a *fait accompli*. Mr Dixon believed that we should be

looking towards a system which encouraged companies to make a case for why they needed capital, and when they had made a good case they should be rewarded for doing so.

7.198. Secondly, the cost of capital very much depended on the willingness of existing shareholders to take more equity; if they were willing to do so then a traditional rights issue would be appropriate. If, for whatever reason, shareholders were not willing holders of more equity in a particular company, then they would demand a higher return for holding that equity, and that would usually be demonstrated by a fall in the company's share price. Therefore, one of the potential advantages of using mechanisms other than the traditional rights issue was that companies could cast their nets wider and could market their shares to a group of new shareholders who might be more willing to take the equity. In those circumstances the company's share price would be expected to rise, which effectively meant that the cost of capital for the company had been reduced.

7.199. Mr Dixon said that the main practical obstacle to the use of alternative mechanisms was the pre-emption guidelines on companies not being allowed to raise more than 5 per cent non-pre-emptively in any one year. Calling an EGM in order to ask shareholders to approve a higher figure would, in Mr Dixon's view, be a cumbersome, expensive and a long-drawn-out matter. The idea that shareholders would actually approve a large non-pre-emptive issue as a generalized clause at an AGM—and without any specific company plan in mind—was unrealistic. Mr Dixon was of the view that there was a certain inconsistency in shareholders' approach because, as a general rule, they did not seek to micro-manage companies. He was in favour of a relaxation of the pre-emption restrictions.

7.200. Mr Dixon felt that the use of standard fees had resulted in the cost of underwriting share issues being higher than it otherwise would have been. He was persuaded by the argument that larger companies subsidized the smaller ones; there was even the possibility that some companies actually got cheaper fees than they would otherwise in a more competitive market. In general, Mr Dixon would prefer to see these subsidies being made explicit; if it was felt that that was a good idea then the Government should give an explicit subsidy to capital-raising by small companies.

7.201. Asked about the research carried out by Professor Marsh, Mr Dixon said that he felt reasonably satisfied with at least the broad thrust of his findings, if not the precise figures.

7.202. Mr Dixon was asked about our provisional conclusion that the standard fee restricted or distorted competition, and whether the introduction of tendering had removed that distortion. He felt that the introduction of tendering was a healthy development; it was difficult to say what effect tendering had had because there had not been a great deal of equity-raising of late. In so far as companies made rights issues, he thought that tendering was now sufficiently well publicized that most companies realized it was an option available to them.

7.203. On the question of competition between financial advisers and brokers, Mr Dixon said that the relationship between companies and their financial advisers tended to be long-term, so companies were not inclined to shop around for services very much. However, if there were to be a significant increase in the number of rights issues then possibly there would be more competition. Mr Dixon said that there was certainly less competition for smaller companies' business compared with that of larger companies.

7.204. Mr Dixon felt that there was a potential conflict of interest in cases where the same company acted as both lead underwriter and financial adviser. There was also a conflict of interest between the shareholder role of institutional investors and their sub-underwriting role.

7.205. On possible remedies, Mr Dixon said that he was not in favour of mandatory tendering for sub-underwriting, nor was he in favour of non-tendered sub-underwriting fees being capped. However, he endorsed a number of the possible remedies, notably:

- (a) Information for companies about share-issuing best practice should be made available.

- (b) The 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.
- (c) The guidelines on the application of pre-emption rights should be relaxed to enable companies to issue up to 15 per cent of their share capital non-pre-emptively in any one year.

HM Treasury

7.206. HM Treasury at official level made a number of comments in response to our issues letter. It said that its overall aim was to help ensure that companies had as wide a range as possible of competitively-priced options for raising new equity capital for the growth and development of their businesses. This flexibility for companies should also be consistent with appropriate and proportionate protection of the legitimate interests of the investors providing this capital.

