



Rights Issue Fees Inquiry

December 2010

In association with:



Association of British Insurers



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Foreword

Providers of capital have long been concerned about the leakage of value away from themselves to intermediaries who bring together providers and users of capital. I was asked by the Institutional Investor Council (IIC) to examine the practices and pricing procedures adopted when new capital is raised through the issue of UK equity securities, and to review whether these uphold the interests of companies, shareholders and markets, and to make recommendations as appropriate.



Douglas Ferrans

This Inquiry takes an historical perspective, using as a starting point the last main report from the Monopolies and Mergers Commission (MMC) in 1999, and endeavours to show how the level of underwriting fees relative to the changing exposure to risk has varied over time. It explores the role of advisers and underwriters, including the sharing of risks and rewards between lead underwriters and sub-underwriters.

Furthermore it investigates how practice has evolved and is evolving in relation to the pricing and structure of capital raising and in particular the transparency of the underwriting fees paid.

The Inquiry identifies significant strengths in the UK's pre-emption regime and market-based rights issue system but also a number of weaknesses that have developed over the years in the underwriting process, specifically in the inefficient and opaque way fees are being paid for taking risk and for other services.

I have, therefore, highlighted a number of actions that could be put in place to assist in keeping the costs borne by companies, and therefore, shareholders, to a minimum. Investors remain unclear about who is being paid and what is being paid for. This has understandably led to the suspicion that shareholders are in aggregate paying too much.

Fees are often wrongly labelled and as a consequence confusion exists. Companies would undoubtedly benefit through an introduction of competitive tension and increased transparency of the appropriately categorised cost.

We have a system of capital raising that in general works well for issuers and investors. Following the understandable dislocation arising out of the financial crisis, which unquestionably increased the risks associated with equity issuance and the costs of providing protection, conditions for capital raising have improved and more appropriate incentives are the order of the day. We would expect the costs of underwriting and sub-underwriting to fall.

This report provides feedback from over 60 submissions we received and meetings we had with interested parties, (including issuers, investment managers, investment banks, financial advisers and lawyers) and gives our analysis of this evidence and our recommendations. During the course of our Inquiry some indications of progress towards lower fees have emerged. We hope that this will continue but this alone will not ensure our capital-raising system works as well as it could.

In June 2010 the Office of Fair Trading (OFT) announced that it would be undertaking a market study into equity underwriting and associated services. We have had several meetings with officials at the OFT and have kept them informed of the issues that have arisen in our Inquiry.

A considerable team effort has gone into the production of this report and it would not have been possible without the invaluable support of the Investment Management Association (IMA), Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF). In particular personal thanks to all those who contributed to our deliberations and a devoted project team of Michael McKersie at the ABI, Liz Rae and Debra Clarke at the IMA and to City veteran William Claxton-Smith who served as the principal institutional investor consultant on this project.

A handwritten signature in black ink, appearing to read "D. Ferrans", with a horizontal line extending from the end of the signature.

Douglas Ferrans

Executive Summary

Both investors and issuers are wholly supportive of the UK's approach to pre-emption and believe that rights issues are an efficient and fair way for companies to raise equity capital. The pre-emption framework provides shareholders with protection against dilution of their existing holding, and the issuer receives certainty of funds by way of the underwriting process.

Until the late 1990s rights issues were conducted for the most part on standard terms which had not varied for some time. After the MMC report in 1999 gross fees did fall briefly and issues carried out on a 'deep discount' basis became more common, but fees subsequently rose to levels higher than those prevailing before 1999. The financial crisis of 2007-08 put markets under significant pressure and the risks facing underwriters were significantly greater than for some considerable time. It is understandable that gross fees and discounts rose as both underwriters and sub-underwriters required more reward for the risk that they were assuming. It is the case, however, that in the more benign market environment since mid-2009 fee levels and discounts have remained high.

Amongst the issues identified by the Inquiry were:

- A key concern for investors is the level of fees paid by companies, particularly to their banking advisers, and a lack of evidence of competitiveness. We were told that there is appetite to sub-underwrite at lower fee levels than those prevailing currently, but there is a reluctance to consider this in the absence of a corresponding reduction in lead underwriting fees.
- To provide context we compared underwriting fees paid by a selection of companies that raised capital via rights issues to total directors' remuneration in the year of the issue. Typically gross underwriting fees were ten times the total reward for executive directors in the year that the rights issue took place. Yet shareholders are under much greater pressure to oversee the latter.
- A potential shortfall in sub-underwriting capacity has appeared over the past decade. While UK life and pension funds used to be natural buyers of new UK equities, that role has declined so that UK institutional investors now own just 40% of UK equities overall. While international investors now own a larger proportion of UK equities than before, they are either unwilling or unable to sub-underwrite in the way UK investors did in the past.
- Most non-financial companies are not regular users of the capital markets. As a consequence they are negotiating fees from a less well-informed position than their bank advisers. In addition their perception of the 'cost of getting it wrong' may inhibit attempts to negotiate fees lower. While issuers told us that a high degree of professional competence is exhibited by City advisers, we were also consistently told that underwriting fees are certainly too high.
- There is opacity around what fees are actually paid, to whom and for what.

- The risks that the lead underwriters bear have fallen in the last decade (with the possible exception of the height of the financial crisis in 2008). There has been an increasing tendency to alert significant shareholders, in confidence, to an impending issue and to gauge likely appetite and the appropriate price. The minimum period over which the rights issue takes place was reduced in 2009, with the period of rights trading reduced from three weeks to two and with a similar one week reduction of the underwriting risk period. In addition the majority of issues are now carried out on a deep discount basis.
- Fees have not, however, reduced commensurately with the lower risks resulting from these changes. Indeed they have been higher in recent years than before 1999.
- The regulatory environment is seen to constrain the ability of investors to talk to companies at critical times as these discussions could lead to the transmission of price sensitive information.
- Investors are concerned about the role played by the lending banks as ‘financial’ underwriters with an interest purely in the return on the individual deal rather than acting as natural long-term owners.
- A number of suggestions were put to us regarding alternative structures as a way of introducing competition. For example, we heard proposals for competitive tendering for both primary underwriting and for sub-underwriting, and for sub-underwriting offset.

The Inquiry makes the following recommendations under three principal headings of **transparency**, **competition** and **shareholder involvement**.

Transparency:

- **Issuers should be required under the Listing Rules to disclose in detail all fees paid, to whom and for what.**
- **The European Commission should include similar provisions in its current review of the Transparency Obligations Directive.**
- **Audit and Risk Committees should incorporate details of the issue and alternatives considered as part of the governance reporting process.**
- **Issuers should be actively involved in compiling the proposed sub-underwriting list and should be given the final list.**

Competition:

- **Companies should seek independent advice unless the executive team or board is particularly experienced in equity capital raising.**
- **Companies should, wherever possible, put the primary underwriting contract out to tender.**
- **There should be no automatic assumption that issues should be fully underwritten. Issuers should decide what proportion of the issue should be underwritten, by whom, and at what price.**
- **Institutional shareholders, advisers and issuers should collectively evaluate the practicalities of sub-underwriting offset and of reintroducing tendering for sub-underwriting as a means of reducing issue costs.**

Shareholder Involvement:

- **Institutional shareholders should consider appointing a named individual who can be taken 'off market' and speak to issuers and their advisers with authority on matters such as support for a rights issue, pricing and sub-underwriting.**
- **Institutional shareholders should develop and maintain guidance as to what they expect of companies in a capital raising.**
- **The FRC in its next review of the Stewardship Code should consider how to encourage asset owner participation in equity sub-underwriting.**
- **Regulators should ensure that there are no unnecessary impediments to shareholders' participation in the underwriting of rights issues. Appropriate changes should be introduced into the Markets in Financial Instruments Directive (MiFID) which is currently the subject to a review by the European Commission.**

1

Background

1.1 Rights issue

The principal way in which fresh equity capital is raised by a quoted company in the UK is through a mechanism known as a rights issue. Existing shareholders are invited to subscribe for shares in proportion to their existing holding; if they elect not to do so they can sell their rights to other investors in the market or otherwise be compensated at the completion of the issue for the value, if any, of the rights they have not exercised.

This framework therefore provides shareholders with protection against dilution of their existing investment, the adverse effects of which occur most obviously when the subscription price of the new shares is set below the market price of the company's listed shares in the secondary market. Those effects of dilution, including of ownership rights, however go wider than this. It is pre-emption rights that provide shareholders with protection against dilution by giving them the first right to subscribe and through the market-based system that, in the event they decide not to subscribe, enables them to sell their rights. The value of these (nil-paid) rights is broadly equal to the dilution of their existing shareholding.

Rights issues offer an efficient and fair way for companies to raise equity capital. Existing shareholders are best placed to provide finance in a fair and cost effective manner if the proposition behind the capital raising offered by the corporate is sufficiently robust.

Rights issues may be undertaken for a variety of reasons, including to fund organic growth, to fund acquisitions and to restore depleted balance sheets. These different circumstances may have implications for the precise terms of the issue including decisions around whether to seek a guarantee that the rights issue will successfully raise all the funds that are being sought. How to obtain certainty of funding is addressed in section 1.3 below.

1.2 Discount

Shares that come by way of rights entitlement are usually offered at less than the prevailing market price before the issue is announced. This price difference is known as the discount and generally the market measure of this discount is by reference to the Theoretical Ex-rights Price (TERP).

The TERP is a calculated price for a company's share after issuing the new shares with the assumption that all these newly-issued shares are taken up by the existing shareholders. The consequence would be that the price will be lower than the old shares but higher than the newly-issued shares.

