

ASSOCIATION OF BRITISH INSURERS
AND
NATIONAL ASSOCIATION OF PENSION FUNDS
JOINT POSITION PAPER

There has recently been considerable publicity concerning the system of underwriting fees in the UK. Two important but unrelated subjects, namely pre-emption rights and the cost of capital, have become attached to this debate. We set out below our views on these issues.

1 PRE-EMPTION RIGHTS

- 1.1 The right of existing shareholders to subscribe for new share issues represents a fundamental right of ownership which is enshrined in UK and European law. This right protects company owners from having their interest in the company and the value of their investment diluted involuntarily. We believe that pre-emption rights play an essential role in protecting the long term interests of shareholders and should continue to provide the umbrella under which all new equity issues take place.
- 1.2 Discretion is routinely given by shareholders to company boards to raise limited amounts of equity by non pre-emptive methods. Companies seek annual authority to make such cash issues of up to five per cent of their existing share capital. Companies are also routinely permitted to issue shares to make acquisitions up to a certain size without seeking further shareholder permission, subject to Stock Exchange class tests. We believe that these arrangements recognise the desire of managements for a degree of flexibility. We would encourage all companies, however, to make all equity issues on a pre-emptive basis as this is always fair and equitable to their existing shareholders.
- 1.3 Where there are compelling reasons for disapplying pre-emption, companies can and do seek permission to do so from shareholders. When supported by appropriate justification, such permission is rarely withheld.

2 COST OF CAPITAL

- 2.1 It is a fallacy to suggest that pre-emption rights affect the cost of capital to a company. The dividend, should a company choose to pay one, is only one component of the total return to shareholders which determines the equity cost of capital. Furthermore, the discount in a rights issue does not affect either the cost of capital or shareholders' wealth. It makes no difference to an existing shareholder whether new shares issued by way of rights are issued at a deep discount to the market price, at a modest discount or at the market price itself. A rights issue is essentially an issue of shares at the market price, combined with a scrip issue. All earnings, assets and dividends per share should be adjusted to take account of this scrip element, and this is fully recognised by institutional investors. The discount should only be of relevance to an underwriter, who decides at what price level he is prepared to give the company a guarantee that funds will be available.

- 2.2 It is asserted by some that potential new investors overseas will be prepared to buy shares at a narrower discount than existing UK shareholders and that, as a consequence, rights issues prevent the establishment of an international share register. However, any discount represents a transfer of value from, and therefore a cost to, existing shareholders. We believe that potential new investors can always buy shares in the market and should not have preferential access to new and usually cheaper shares. Furthermore, long experience demonstrates that shares placed at a discount with new investors overseas usually flow back to their dominant domestic market.

3 UNDERWRITING FEES

- 3.1 The real cost of new equity to a company and its shareholders arises from the fees involved in raising new money and any transfer of value should the issue be made on a non pre-emptive basis. It has been suggested that the rights issue underwriting system appears to be uncompetitive, because it operates at a fixed rate regardless of the size or quality of an issue. However, the variation in risk between issues is generally reflected in the discount rather than in the fee.
- 3.2 We believe that the current system has notable advantages in terms of speed and certainty of funds for the issuing company. Furthermore, although some parties may be commercially interested in moving to US style book building arrangements, the existing UK system is demonstrably cheaper in comparison with the general cash offers and accompanying fees which usually prevail in the United States.

4 ALTERNATIVE METHODS

- 4.1 Under the umbrella of pre-emption, we welcome a wider range of methods for companies to raise new equity in a cost effective manner. The size and complexity of many issues can make it difficult to introduce open competition in underwriting when confidentiality, speed and certainty of funds are the major consideration. Even so, where competition is practical we welcome it. Indeed, major institutional investors are at this time actively encouraging companies and their financial advisers to reflect upon alternative arrangements for new equity issues.
- 4.2 One alternative would be to introduce a sliding scale of commissions depending on the discount and quality of the issue; another would be for companies to make greater use of deep discounted non-underwritten rights issues. We recognise that deep discounted rights issues may impose a substantial tax burden on private shareholders who cannot take up their rights and would hope that the government might be able to offer relief in this area.

5 SUMMARY

- 5.1 Pre-emption rights play an essential role in ensuring that neither shareholders' wealth nor their control of a company are diluted without their consent.
- 5.2 These rights - enshrined in UK and European law - must remain as a basic tenet of ownership and an important element in effective corporate

governance. Under the umbrella of pre-emption we welcome flexibility where this reduces the real costs of raising equity, namely the fees.

July 1996

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