7.207. It considered that financial regulation was best focused on protection of investors and other market participants unable to look after their own requirements adequately. Where market participants were acting in their professional capacity and had the expertise and incentives to assess the financial advice they received, there should be a correspondingly lower requirement for financial regulation. As such, extra rules designed to protect company finance directors from their merchant bank advisers and brokers might be largely otiose. There might, however, be some role for dissemination by trade bodies of market information to help educate companies in the range of options available. There might also be scope for financial regulators to clarify the implications of existing rules as they affected advice on share offers, without necessarily adding to the number of regulations.

7.208. HM Treasury said that professional fund managers which acted for institutional investors should also be well able to assess the merits of proposals from companies for the disapplication of pre-emption rights in specific cases. This suggested that there might be scope for some liberalization in general industry-wide guidelines on the extent to which companies could disapply pre-emption rights, perhaps by permitting companies to issue up to 15 per cent of their share capital non-pre-emptively in any one year.

7.209. HM Treasury did not believe that CGT was an important factor in deciding the level of discount in a rights issue. It said that the differential tax effect (between a shallow- and a deep-discounted rights issue) did not appear to be significant when compared with the overall amount of capital raised. Its provisional assessment was that any CGT problem was likely to be more of perception than practical difficulty; the fact that CGT matters concerned mainly retail investors, rather than tax-exempt investors, might inhibit some companies from deploying this issuing technique.

Inland Revenue

7.210. We asked the Inland Revenue about the CGT position in relation to deep-discounted rights issues (see Appendix 3.2) and whether it had received representations about this matter. It said that it had not received such representations. It commented that small shareholders making relatively small gains benefited from an annual CGT threshold and that their situation might well have been improved in the most recent budget. 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. Pension funds were tax exempt. Unit and investment trusts were not generally subject to tax on their gains. Life companies did pay corporation tax on capital gains, but would be likely to take up all their rights. Companies were not exempt from tax on their gains; so if companies were large shareholders, their position might be affected by a deep-discounted issue in that they would have to pay more tax in the short term than if the issue were not made at a deep discount. The Inland Revenue said that its overall stance remained one of scepticism that CGT was an important feature in deciding the level of discount in a rights issue.

7.211. We asked the Inland Revenue for its views on whether a change to the tax rules could be made to facilitate tailswallowing. It said that when a taxpayer sold shares and used the proceeds to buy other shares, there was no general roll-over relief for the gain on the shares. There would therefore need to be a policy justification for treating tailswallowing differently from other transactions and a sufficiently strong case for action.

7.212. The Inland Revenue also informed us that its appeal against the decision of the Special Commissioners of Income Tax, in the case of the British Telecommunications and Post Office pension schemes, that sub-underwriting by those schemes was not a trade and therefore not subject to tax, had been upheld by the High Court (see paragraph 5.48). The High Court had taken the view that sub-underwriting by these schemes did involve trading and was therefore subject to tax. The taxation treatment of sub-underwriting by other pension funds would depend on the facts in each case: if the activity amounted to the carrying on of a trade it would be taxable, but if it did not it would be tax exempt.

London Stock Exchange Limited

7.213. The Listing Authority of the LSE attended a hearing and gave its views on the hypothetical remedies set out in the issues letter (see Appendix 2.1). The LSE said that it would welcome any initiative that would enhance market efficiency but remedy relating to a possible shortening of the 21-day initial offer noted that the regulation of the corporate finance activities of financial advisers and underwriting arrangements were outside the scope of the listing rules.

7.214. On the hypothetical remedy of requiring financial advisers to advise clients of the alternatives to underwriting at standard fees, the LSE said that it could not impose such a requirement on advisers as this fell outside the statutory scope of the listing rules. The suggested, indirect alternative of requiring companies to disclose the receipt of such advice might well prove expensive for listed companies and lead to no more than standardized statements without necessarily changing underlying behaviour or providing additional benefit to investors. If such an approach were considered essential, the LSE would raise the matter in the next consultation on changes to the listing rules. However, both for the reasons given above and the resulting lack of clear, additional investor protection, companies and investors might not be willing to support this proposal.