1.3 Underwriting

When raising capital by way of a rights issue the issuer normally seeks certainty of funds via an intermediated underwriting process. The intermediary, most commonly a bank or syndicate of banks, will provide insurance to the effect that if the share price falls to a level such that existing shareholders do not exercise their option to take up their rights, the intermediary will provide the company with the funds it is seeking to raise.

This intermediary will seek to lay off that risk similarly to the way that an insurer will look to reinsure large risks. The risk is therefore commonly passed on to existing long-term shareholders, who would tend to be predisposed to acquire additional shares at the issue price, and others by way of a sub-underwriting agreement. Non-shareholders may also be invited to sub-underwrite.

Gross underwriting fees paid by the issuer include the fee paid to the lead underwriter for the risk that he would be liable to take up the whole or part of the issue if it is not fully subscribed. As described above however this risk is often fully or partially laid off with sub-underwriters adopting all or part of the risk for the issue period. The lead underwriter therefore pays the sub-underwriters part of the underwriting fee for the risk that they are assuming.

The gross underwriting fee is made up of four components in what is termed a ‘bundled’ fee in that as well as covering the underwriting risk it also covers advice on the transaction, due diligence and, commonly, on-going corporate advice.

1.4 Underwriting risks

The role of the primary underwriter, as it has traditionally been understood, has been to provide certainty that the issuer will receive the funds at the rights offer price and to put significant capital at risk to back this guarantee. A number of different risks are involved:

- The share price of the issuing company might fall – whether because the market falls or for reasons specific to the company – during the overnight period when the lead underwriter is solely at risk, to a level where subscription by shareholders is doubtful.
- Advisers and issuers may have been over-optimistic about the market’s view and underestimate negative reaction to the issue.
- Even if no new information comes out of the issuer, competitors may make announcements which are deemed negative.
- On the day of announcement, the underwriter may be unable to lay off the risks he wishes.
- Finally, there is a small risk of sub-underwriter default.

Over the period reviewed, underwriting risks appear not to have increased while fees have risen. Indeed the risks appear to have fallen. It is commonplace to mitigate some of the risks the underwriter faces (including the hedging of market risk) but short-selling is not welcomed and terms of underwriting and sub-underwriting agreements generally prevent this.

A number of factors combine to minimise risk.

1.4.1 Pre-marketing

It is standard practice to wait until the night before the announcement to decide the issue price. There has been an increasing tendency to ‘pre-market’ a deal whereby significant shareholders are alerted to an impending issue and their reaction assessed. The issue price is then set at a level where there is a strong expectation that existing shareholders will subscribe to the issue. Indeed in some issues there has been a commitment entered into between primary underwriters and sub-underwriters (i.e. current shareholders and commercial sub-underwriters).

We learned that the underwriting agreement between the issuer and the bank that acts as lead underwriter is often not signed until the bank has near certainty that a large portion of the issue has been sub-underwritten.

Before agreeing to underwrite the issue the underwriter (through due diligence undertaken in preparation of the prospectus) will be party to full information about the company raising capital.

Typically, the underwriting agreement is signed during the course of the evening/night before the day on which the rights issue is formally announced. A combination of the due diligence process and the timing of when the underwriting agreement is signed means there is very little risk of any material information being disclosed between the execution of the underwriting agreement and announcement.

1.4.2 Offer period

A further change which has had the effect of reducing risk was the reduction in the minimum length of a rights issue and thus of the underwriting risk period. Changes in company law and the Listing Rules reduced the period of nil-paid rights trading from three weeks to two. The first major rights issue on the shortened timetable was that by HSBC in March 2009, which at £12.9bn was then the UK’s largest ever rights issue.

1.4.3 Discount

There has been a marked increase in the level of discounts at which issues are offered to existing shareholders. This was justified by primary underwriters in the rights issue process by citing exceptionally high levels of volatility, reduced risk appetites and the high volume of issuance that the market had been required to absorb. In the improved market conditions since 2008-09 the risks faced by underwriting at 30% plus discounts to TERP do not equate with the high gross underwriting fees currently being levied.

1.5 Professional Advisers

1.5.1 Corporate Broker

When contemplating a capital raising exercise an issuer will typically approach its corporate broker for advice. In practice all London listed corporates will retain one or more corporate brokers. Corporate brokers to the major London listed companies now tend to be part of integrated investment banks. Typically, the corporate broking parent(s), utilising their own balance sheet capital, are the primary underwriters. This arrangement creates inherent conflicts, and therefore many companies also seek independent advice.

Corporate broking services in relation to a rights issue include an assessment by the broker of the likely response of shareholders/new investors as sub-underwriters and/or subscribers to the issue. Together with the sponsor (and where appropriate independent adviser) more complex issues might include advice on alternative structures, for example those including a non-pre-emptive component or as to whether a placing, subject to claw back, should be considered. If, as has often been the case in recent times, an equity issue accompanies a debt restructuring, this will also need to be coordinated. If the issue is to fund a takeover, perhaps partially debt financed, this may require significant technical input.

1.5.2 Sponsor

A Sponsor is required on all documented UK capital raisings. The role can be fulfilled by any corporate finance firm listed by the Financial Services Authority (FSA) as an entity approved to act as Sponsor. Typically the primary underwriter(s) and/or independent financial adviser will act as (Joint) Sponsor(s) to a rights issue.

The Sponsor(s) will be appointed to liaise with the UK Listing Authority (UKLA) in accordance with the Listing Rules. Significant work is also carried out by the Sponsor in the preparation of the offering circular and prospectus and the associated due diligence. The Sponsor should be free from conflicts or have procedures in place to ensure that any conflicts are appropriately managed. Under the Listing Rules, the Sponsor is required to provide declarations to the UKLA in connection with the sufficiency of disclosure in the prospectus before it is formally approved by the UKLA as competent authority in the United Kingdom.

1.5.3 Independent Financial Adviser

A growing number of companies undertaking rights issues have used independent financial advisers (e.g. non-integrated investment banks) to provide advice to their boards. In contrast to an integrated investment bank or broker which is part of an integrated investment bank (both of which seek to offer primary underwriting and capital markets services), an independent financial adviser does not have institutional clients, nor does it seek to mitigate underwriting risk. Given an independent financial adviser's role is simply to advise the board of the issuer on the rights issue, it is therefore not conflicted in offering advice. It can therefore freely explore alternative offer structures, mechanisms and underwriting arrangements for the deal. One such arrangement could be to explore the formation of a sub-underwriting group of investors willing to sign up to the process early, thereby potentially reducing the need for primary underwriting fees to be levied to the total issue size.

1.5.4 Legal Counsel and Reporting Accountants

Although normally invoiced separately, the accountant's report in connection with prospectus disclosure requirements (including the working capital statement and significant change statement) is usually addressed to the company and sponsors/primary underwriters. The work done by the lawyers for the underwriters and for the company also forms part of the due diligence/advice process. It has been suggested that as complexity has increased, the burden, for example of regulatory compliance, has principally fallen upon the lawyers rather than the bankers. These accountant's and legal fees are included in the gross costs of the issue, disclosed as an inclusive total, together with the underwriter's commission, in the prospectus and are paid by the issuer. While the underwriting fees are charged on an *ad valorem* basis depending on the size of the issue, accounting and legal fees are generally charged on a flat basis depending on the extent of distribution to territories outside the UK and broader complexity of the transaction.

Monopolies and Mergers Commission

The MMC, following a referral from the Office of Fair Trading, began an inquiry in 1997 which led to its report on 'Underwriting services for share offers' being published in 1999. It considered whether monopoly situations existed and concluded that these did for both lead underwriting and sub-underwriting. The Commission considered that competition at that time among advisers and brokers was vigorous and, on the basis at that time of standard 0.5% fees being retained by lead underwriters and 0.25% being paid to distributing brokers, found no evidence to conclude that these were higher than would be charged in the absence of standard fees.

On sub-underwriting the Commission concluded that the use of standard fees of 1.25% was likely to have increased costs during the period up until 1996 above those that would have otherwise resulted. With the move to tendering of sub-underwriting however, that had already occurred. The competitive element this introduced meant that the adverse effect of standard terms on fee levels had ceased to have an effect. The Commission on balance did not believe that Black-Scholes option-pricing methodology could be applied in a manner that would allow conclusions as to pricing of sub-underwriting.

The Commission considered the application of pre-emption rights to capital raising and whether a relaxation of these would reduce the costs associated with capital raising. They concluded that it would not and that, further, the application of pre-emption guidelines under the Pre-emption Group (PEG) was primarily a corporate governance matter rather than a competition issue.

Pre-emption Group

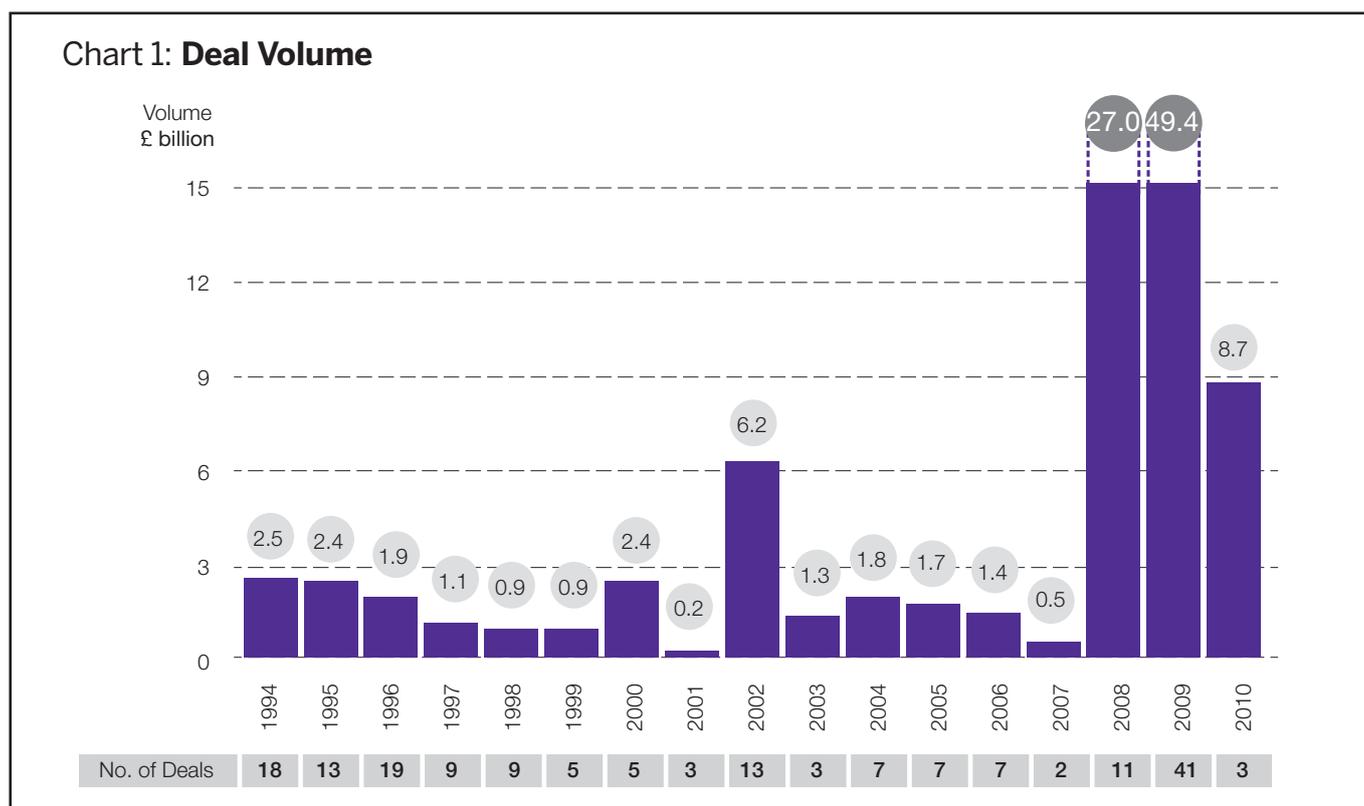
In its present form the PEG was constituted in 2005 under the auspices of the Financial Reporting Council to produce a Statement of Principles to be taken into account when considering the case for disapplying pre-emption rights. Its members represent listed companies, investors and intermediaries. Its role is to monitor the development of practice in relation to the dis-application of pre-emption rights; to agree to any revision of the Principles after consultation with interested parties; and to examine whether the processes relevant to pre-emptive issues could operate more efficiently for the benefit of companies and shareholders.

2

How practice has developed over time

2.1 Volumes

The chart below shows how volumes of rights issues have varied over the period since 1994 together with the number of issues each year in excess of £50million.



Sources: Dealogic and prospectuses

It clearly illustrates the huge amount of issuance in 2008 and 2009 as UK plc recapitalised and reduced borrowings and successfully rebuilt its balance sheet. The banking sector alone, at £38bn, accounted for half of this £76bn recapitalisation.

The chart also illustrates the variability over quite long time periods of secondary issuance. Over the three year period 1994-96 issuance was quite high with both a high number of issues and the annual average of equity raised in excess of £2.2bn. Apart from the calendar year 2002 when more than £6bn was raised from 13 issues, the next eleven years, 1997-2007, proved to be light in both number and value.

2.2 Fees and Discounts

Broadly speaking, we have identified three distinct periods in the evolution of underwriting fees and they have displayed the following characteristics:

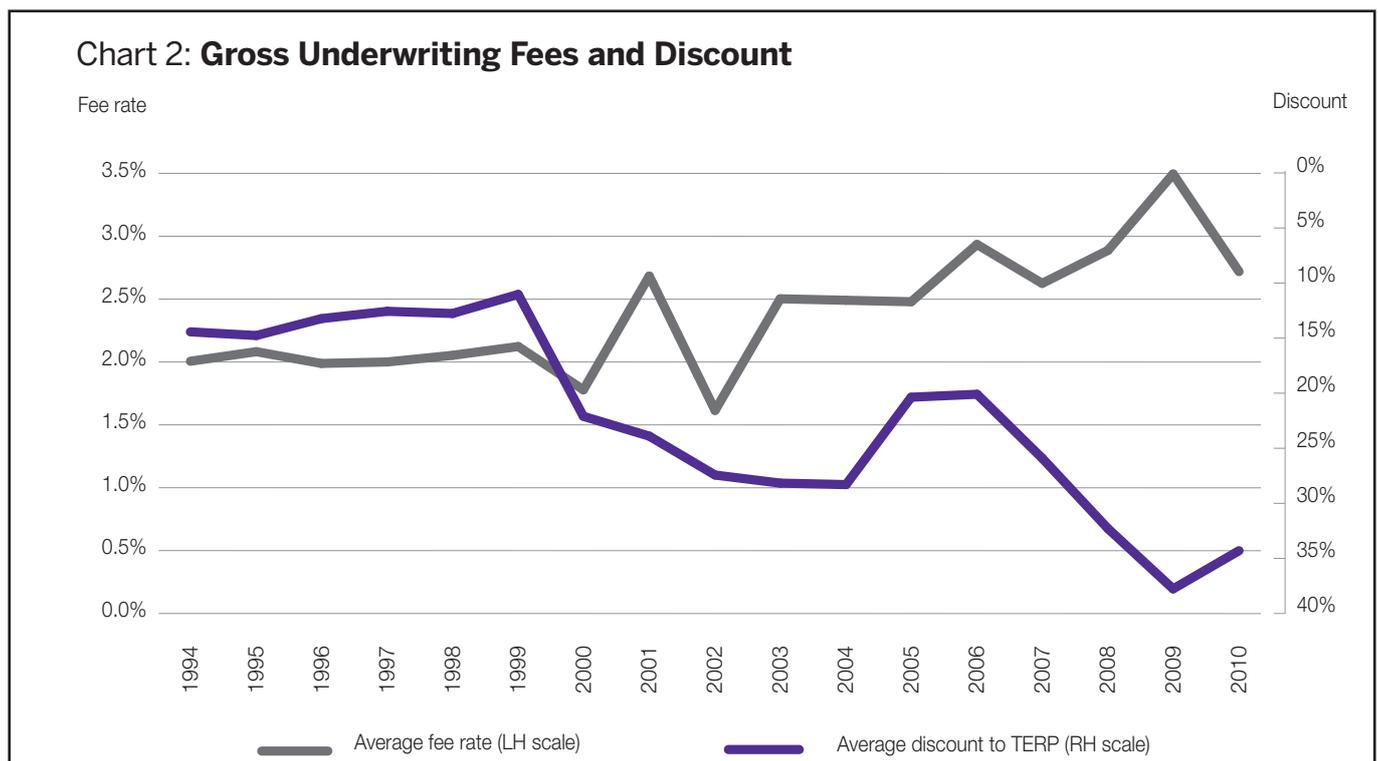
Period	Gross underwriting fees	Sub-underwriting fees
Pre MMC Report	2.0%	1.25%
MMC Report to 2007	Increase from 2% to 2.9%	1.25%
Post 2007	3-4% (average 3.4%)	1.5%-1.75%

2.2.1 Pre MMC Report

Typically gross fees were 2%, of which the lead underwriter would keep 0.5% and pay 0.25% to the company’s broker for distributing the issue, with the remaining 1.25% (i.e. 5/8ths of the total fees) being passed to the sub-underwriters.

Discounts to TERP on issues carried out over this period were typically in the 12 -15% range.

The following chart shows in more detail how that relationship changed over the following years.



Source: Dealogic and prospectuses

2.2.2 MMC Report to financial crisis

Following the MMC report in 1999 and in keeping with their recommendations there was a move away from standard terms to more deeply discounted issues. Issues which came at a deep discount at around this time were done either without underwriting (Cookson in 2002 at a 50% discount) or at much lower than normal fees (Pearson in 2000 at 0.50%). This reflected the significantly reduced risk to which underwriters and sub-underwriters were exposed.

As evidenced by the chart gross underwriting fees therefore did trend down for a short period up to 2003. The data point in 2001 is anomalous as there were only three issues totalling £200m in that year.

After 2003 fees on the whole began to trend a little higher averaging 2.6% even with discounts remaining in the 20-30% region.

Throughout this period, whilst gross underwriting fees rose, the amounts paid to sub-underwriters remained static at 1.25%. Less than half the gross underwriting fee was being passed on to sub-underwriters despite them bearing greater risk.

2.2.3 Post 2007

Clearly the risks facing underwriters (and sub-underwriters) during the financial crisis were significantly greater than they had been for some considerable time. Financial markets were under severe pressure and share prices and markets globally were exceptionally volatile. Given heightened risk and the amount of re-capitalisation taking place, both underwriters and sub-underwriters may legitimately have increased their required reward for the risk they were assuming. It is notable that during 2008-09 UK companies re-capitalised their balance sheets to the sum of £76bn principally via the rights issue process with, as already mentioned, half of this being raised by a very fragile banking sector.

In March 2009 the outstanding underwriting exposure reached as high as £23bn as companies such as Xstrata, HSBC and several real estate companies embarked on rights issues. This almost matched the entire record figure raised by way of rights in 2008 and more than the entire total raised in the previous fourteen years.

Throughout this period gross underwriting fees varied between 3 and 4% (averaging 3.4%) and discounts fluctuated between 30 and 40%, averaging 37% in 2009.

For the larger risk issues sub-underwriters received an increased absolute fee rate but nevertheless typically received only 40% of the gross underwriting fees: while the lead underwriters retained 60% of the gross fees. This compares to the 37.5% which the lead underwriter typically received historically.