7.215. On the possible remedy of requiring companies to disclose in their annual reports the reasons why tendering of underwriting was not arranged, the LSE considered that this proposal would result in the imposition of costs for companies and lead to no more than standardized statements without necessarily changing the underlying behaviour or providing additional benefit to investors. The LSE did consider that additional factual disclosure requirements about underwriting might be possible.

7.216. On the possible remedy of making information about share-issuing best practice available, the LSE said that it did not currently have the necessary degree of expertise or experience to prepare guidance of this kind or assess the appropriateness of any guidance produced. It would need to recruit the necessary resources and expertise to answer detailed, practical questions once the guidance had been published. However, it agreed that guidance needed to have credibility and weight and to that end should be drawn together by the business, investor and corporate finance communities jointly and have their collective endorsement. Those who might be consulted about taking this forward included the CBI, the ABI, the NAPF and LIBA.

7.217. We asked the LSE why it had included in the listing rules a requirement for companies to state in their annual reports how they had complied with the provisions of the Combined Code, which had been appended to the listing rules although it did not form part of them. The LSE said that its approach taken on corporate governance was unique in terms of the listing rules. The clear cross-market support and consensus on the Combined Code, the political and public demand for a corporate governance regime, the context from which the Code had arisen and its overarching nature in respect of corporate governance provided a clear basis for distinguishing it from other guidelines.

7.218. On the possible remedy to reduce the length of the 21-day offer period in rights issues, the LSE said that the 21-day period laid down in Company Law listing rules effectively comprised a

maximum of only 15 business days. Thus the time available to private investors, in particular, was considerably shorter than was immediately apparent. The 21-day offer period was a reflection of the Companies Act requirement. If the Government were to adopt a new policy in this regard, the LSE would reconsider the 21-day rule.

Mr J R MacLaren

7.219. Mr MacLaren said that, in practice, issuing houses seemed to advise a price for new shares which was sufficiently high so that a case was made for underwriting, yet low enough to ensure success. In most cases, simple adjustments of the terms would avoid underwriting costs, for example by doubling the number of shares at half the price. In some cases the absurdity of the current practice was seen when the share premium was subsequently distributed as a free bonus issue. Institutional investors were regular recipients of underwriting commissions because of their favoured client status. As shareholders in the capital-raising companies they got more from their underwriting commissions than they lost indirectly as equity holders.

Mr J E Paterson FFA MSI

7.220. Mr Paterson said that the greatest problem which sub-underwriters had with most issues was a lack of time in which properly to consider their merits. He suggested an arrangement whereby sub-underwriters could be invited to commit themselves in principle on one day and normally approached with a tender on the next day. He was in favour of rights being made at a deep discount without underwriting. Problems of a deep-discounted issue could be avoided by allowing shares to be issued at below par value, and by making the tax treatment the same as for normal scrip issues.

ProShare (UK) Limited

7.221. ProShare (UK) Limited (ProShare) said that its views were given from the perspective of the private shareholder. Commenting on the hypothetical period, it said that the protection of small shareholders most certainly could not be reconciled with a shortening of the period.

7.222. The lessons of the privatizations of the 1970s and 1980s, together with the more recent demutualizations, had shown how little understood even the most rudimentary mechanics of share ownership were, let alone the more complex issues relating to a rights issue. Whilst the highly active 'do-it-yourself' shareholders (of whom there were probably not more than 200,000 in the UK) might be able to evaluate and respond within a relatively short timescale, the vast majority of shareholders simply could not do so.

7.223. ProShare said that it was not aware of any evidence to suggest that private shareholders might, in certain cases, be willing to agree to a reduction in the 21-day period. The considerable amount of professional market research which it undertook into investors' needs and attitudes constantly highlighted their need for advice in relation to investment matters; the provision of such advice took time to obtain. Add to this the potential effects of holidays and postal delays, then the argument for reducing the notice period became weaker still.