It is the case, however, that in the more benign market environment since mid-2009 discounts have remained relatively high but fees have not fallen as they may have been expected to do. In addition underwriters of an issue retained a greater part of the fee after payment to the sub-underwriters than has historically been the case.

The comparatively limited data for 2010, which saw a reduced number of issues, compared to the previous two years means that the apparent reductions in fee levels and discounts should be seen as essentially provisional in nature. A number of these issues were intrinsically of lower risk than those undertaken in the previous two years. It is difficult to draw conclusions from this small data set.

We examine the implications of this in Section 2.3.3 below.

Rights Issue Review Group

Following the onset of the credit crunch in 2007 and difficulties in the early parts of 2008 in equity capital raising, the government set up the Rights Issue Review Group. The Group began its work before the acute phase of the banking crisis in the autumn of 2008 but reported in the immediate aftermath. The Group's report made a number of short and longer term recommendations, several of which focused on attempts to reduce the duration of rights issue offer periods in order to reduce market risk. In particular, the offer period was reduced from three to two weeks.

The ABI also amended its guidelines on capital issuance to ensure that companies would not be obliged to call an additional general meeting, which would delay the commencement of the offer by at least two weeks, simply because the rights issue was at a discount to the prevailing market price.

Longer term recommendations included the pursuit of changes to the EU Prospectus Directive in order to streamline prospectus information produced in support of a rights issue. A number of other proposals were made for streamlined offer and rights trading mechanisms in order to reduce further the rights timetable.

Other approaches that maintain elements of pre-emption but which fall short of the full rights issue model have been developed. The 'compensatory open offer' approach seeks to compensate shareholders for the value they lose if they do not elect to subscribe for their allocation of new shares. Equivalent compensation has been an integral feature of rights issues for many years but for open offers this has not been the case. This method was of interest to the Rights Issue Review Group who wished to ensure there were no unnecessary regulatory impediments to its use.

In addition the FSA was asked to give further consideration to a mechanism, the 'Renounced Accelerated Pro-Rata Issue with Dual Bookbuild Structure' (RAPIDS) that has become prevalent for making pre-emptive equity issues in Australia. The FSA concluded in April 2010 however that the disadvantages of this approach, including the need for the suspension of share trading for a significant period following the announcement, made this approach unsuitable for use in the UK market.

Although a range of possible equity financing tools is now available and regulation has been amended to accommodate them, there is little evidence that these provide a viable alternative to the rights issue as the preferred method of raising equity capital.

2.3 The changing roles of the participants

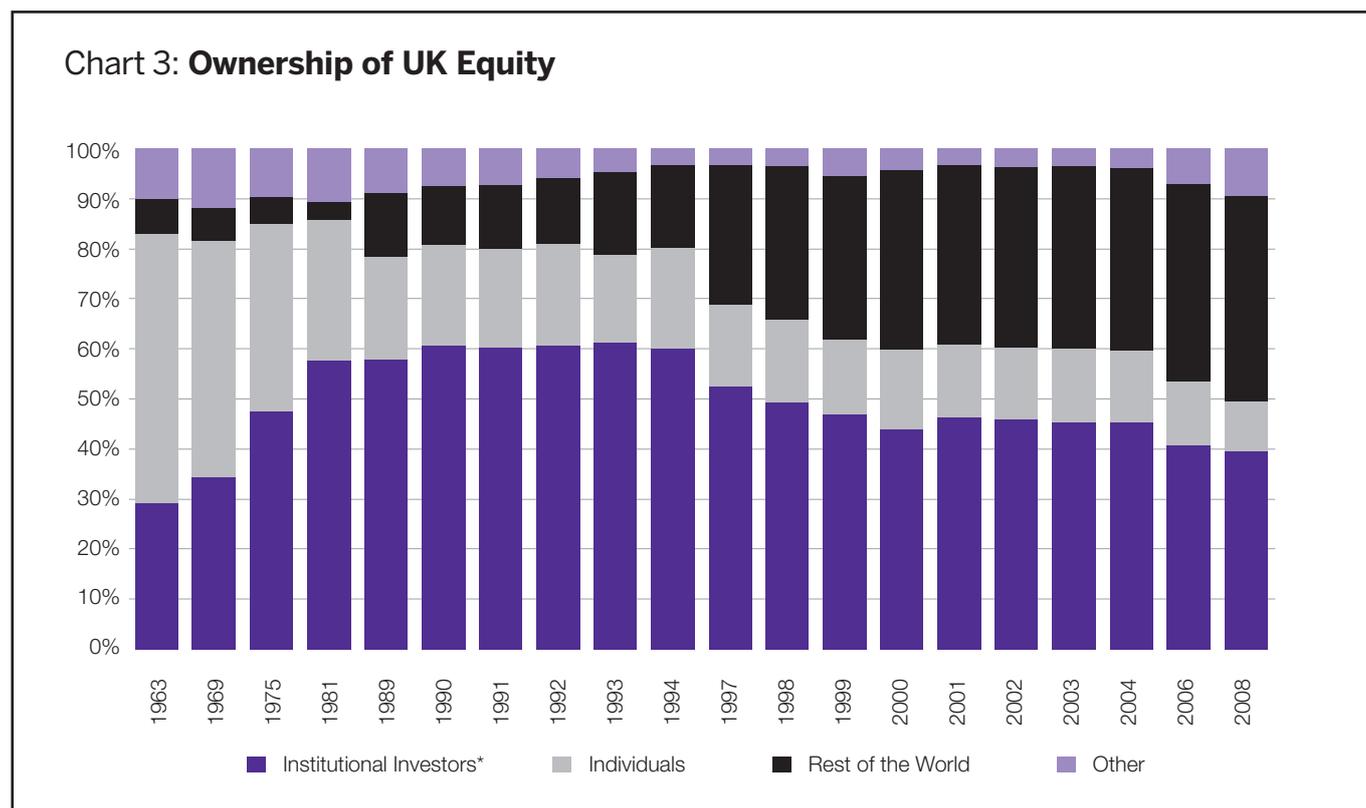
2.3.1 Broker

Following Big Bang in 1986, the roles played in capital raising initially changed less dramatically than might have been expected, given the radical nature of the changes that took place elsewhere. This was because of a strong thread of continuity, based more on people than the structures within which they now operated. Thus the particular role of the corporate broker, as trusted adviser, continued albeit often residing within an integrated investment banking house. By 2008 however this traditional role had changed. We were told that UK corporates increasingly recognise this and rarely regard their broker as independent from the other banking division of their parent if both reside within the same group.

2.3.2 Shareholder

UK insurance funds and pension schemes were typically the major long-term owners of UK equities with exposure approaching 60% of the UK equity market. They were natural buyers of UK shares and, as potential buyers of shares on weakness, viewed sub-underwriting not simply as a risk exposure but also, conversely, as a potential opportunity to acquire shares at lower prices. If they already owned the issuer’s stock then they would be seen as most likely to support further issuance and to subscribe to shares at a discounted price could be an attractive proposition. They also wished to provide support to their investee companies when raising new equity capital. Sub-underwriting was thus regarded as a natural extension of their share-investing activity and share-owning responsibilities.

As the chart below indicates, however, since the mid-1990s the proportion of UK equities owned by UK institutional shareholders has declined from 60% to 40%. There are several reasons for this. First, there has been a trend worldwide towards investing in international equities and not just domestic shares. Second, the equity allocations of UK pension funds and life insurers have declined, reflecting the changing nature of liabilities and the impact of accounting and solvency based regulation. These changes also make it more difficult for long-term institutions to buy into falling markets. At the same time while there has been strong growth in UK mutual fund holdings of UK equities, this has not been sufficient to counteract these other trends.



Source: ONS

* Institutional investors include: Insurance companies, pension funds, unit trusts, investment trusts and other financial institutions

2.3.3 Primary underwriter

In the past, the primary or lead underwriter would typically retain no more than a small exposure to the issue. Although there is limited publication of relevant data we were told it has become commonplace in the post-2007 period for banks to retain 40% to 50% outright exposure to issues carrying what have been much higher fees. If there is no incentive for them to pass on the underwriting that would suggest the risk must be mispriced. We understand that an issuer's lending banks are also increasingly willing to take on, or indeed insisting on taking on, a part of the underwriting (and sub-underwriting) risk.

2.3.4 Sub-underwriter

In the past underwritten issues were largely sub-underwritten by institutional investors who could be relied upon by the corporate broker to support the issue. As the above chart shows, international investors, including sovereign wealth funds, have significantly increased their exposure to UK equities. International investors however are generally unable or unwilling to sub-underwrite in the way that UK investors did in the past. This move to global investment coincided with a period of relatively low levels of issuance as illustrated earlier and has resulted in something of a 'rusting up' of the machinery used for effecting the classic underwritten rights issue.

Our discussions both with investors and with advisers reveal that there is now a wide range of approaches to sub-underwriting by investment managers. Many see participation in sub-underwriting as an extension of their decision-making, essentially whether an investment at the rights issue price would be attractive. This group sees a close interaction with their ownership role, regarding a decision to sub-underwrite as a mark of approval of the capital raising exercise and its structure.

A number of investors still see commitment to sub-underwriting as a duty or obligation arising out of owning UK equities.

Others regard sub-underwriting as a separate activity from ownership with decisions made on an arm's-length basis on pure investment grounds. It is not uncommon therefore for some shareholders to support the decision to undertake the issue but to decline to sub-underwrite, while others who harbour reservations nevertheless seek substantial allocations of sub-underwriting.

In addition, long-term investors have tended to be replaced in part by 'financial' sub-underwriters. An example is commercial lending banks, with an interest purely in the return on the individual deal rather than an opportunity to own the shares if the issue does not go well. Indeed were the issue to fail and the sub-underwriters called upon, such banks would be likely to be sellers of shares whereas existing institutional shareholders would be more likely to hold the shares.

It should be emphasised that it is the asset owners, not their asset managers, which act as sub-underwriters and to whom the fee accrues. Asset managers, therefore, require authorisation from their clients, whether via the investment management agreement, regulation, or otherwise, in order to support an issue.

3

Issues identified by the Inquiry

3.1 Context

Throughout this Inquiry it was often suggested that we were addressing an issue which was small relative to the market capitalisation of the companies paying the fees. We were looking at ‘basis points’ rather than something large and important. We do not agree with that argument.

For many years now shareholders have been concerned about leakage of value away to intermediaries. A key area of concern to many has been executive remuneration, which is addressed both in regulation and in investment industry codes.

Executive remuneration is something which commands the attention of regulators, shareholders, media and politicians. Company Report and Accounts contain significant and detailed information on executive reward including cash bonuses, share awards and long-term incentive plans. One of the important reasons why so much interest is taken in directors’ remuneration is that it is a test of the involvement of non-executives in ensuring appropriate oversight of executive management. We will return to that issue later.

To provide context we compared underwriting fees paid by a selection of companies that raised capital via rights issues to total directors’ remuneration in the year of the issue. Typically gross underwriting fees were ten times the total reward for executive directors in the year that the rights issue took place. While, unlike directors’ reward, underwriting fees are not an annual event, they involve significant sums of money which are fully deserving of investor scrutiny.

3.2 Level of underwriting fees

Chart 2 clearly suggests that gross underwriting fee rates have increased significantly from the standard rate prevailing in the 1990s. At the same time, the proportion of the total accruing to sub-underwriters has fallen.

The same chart indicates that there has been a significant increase in the typical discount on rights issues, suggesting that, all other things being equal, the risks facing the underwriter are lower, particularly when one factors in a reduced number of weeks on risk. Indeed issues undertaken at deep discount have in the past been so structured in order to carry no underwriting cost.

Why have underwriting fees risen? Financial market volatility undoubtedly increased the risks facing underwriters of rights issues in 2007-09. It is important to note that even in the very difficult market conditions of that period underwriters and sub-underwriters avoided major losses¹, unlike those taken in the 1987 market crash.

In addition the burden and lead times associated with due diligence (pre-announcement) have increased significantly in recent years. Other factors however may have been at work. We consider these in turn.

¹ The rump of the RBS issue was placed at a small premium, HBOS traded close enough to the issue price to avoid net losses. Bradford & Bingley was the only major loss, albeit to a specialist and supportive group of investors including the clearing banks.

3.2.1 Position of issuers

Non-financial companies may not be regular users of the capital markets, and will be coming from a position of being less well-informed of market practice than their advisers, who will also typically be the lead underwriter(s). In addition the perceived downside costs of ‘getting it wrong’, relative to slightly higher fees, may inhibit any desire to negotiate fees downwards. This might be regarded as a rational view for a board to take, but is not necessarily in the interests of investors as a whole.

If the negotiating position of issuers is relatively weak, that of advisers is correspondingly strong. If issuers refuse the terms offered, the bank has the ability to walk away but the issuer will find it extremely difficult to find alternative advisers prepared to take a lesser fee. Changes in investment banking group structures and loss of independence of company brokers have undoubtedly had an effect here. It is likely that their independence acted in the past as a valuable check on the bargaining position of brokers and other advisers. Many issuers have sought to address this by employing independent advisers in addition to their now non-independent corporate brokers.

Non-financial companies in general depend heavily on the expertise and integrity of their advisers, though less in the case of those that tap the debt or equity markets reasonably frequently.

All, however, have difficulty in finding and seriously considering an alternative course of action to that proposed by their existing adviser(s) at the critical stage. If the balance sheet is in urgent need of bolstering, the financing propositions may be given effectively on a take-it-or-leave-it basis. It is highly doubtful that directors, whose duties are owed to the company, could take any other decision than to accept the financing terms which are offered.

Issuers are in many cases unaware as to what proportion of an issue is being sub-underwritten and what proportion of this is taken by existing shareholders.

3.2.2 Issuers’ views on fee levels

The issuers we spoke to believe that a high degree of professional competence is exhibited by City advisers, and that the ‘machine’ for carrying out issues is effective and impressive. We were consistently told by issuers that, while they received fair value for money from their lawyers, bank fees are too high and indeed in the words of one, ‘usually immoral’. Those that had undertaken rights issues within recent years, however, considered they had negotiated acceptable terms in the circumstances, in that they reflected the market rate. We were told that extreme pressure could be brought on issuers to pay additional costs, the need for which appeared to come to light only once the process had started. Indeed, one sought to protect itself at the outset from these risks by paying an additional fee dependent on ‘not being held to ransom’ after the process had started.

Issuers suggested that they wanted the best not the cheapest; that may mean that they pay over the odds. Like other professional services, banks may be insufficiently inclined to compete on price lest issuers interpret low fees as a sign of low quality.

We found significant questioning among issuers (as well as some investment banking advisers) as to whether the underwriting system worked as well as it should in dealing with risk and avoiding costs where risk did not exist. From their stand-point shareholders had been supportive of an issue but a cumbersome underwriting and sub-underwriting process was nevertheless required to provide assurance that the funds would ultimately be forthcoming.

3.2.3 Views of institutional investors

The key concern for investors was the level of fees payable by companies and a lack of evidence of competitiveness. While sub-underwriting fees had risen and seemed to have become standardised at 1.75%, shareholders, even those sub-underwriting at a higher fee, were worse off overall because of the value lost within the total costs of the issue. We were told there was appetite to sub-underwrite at lower fees if the risks on a particular issue were seen to be lower than average. There was a reluctance to consider this however in the absence of a corresponding reduction in lead underwriting fees. We were told of one occasion on which a shareholder had offered to take a lower fee on the condition that the difference was rebated to the company, but that the investment bank declined.

We were told by many respondents, and not just by shareholders, that it was wrong for just half of the fee in a typical issue to be passed to the sub-underwriters. We were also told that the primary underwriters (given their risk mitigation techniques) should not receive more than one-third of the aggregate underwriting commission. Institutional investors felt that for a plain vanilla issue, given the current discounts and shorter underwriting period, 1.25% was a fair economic reward for sub-underwriting with minimal risk of loss. These views are not always passed back to issuers by advisers.

We were told by both existing and potential shareholders of issuers that they had requested sub-underwriting or additional sub-underwriting. These requests were turned down despite the bank retaining a significant outright underwriting position on its balance sheet. We were also told of instances when shareholders have asked for more participation than originally offered (or at a lower fee) and been refused, indicating further evidence of mispricing.

Institutional investors expressed concern to us about the role played by lending banks, in particular the privileged access they may enjoy to sub-underwriting business. We found, however, that this was a lesser concern to issuers who were keen to ensure that these relationships were nurtured. In one case we were told by the company that they had insisted that their lending banks were included, although after the overall underwriting fee had been agreed.

3.2.4 Conclusions of the Inquiry

Various reasons can be advanced for the increased costs of underwriting. The real risks facing underwriters of rights issues on average in the 2007-09 period have been higher than in previous years. It is also reasonable to postulate that perceptions of risk in the markets have changed and both investment banks and institutional investors may legitimately have increased their required return for the risk they were assuming.

The factual evidence of fees paid however has been of a steady rise since the time of the Monopolies and Mergers Commission investigation of 1997-99 for which there has not been a plausible justification other than during the acute phase of the banking crisis. We have seen a material rise in fees and in particular in fees for deeply discounted issues. There has also been less evidence of flexibility and choice around the discount/fee equation of the issue structure and this has consequently removed a significant competitive element.

There was little evidence of issuers and their advisers having addressed the question of whether to underwrite the rights issue as other than a binary decision. The underwriting of the issue relates, however, to the issue of shares at the price of the rights offer and not to whether, at the start of the offer period, the decision to issue equity shares is appropriate. If the cost of underwriting the issue in full is relatively high, and especially if the capacity of the market to underwrite it is stretched, there would be merit in reassessing whether the company genuinely requires a full guarantee over

all the shares being offered through the rights issue. It is possible that better value could be obtained through a partial underwriting that ensures that the issuer is covered for those funds it must obtain through subscription of new share capital but that it does not pay to guarantee funds that it would not choose to source from new equity issuance at the discounted rights offer price.

3.3 Competition

Underwriting is a regulated activity subject to the rules of the Financial Services and Markets Act 2000 (FSMA), the FSA Handbook and MiFID which require that underwriters act in accordance with the best interests of their clients. There are however significant barriers to entry that potentially act as an impediment to competition. If there are alternative ways of structuring the underwriting process that would be less costly and in the interests of the issuer client, it is not clear what, if any, incentive an incumbent investment bank would have to facilitate such alternative structures.

A number of suggestions were put to us for improving competition. Fundamentally, all seek to address how to expand the market's underwriting and sub-underwriting capacity.

3.3.1 Tendering by prospective lead underwriters

The view was expressed by some respondents that tendering should be part of the routine process for primary underwriting; that this is the most effective way to reduce gross fees to reach the right price for the risk. With bundled advice and underwriting fees the norm, tendering in practice has proven difficult up to now.

There have been some claims that competitive tendering for lead underwriting increases the risk of leaks but we have seen or heard little evidence of this. It is probable that the rewards are such that it is worth issuers taking this additional marginal risk. In practice, problems with leaks have arisen only as impact day is approached, when fee rates have already been decided.

If there were a sustained move to unbundling of fees for the risk-taking part alone, it would become more practicable. We would encourage such a development.