7.224. Given that within the underlying fee structures, price was directly linked to time, ProShare said it could be argued that simply reducing the fee by attempting to reduce the notice period was not actually addressing the underlying problem of a complex monopoly.

7.225. ProShare said that the following possible remedies (see the issues letter at Appendix 2.1) all had merit from the perspective of the private investor:

- (17f) Financial advisers should be required to advise their clients who are considering share issues of the alternatives to underwriting at standard fees;

- (17g) Companies who undertake an underwritten share issue not involving tendering should be required to explain to their shareholders why they have chosen this route; and
- (17hiv) Information for companies about share issuing best practice should be made available and should encourage companies to seek financial advice from more than one source and, whenever possible, to separate the roles of financial adviser and lead underwriter.

Mr N Turnbull

7.226. Mr N Turnbull, Finance Director, on behalf of The Rank Group plc, said that, ideally, companies which only made share issues once every few years should have an adviser to steer them through the exercise, and be able to create a competitive process for fixing underwriting fees and setting the issue price. Normally the lead underwriter acted as adviser and, at the critical decision point when companies needed advice, he had a vested interest in the price at which the issue was fixed, since the lower the price was the less the risk to the underwriter.

7.227. As regards the competitive process for fixing fees, the present structure provided certainty and uniformity. In practice, it said that fixed underwriting commissions probably favoured smaller companies at the expense of larger ones. The difficulty in organizing competitive tendering was the price-sensitive nature of the information required; it might be possible to do so in respect of fees, but unless 'bought deals' were allowed, there was no certainty with regard to the issue price. Therefore, competitive tendering on fees and a book-building exercise to establish the optimum market price was an attractive alternative.

7.228. Mr Turnbull believed that a competitive system would reduce the level of fees. But until such time as there were sufficient issues to establish the system, it was not clear whether the fees would be higher or lower than those charged at present. He believed that under the proposed system the pre-emption rights of shareholders could be protected.

7.229. He said that whilst the cheapest rate for shareholders was a non-underwritten offer at a deep discount, companies were reluctant to use this because of the perception that it represented failure, although for participating shareholders it was the most cost-effective option.

The Accounting Standards Board Limited

7.230. We asked the ASB for its views on remedy 17(i) in the issues letter (see Appendix 2.1), namely that the 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 its existing guidance about the treatment of earnings per share. The ASB stated that it was introducing a new financial reporting standard on computation and disclosure requirements in respect of earnings per share which would include explanatory material on the adjustment of equity dividends.

7.231. The ASB sent us its new financial reporting standard, FRS 14, 'Earnings per Share', which was published on 1 October and which it said would be mandatory for financial reporting periods ending on or after 23 December 1998. The ASB drew our attention to the following paragraphs in the standard:

Financial statistics in any historical summary

76 In order to give a fair comparison over the period of any historical summary presented, the basic and diluted earnings per share figures, ... need to be restated for subsequent changes in capital not involving full consideration at fair value (ie bonus issues, bonus elements in other issues or repurchases, share splits and share consolidations other than those combined with special dividends ...). The cumulative effect of all such events is taken into account and the resultant earnings per share figures are described as restated and are clearly distinguished from other non-adjusted data.

77 Similarly, for comparison purposes, any record of equity dividends for the same period set out in the form of pence per share is adjusted by the factors applied when restating earnings per share as above. The equity dividends are described as restated and, with the restated earnings per share, are clearly distinguished from other non-adjusted data in the summary.

Chairman of Workspace Group PLC

7.232. The Chairman of Workspace Group PLC, who had had experience both as an institutional investment manager and as Chairman of a limited company involved in placing ordinary shares in a stock market issue, had no doubt that a cartel existed in relation to fees for the supply of underwriting services in which tradition prevailed and competition was suppressed. He believed the level of fees charged was about twice that which was necessary to provide underwriters with a reasonable return for the services they provided.

D P B KINGSMILL (*Chairman*)

M CAVE

R H F CROFT

R LYONS

K M H MORTIMER

P A BOYS (*Secretary*)

18 November 1998