3.3.2 Competition in sub-underwriting

Underwriting is a risk mitigation service. Where the current system appears less than efficient is that it does not permit the early neutralisation of risk but rather requires sub-underwriters to be 'on the hook' for the entire issue across the whole of the issue period. In practice this is less of a problem than it appears as lead underwriters solicit sub-underwriting from those most likely to take up their entitlement i.e. existing shareholders. This overlap between shareholders and sub-underwriters will in practice mitigate this magnification of risk but it does not eliminate it. In principle it should be possible to achieve better risk mitigation in respect of shareholders underwriting the risk attaching to their own decisions to take up their rights and subscribe to the offer.

3.3.3 Tendering for sub-underwriting

A return to competitive tendering for sub-underwriting could improve competition. The clear majority, however, in all constituencies of respondents who expressed a view on the merits of tendering were opposed to it. This was largely on the grounds of practicality and experience gained at the time tendering was employed in a few issues after the MMC inquiry. On this view there is a

distinct limit to the variability of elements where fast decisions are required to be made. A minority of respondents however believe that there remains a strong case for tendering in order to ensure a competitive element in the process, especially given the prevalence of deep discounts.

Nonetheless, we consider that competition in sub-underwriting is important and that the issue is worthy of further study.

3.3.4 Sub-underwriting offset

Sub-underwriting with offset is another possible means of achieving lower costs by dealing with the risk more efficiently. Under this approach, if a shareholder sub-underwrites a number of shares equal to or less than the number he is offered in the rights issue he is deemed to discharge the sub-underwriting obligation by virtue simply of his subscribing for his rights entitlement. He would therefore be simply sub-underwriting his own defined portion of the issue. In principle a shareholder can achieve this position already but only if he can accurately predict the size of the take-up and therefore the rump and scale back his subscription through the pre-emptive offering accordingly. This prospective information is not available to sub-underwriters and the practical uncertainty is likely to be greatest when at the close of the offer period the company's share price is at or close to the subscription price of the new shares.

Offset arrangements would be beneficial to the shareholder sub-underwriter but adverse for other underwriters and for sub-underwriters not being offered the ability to offset. Whilst relatively common a number of years ago, offset arrangements are offered only sporadically now. An improved approach to offset, however, especially if it could be arranged in a way that deepened the pool of sub-underwriters, would be well worth exploring.

We were, if anything, surprised by the positive encouragement to pursue this in various different constituencies including issuers who believed it must be possible and beneficial overall to eliminate unnecessary underwriting risk in this way.

3.4 Transparency

3.4.1 Fees

Promoting competition requires information to be made available to the market. There is a lack of detailed information about the costs of rights issues, without which it is very difficult for issuers to form a view about any proposal put to them by their advisers. The existing rules under the Prospectus Directive do not require any disclosure beyond an estimate of the total expenses of the offer, the net proceeds, and the terms of material contracts (including the underwriting agreement). There is thus no indication of how it breaks down between primary and sub-underwriting fees, of the recipients of sub-underwriting fees, or of the purpose for which primary underwriting fees are paid. In many cases the direct retained exposure of the primary underwriter to the issue is zero or very small, so that the fee cannot be held to be remuneration for underwriting risk.

3.4.2 Bundling of underwriting and advice fees

Any assessment of the fees paid to investment banks for underwriting services requires a clear understanding of what is actually being paid for. In reality there are at least four conceptually distinct services. These are:

- The core underwriting service involving the assumption of the risk that the issue will not be subscribed at the rights issue price.

- The work that is performed in effecting due diligence on the rights issue offer documentation with its attendant risks, reputational and otherwise, for the firm. This work is clearly related directly to the actual transaction and will be performed largely around the time of the announcement of the intention to undertake the offer.
- The advice provided to the issuer in respect of the transaction. This can be provided over relatively short but possibly quite extended timeframes.
- The on-going provision of advice over perhaps many years which is in practice remunerated through fees earned when the client company undertakes capital market transactions, including rights issues.

We found no issuers who were actively against this resultant bundling of fees for their advisers and most actively favoured it to some degree. They all claimed to understand what they were paying for and recognised that this led to a situation where more frequent users of the capital markets were paying more for on-going advice. One corporate respondent specifically thought that paying for on-going advice would be counterproductive in that they would not achieve a commensurate reduction in the fees they would be asked to pay in a future capital-raising. There was a fairly widespread recognition and acceptance by issuers that current practice creates cross-subsidies, albeit modest, in favour of smaller companies.

Institutional shareholders did not seem to hold strong views on this degree of bundling. This may reflect a recognition that a holder of a portfolio of shares will achieve an averaging out over time. Of more concern to them however was the lack of transparency that this involved: the fees payable, in some cases, to a multiplicity of advisers and the understandable view that remuneration of a significant number of advisers meant that overall fees were being driven up.

Transparency as to what each adviser received might shine a light on whether some were rendering a service commensurate with the reward. Some investors as well as others felt that intermediaries were seeking to have their name 'on the ticket' in order to build up 'league table credits'. One adviser however was of the view that transparency of fees might actually increase fees and that some advisers were content to work on issues for low fees provided that their remuneration arrangements were not disclosed.

Although we recognise the very limited appetite of listed companies to contemplate unbundling the remuneration of advisers, we think that change is required in order to improve decision-making in this area and to minimise the risk of perverse incentives. We consider that there is a very strong case at least for improved transparency through the disaggregation of the fees that are actually paid and proper disclosure of the resultant components of the overall total expense. This would improve scrutiny by all market participants and, over time, would help facilitate a move to partial or full unbundling of the actual payment of services. We also suspect that bundling could make future innovation in respect of any elements of the system more difficult to achieve.

We do believe, however, that companies should avoid paying at an *ad valorem* rate to issue size for services which are clearly unrelated to company or issue size. We are also concerned that there may be some residual accounting and tax incentives to roll up into the costs of issuance the remuneration for services that are not linked to the transaction. It is important that additional expenditure beyond the bare costs of share issuance is properly charged against profit and loss.

Active thought therefore needs to be given to developing a methodology for splitting and allocating the components of the overall fee, in order to distinguish those parts that relate to issue size, and should be charged accordingly, from those which do not. We also consider that agreement on this will then allow improvements in measurement of costs for the purposes of proper accounting and in distinguishing aspects of the service that should be treated differently for tax purposes.

3.4.3 Transparency of sub-underwriting fees

At present there is no requirement for disclosure of either the proportion of a rights issue that has been sub-underwritten or the fee that has been paid for this. We recognise that there are legitimate reasons for confidentiality about contractual matters between lead underwriters and the parties to whom they assign their risk through sub-underwriting. We think however that there is a legitimate interest in securing publication of overall data which, in the case of different sub-underwriting fees being paid to different parties, would identify the range. We believe there is a need at this stage for further thought to be given to this by issuers, investment banks engaging in underwriting, and institutional investors who are prospective sub-underwriters.

3.4.4 Publication of fees

We believe that transparency as to fees paid should be improved. Considerable progress can be achieved through better access to information that is already in principle in the public domain. It was suggested to us that at the completion of rights issues all relevant information regarding fees paid should be disclosed via a regulatory news announcement. We agree and wish to see the FSA take this forward probably via what would be super-equivalent provisions under the Listing Rules.

As a matter of record there should also be a requirement for this information to be presented in the next Annual Report.

3.5 Other issues

3.5.1 Proliferation of advisers

One feature of recent years has been a growth in the number of advisers to any issue. This has had an undoubted impact on costs, though the benefits are less clear.

One point that is made is that binding in a large number of firms to a deal may improve its credibility, for example by increasing the extent of verification of the issue by major investment houses. It may also be held to place some constraints around their market activity during the time of the issue and also to generate positive comment. There may be some merit to this argument in the case of systemically significant issuers, as with the major banks' rights issues during the crisis. It is hard however to justify in other circumstances, where it may simply have the effect of weakening the number of independent commentators.

While the issuers we spoke to believed that fees did accrue to advisers in proportion to the work they did on an issue, it does appear that simply being 'on the ticket' has led to some reward for the banks concerned. This might be in anticipation of reciprocal treatment or simply a boost to one's place in league tables.

3.5.2 Leaks

A number of rights issues have seen sensitive information leaked at a critical point in the negotiation of the terms of the issue. The usual impact was a reduction in the share price of the issuer and a consequent impairment of the rights issue price, thus reducing further the overnight market risk assumed by the lead underwriter. While responsibility for such leaks has proved difficult to determine, the expansion in the number of advisers has increased the number of parties with access to information and hence the risk of a leak.

The FSA has identified a wider pattern of abusive activity by those with access to privileged information about corporate deals and for whom it may be advantageous to put such information into the public domain at the expense of listed companies. We commend the FSA for flagging the very real problem.

3.5.3 Index funds

A particular issue exists for index funds which track a nominated index. How the relevant index construction deals with capital changes can have a significant influence on a fund's behaviour even if the fund is seeking simply to only increase its actual investment in proportion to the size of the issue in order to maintain its relative index weighting. This can have a material impact both on the ability of a fund to sub-underwrite and, in some cases, even to take up rights. We believe this needs further detailed discussion with the index providers.

3.5.4 Regulation

The regulatory environment may serve to entrench the advantageous position of incumbent advisers. The ability of companies to talk to their major shareholders at critical times can be materially constrained where these discussions could lead to the transmission of price-sensitive information. We suspect however that issuers could do more to get round this problem by talking to shareholders directly before matters reach the price-sensitive stage; for their part, shareholders could be more prepared to become party to potentially price sensitive information for longer periods of time. There did appear to be misconceptions about the number of investors that could be taken 'off market' should discussions of an inside nature be required, possibly reflecting differences of approach taken by FSA and by the Takeover Panel.

One aspect of super-equivalent regulation that might be seen as a constraint is the requirement that rights issues have a sponsor; this potentially reduces the numbers able to compete for business.

Support for retention of the role was nonetheless universal, with investors in particular reliant on the credibility brought to an issue by the preparedness of the sponsor to put his reputation on the line. Without this role there is a significant danger of a slowing down of the process, as asset managers would individually need to satisfy themselves on issues before investing or sub-underwriting rather than relying on the sponsor having done the due diligence.

3.5.5 Standardisation of documentation

There is a practical need to avoid undue complexity in deal structures. Many respondents agreed that standardisation of documentation would be helpful particularly as quick decisions are required of sub-underwriters. Anything which is non-standard within sub-underwriting agreements should be brought to the attention of participants, as a departure from normal practice.

Shareholders and prospective sub-underwriters could then consider quickly any variations in terms, including lower sub-underwriting fees where the issue has lower risk characteristics, either because of the nature of the company and of the circumstances in which the issue is being made, or if the discount is deeper than the norm.

3.5.6 Shareholder registers

Shareholdings in any UK listed company of 3% and over need to be disclosed, but companies may be unaware of the identity of some of their sub-3% holders with whom they may well want to engage. Institutions may therefore wish to ensure that, where they have holdings in nominee names that are not readily identifiable, they alert companies to their identity as holders and reveal in which registered name they hold their shares.

This is one aspect of a more general problem resulting from the holding of most shares via nominee accounts. The Department of Business has also drawn attention to it in their recent call for evidence on “A long-term Focus for Corporate Britain”. It means that it is very difficult for a company to discover who its leading shareholders are at any time and how many shares they hold. Even when it has identified the investment management firm, it may not be obvious which part of the group – which geographic office, or which subsidiary, for example – is the investor. We suggest that registrars, custodians, investment managers and issuers should examine whether it is possible to provide a more comprehensive service than is available today.

3.5.7 Logistical issues

The logistical arrangements regarding decisions to take up rights have become archaic with, in many cases, institutions being required to make decisions whether or not to take up rights three days or more before the close of the offer. This feature can be a serious disincentive to the potential sub-underwriter. Although this would be less of a problem under any system of sub-underwriting offset, it is an archaic feature in a modern equity market environment.

4

Conclusions and Recommendations

We conclude that recent years have seen a growing mismatch between underwriting fees and the risks actually being taken. It is sometimes suggested that this is the result of the extreme volatility in equity markets since 2007; but in reality this phenomenon stretches back significantly further.

To make equity capital raising work as effectively and efficiently as possible requires the co-operation of many parties.

We make recommendations in pursuit of that objective which we group under three principal headings of **transparency, competition** and **shareholder involvement**.

4.1 Transparency

We believe that greater visibility and disclosure throughout the rights issue process would help minimise costs and reduce the risks to issuers.

Boards should be fully sighted as to benefits and costs of all alternative mechanisms for underwriting and sub-underwriting equity issues.

Increased disclosures about a company's processes for evaluating the cost and allocation of capital would improve accountability and lower the perception of risk associated with such an issue. Companies need to ensure that appropriate governance is put in place at time of issue.

There is often mystique about who is actually sub-underwriting the issue. It is in the company's and shareholders' interests that sub-underwriters are natural, long-term holders of the shares and the identities of those taking this sub-underwriting risk should be provided to the company.

The FSA has oversight of transparency obligations and is guardian of the quality of the UK listings. We believe that transparency as to fees paid can be improved, mainly through ensuring that information that is already being published, is made available in a way that can easily be found and understood.

At the completion of rights issues there should be disclosure, via a regulatory news announcement, of all relevant information regarding fees paid for underwriting and advisory services. As a matter of record this information should also be presented in the next Annual Report.

This will assist companies in respect of future issues in that having a benchmark as to what is the competitive market rate for advisory and underwriting roles would avoid the suspicion that in practice they pay the 'rack rate' for all services.

As a consequence we recommend that:

- **Issuers should be required under the Listing Rules to disclose in detail all fees paid, to whom and for what.**
- **The European Commission should include similar provisions in its current review of the Transparency Obligations Directive.**
- **Audit and Risk Committees should incorporate details of the issue and alternatives considered as part of the governance reporting process.**
- **Issuers should be actively involved in compiling the proposed sub-underwriting list and should be given the final list.**

4.2 Competition

There is little compelling evidence of sufficient price tension at both primary and sub-underwriting level. Indeed the inherent conflicts suggest that all the incentives work to increase the cost of the issue.

Companies and their advisers should seek to achieve the best possible underwriting terms from each of their investment and commercial banks and potentially from institutional shareholders.

There have been some claims that competitive tendering for lead underwriting increases the risk of leaks but we have seen or heard little evidence to support this. It is probable that the rewards are such that it is worth issuers taking this additional marginal risk. In practice, problems with leaks have arisen only as impact day is approached, when the structure of the underwriting syndicate and fee rates have already been decided.

Currently a significant portion of the shareholder base is unable or unwilling to sub-underwrite an equity issue. The shortfall has been taken up by a new group of 'commercial underwriters' attracted by the significant rewards and the relatively low risk inherent in an issue at what may be a large discount.

While in principle new entrants into the sub-underwriting market should lead to lower fees, this has been slow to emerge, perhaps because, unlike shareholders, they have little incentive to keep fees low.

As a consequence we recommend that:

- **Companies should seek independent advice unless the executive team or board is particularly experienced in equity capital raising.**
- **Companies should, wherever possible, put the primary underwriting contract out to tender.**
- **There should be no automatic assumption that issues should be fully underwritten. Issuers should decide what proportion of the issue should be underwritten, by whom, and at what price.**
- **Institutional shareholders, advisers and issuers should collectively evaluate the practicalities of sub-underwriting offset and of reintroducing tendering for sub-underwriting as a means of reducing issue costs.**

4.3 Shareholder Involvement

Relationships between listed companies and their major institutional shareholders are crucial and both sides have an obligation to keep this engagement in good order. There is no substitute for quality relationships built over time. Companies are accountable to their shareholders and need to listen to what they say.

The views of institutional shareholders, with their understanding of markets and the drivers of shareholder value, are an important external resource available to companies. Institutional investors can facilitate this by designating a nominated individual should a company need to consult.

Institutional investors also need to recognise that their obligations as owners will require them to agree to be 'off market' for a period while involved in discussions involving transfer of privileged information. The ability of institutional investors either to talk on a price sensitive basis or to decide whether to do so seems to vary considerably. To solicit shareholders' views well in advance of an issue will add weight to the company's negotiating position. Issuers should likewise be encouraged to consult shareholders, not only about the principle of an issue, but also its terms.

Asset owners have an interest in ensuring that the investment managers they employ can discharge their ownership obligations. Investment managers, if they are to be fully supportive of investee companies and the capital raising system need to be empowered by their contracts of engagement to accept offers of sub-underwriting on behalf of their clients.

If this is not the case an important aspect of investment management is off limits which benefits neither the fund and its beneficiaries nor the investee company. Asset owners need to encourage their fund managers to engage with investee companies as part of their stewardship functions. Few matters can be as important for investment value as ensuring the right decisions on financing. At present the Financial Reporting Council's (FRC) Stewardship Code makes no explicit mention of this.

Companies themselves are the party at the sharp end of negotiations. We believe it would be useful to have some generic guidance relating to the expectations of their shareholders and on how the challenges might best be navigated; we offer a first draft for discussion within the investment community at Appendix II.

As a consequence we recommend that:

- **Institutional shareholders should consider appointing a named individual who can be taken 'off market' and speak to issuers and their advisers with authority on matters such as support for a rights issue, pricing and sub-underwriting.**
- **Institutional shareholders should develop and maintain guidance as to what they expect of companies in a capital raising.**
- **The FRC in its next review of the Stewardship Code should consider how to encourage asset owner participation in equity sub-underwriting.**
- **Regulators should ensure that there are no unnecessary impediments to shareholders' participation in the underwriting of rights issues. Appropriate changes should be introduced into the MiFID Directive which is currently the subject to a review by the European Commission.**

4.4 Other Issues

We recommend that:

- **A model sub-underwriting agreement should be drawn up by investors and underwriters.**
- **Registrars, custodians, investment managers, issuers and other interested parties should examine how to improve the availability of information enabling identification of major shareholders and relevant fund managers.**
- **Registrars and custodians should examine how to enable shareholders to decide nearer the closing of the offer period whether to take up their rights.**

APPENDIX I

Inquiry into the UK capital raising market

Terms of reference

To review the practices and procedures adopted when new capital is raised through the issue of equity securities to uphold the interests of companies, shareholders and markets, including:

- the role and selection of advisers and underwriters;
- how practice has evolved and is evolving in relation to the pricing and structure of capital raising;
- the level of underwriting fees relative to the changing exposure to risk and whether, and if so how, this has changed over time;
- the transparency in respect of the underwriting fees paid; and
- practices in relation to sub-underwriting, including the appointment of sub-underwriters and the sharing of risks and rewards between lead underwriters and sub-underwriters,

and to make recommendations as appropriate.

Approach

The Inquiry will proceed on several fronts:

- it is today issuing a public call for written evidence from interested parties;
- it will seek to gather available data about UK capital issues over time;
- it will work with the bodies representing issuers to gather views of companies which have raised capital via questionnaires and interviews; and
- it will seek the views of investors and of advisory and underwriting firms.

Timetable

The following timetable is envisaged:

May-June:	Call for evidence and initial research
July-September:	Interviews
October-November:	Consultation on the output
December:	Publication of report and recommendations

APPENDIX II

Generic Guidance from Institutional Shareholders to Issuers:

Key matters to consider

Shareholder Value

Decisions by companies to access the market to issue fresh capital and the basis on which they do so have potentially great implications for their ability to achieve successful delivery of long-term shareholder value. Shareholder value however can easily be lost, even where undertaken for the right reasons, when the issue is not undertaken on an efficient basis. Institutional shareholders, as responsible owners of the companies in question, firmly believe that issuance by means of a rights issue is to raise new equity on the most efficient basis as well as respecting shareholders' pre-emption rights and avoiding dilution. Both direct and indirect costs are generally lower than for other methods but it is still the case that inappropriate structuring of fees can detract significantly from the efficiency of the process.

Companies should also understand the relative costs of different methods of issue as well as their other potential advantages and disadvantages, including market risk.

Underwriting decisions

In rights issues the most significant decisions revolve around whether to have issues underwritten and, if so, how this underwriting should be structured and what fees should be paid. Although deep-discount rights issues have sometimes been regarded as a means of avoiding the cost of underwriting it is evident that many companies, even when selecting the deep discount route, value the benefit of certainty of funding which underwriting confers. This in no way invalidates the recognition that the risks in underwriting a deeply discounted issue are different compared to those undertaken at closer to the prevailing market price.

Evidence should be sought as to the relative market rates for plain vanilla issues against what are possibly more complex and risky transactions.

Investor dialogue

The advice that companies receive from their financial advisers in navigating these matters can be valuable and important. This is not a substitute however for companies understanding the views of their owners, their shareholders, which they will be more able to do if they have maintained a constructive relationship with them and engaged in dialogue over time.

Early engagement with institutional investors is encouraged.

Examine sub-underwriting lists

In respect of underwriting agreements companies need to pay particular attention to the commitments being entered into as these can have a material effect on the essence of the service being provided. In particular there are dangers posed by underwriters undertaking hedging activities as this will tend to increase the volatility of the shares and the probability that an issue will fail, the consequences of which are the very thing the purpose of underwriting is meant to mitigate. In this

regard, companies are well advised to take a careful interest in the arrangements for sub-underwriting to ensure the parties involved are those, such as existing shareholders but not exclusively so, who will wish to support the issue.

Companies should insist on examining the sub-underwriting list.

Sub-underwriting offset

Companies should consider with their advisers whether it will be desirable to provide 'sub-underwriter offset' which may enhance the attractiveness of being a sub-underwriter as well as providing encouragement to existing shareholders who wish to support the issue being made by their company.

This should encourage more existing shareholders to participate in sub-underwriting.

Advice

Navigating through a rights issue process is a complex matter particularly for companies and individual executives embarking upon this for the first time. Non-financial companies, especially those that tap the markets, whether debt or equity, on an infrequent basis, depend to a greater extent on the expertise of their advisers and thus on their integrity.

Where appropriate the use of independent advisers should be considered.

Governance

Increased disclosures about a company's processes for evaluating the cost and allocation of capital would improve accountability and lower the perception of risk associated with such an issue.

Audit and Risk Committees could usefully incorporate details of these considerations as part of the governance reporting process.

APPENDIX III

Glossary

Asset Manager/Investment Manager

A firm that provides the professional management of various securities (shares, bonds and other securities) and assets (e.g. real estate) to meet specific investment goals for the benefit of their asset owners.

Asset Owner

The ultimate beneficial owner of shares. May be a pension fund or an insurance company. For retail (e.g. mutual fund) investors ownership responsibilities are normally fully delegated to an asset manager.

Big Bang

The structure of UK capital markets was reformed in 1986; an event known as Big Bang. Of particular relevance to this inquiry was the removal of ownership restrictions on brokers leading to the rise of the integrated investment bank.

Bookrunner

Bookrunners are increasingly named on rights issues but more typically used on non pre-emptive equity issues to manage the distribution of shares to new investors. In a rights issue the Bookrunners will have to distribute any rump to new shareholders but they otherwise perform the same role as a Lead Underwriter. Key tasks include: conducting due diligence, assisting on documentation, organising the marketing strategy and providing market feedback to the issuer and Global Co-ordinators (where used). The Bookrunner position is the role which league table producers, advisers and issuers often use to rank equity underwriters to judge the most prolific distributor of primary equity issues.

Co-Lead Managers

More commonly used on larger transactions. Co-lead managers form the lowest tier of the primary underwriting syndicate and perform a similar role to a Joint-Lead Managers but will underwrite a smaller percentage than the Joint-Lead Managers.

Corporate Broker

Each listed company appoints, on an ongoing basis, one or more corporate brokers. As well as providing continued market advice and market making activities, the corporate broker is often the FSA's first point of call, when it has a matter to discuss in relationship to the company. For FTSE 100 companies the market is dominated by less than a dozen brokers.

Custodian

A bank which holds shares in safe keeping on behalf of shareholders.

Discount (including Deep Discount) To TERP (Theoretical Ex-Rights Price)

The level of TERP discount indicates the size of the 'buffer' available between the rights issue price and the theoretical share price post offer. The 'buffer' offers protection to the underwriters against a downward movement in the share price, to ensure that the intrinsic value of each right remains positive. It can be calculated as: $(\text{TERP} - \text{Rights Price}) / \text{TERP}$.

For example, on a 1 for 4 rights issue at 60p where the prevailing share price is 80p the TERP is calculated as: $(4 \times 80 + 1 \times 60) / 5 = 76$ p.

Therefore the discount to TERP is 16p or 21%.

Financial Adviser

The lead adviser to a company raising money. Often an existing arrangement, hence the term 'retained financial adviser'. Would normally be involved as Lead Underwriter of an issue.

Global Co-ordinator

Typically a role taken by one or more of the Bookrunners or Lead Underwriters where an equity issue is being sold into jurisdictions outside the domestic listing venue, but increasingly used on transactions with limited international distribution. Apart from carrying out the Bookrunner roles, the Global Co-ordinator leads the process, manages and coordinates the syndicate, organises the marketing strategy and formulates the offer structure and recommendation

Independent Financial Adviser

A regulated firm that provides advice (but not capital) to the board of an issuer. Such a firm would not underwrite a rights issue and therefore has no conflict of interest.

Institutional Investor

Normally a large scale asset manager acting on behalf of clients, but can also refer to large asset owners.

Joint-Lead Managers

Joint-Lead Managers represent the second tier of the primary underwriting syndicate; although they underwrite a percentage of their relevant tranche, they do less than the Bookrunners or lead underwriters. Their other roles include: performing limited due diligence, investor education and the provision of feedback to the Bookrunners/Global Co-ordinators.

League Tables

Investment banks are judged (judge themselves) against/by their competitors as to where they appear in the league tables. The most common league table used by data providers, advisers and issuers to compare capabilities, compares the value distributed by each bank where it had a Bookrunner role. The tables are published by information providers such as Thomson Reuters and Dealogic.

Offset

An arrangement by which sub-underwriters discharge their obligation to take up their underwriting commitment by subscribing only for new shares issued pre-emptively over their existing shareholding. Allows sub-underwriters to avoid sharing sub-underwriting risk on any sub-underwriting gap or the non sub-underwritten portion of a rights issue.

Pre-emption

Offering first refusal on new shares to existing shareholders pro-rata to their holdings.

Record Date

The date at which the company's registrar 'closes' the shareholder register for the purposes of determining who is eligible to receive the right to subscribe to new shares

Reverse Enquiry

When investors approach an issuer expressing interest in supporting a capital raising, if it were to happen.

Rights Price

The price at which new shares are issued; usually set at a discount to the market price

Rump

New shares not taken up by shareholders which are, if a premium is achievable, sold into the market with the net proceeds paid to the non-participating shareholders. Any rights not taken up by the market in the placement will be purchased by the underwriters (known as the 'stick').

Sponsor

A Sponsor is required on all documented UK capital raisings. The role can be fulfilled by any corporate finance firm listed by the FSA as an entity approved to act as Sponsor. Typically the Lead Underwriter(s) and/or independent financial adviser will act as (Joint) Sponsor(s) to a rights issue. The Sponsor(s) will be appointed to liaise with the UK Listing Authority (UKLA) in accordance with the Listing Rules. Significant work is also carried out by the Sponsor in the preparation of the offering circular and prospectus and the associated due diligence.

Stewardship Code

The code of practice for investors drawn up by the ISC now sponsored by the FRC. <http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf>

Sub-Underwriter

Bilateral arrangement between Primary Underwriters and other institutions to pass-on underwriting risk to shareholders or commercial sub-underwriters.

Taken off market

Be made an insider which restricts the ability to deal. Same as off-side and taken over the wall.

Tendering

A mechanism analogous to an auction, in which potential underwriters or sub-underwriters are asked to name their underwriting fee or 'price'. The cheapest bids would normally win the contract.

TERP

TERP is the theoretical share price after the ex-rights date; it can be calculated as the weighted average price of existing shares at the pre-announcement share price and the new shares at the rights price. It is used to restate historic per share metrics and to calculate the discount to market value at which the rights issue price has been determined.

For example, on a 1 for 4 rights issue at 60p where the prevailing share price is 80p the TERP is calculated as: $(4 \times 80 + 1 \times 60) / 5 = 76 \text{ p}$.

Underwriter

Used in relation to the primary underwriting syndicate, who, in return for a fee, guarantee that all shares underwritten in a rights issue are taken up at the issue price. The Lead Underwriters will usually also be named as Bookrunners (and Global Co-ordinators where applicable). In recent transactions, the Lead Underwriters are often also the Issuer's Corporate Brokers and Joint Sponsors of the rights issue. Other members of the primary underwriting syndicate (Junior Underwriters) will include Joint Lead managers and Co-Lead managers.

UKLA (United Kingdom Listing Authority)

The UK's designated competent listing authority. Currently part of FSA's Markets Division. Responsible for approving prospectuses

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