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Recent Developments and Proposals for Change in Market Practices Relating to New Share Issues by UK-Listed Companies

In June 2008, the Chancellor of the Exchequer agreed to establish a high-level working group (the "Rights Issue Review Group" or "Group") to review current market practices (including short selling) in relation to equity capital fundraisings by UK public companies. Specifically, the Group was asked to consider and to report on any measures that might be taken to make equity capital fundraising more efficient and orderly, whilst taking account of the rights of shareholders and the need to ensure financial stability.

In November 2008, the Group submitted its report for consideration by the UK Government. This has been followed in January 2009 by the publication of the Financial Services Authority's Consultation Papers 09/1 on temporary short selling measures and 09/4 on rights issue subscription periods, and by the announcement of revisions to the Association of British Insurers' guidance as to the financial limits which companies should place on the authorities granted to directors to allot shares.

In this article, we summarise the key recommendations of the Group in its report to the Chancellor, and the Financial Service Authority's proposals in response to those recommendations, on which consultation is now being sought. In addition, we draw attention to recent developments under US securities laws affecting the participation of US persons in rights issues by UK public companies.

Background

UK public companies traditionally raise equity capital by way of a pre-emptive offering of shares to existing shareholders, either by way of open-offer or by way of a rights issue. A non pre-emptive offering of shares can also be made by way of a placing within the limits of the authority conferred on directors by the shareholders of a company in a general meeting pursuant to the Companies Act 1985.

Placings by their nature can be quickly arranged, and allow a company quick and cost-effective access to capital. However, the limits set by the Pre-emption Group Statement of Principles with which UK-listed companies are expected to comply, are that routine placings should be limited to 5 per cent of the company's share capital in any one year and 7 per cent in any rolling three-year period. The principles also include a recommendation that the discount to market price at which shares may be issued in a placing be limited to 5 per cent.

As an open offer is a pre-emptive offering to existing shareholders, in principle the only limit on the number of shares that may be issued is that set by the amount of the authority to allot shares conferred by shareholders under the Companies Act 1985. However, market practice for listed companies has been to follow the guidance issued by the Association of British Insurers. Until recently, this guidance (which dated back to 1995) limited the nominal amount of the authority to allot shares to one-third of a company's existing issued share capital.

A rights issue differs from an open offer in that the shares are provisionally allotted (subject only to payment) to existing shareholders and these nil-paid rights can then be sold in the market. However, the provisional allotment of shares under a rights issue may require a company to seek additional allotment authority from its shareholders in a general meeting, in which case the period during which nil-paid rights can be dealt in and during which the rights issue is open for acceptance will run from the date the resolution is passed, not from the date the general meeting is convened. The reason for this is to avoid conditional dealings in nil-paid rights in the event that the shareholder resolution is not passed. In contrast, the period for acceptance of an open offer can run from the date a meeting of shareholders is convened, if that is also the date on which the offer is made.

Whilst the UK Listing Rules impose a limit of 10 per cent on the discount to the market price at which shares can be issued in an open offer, there is no such rule in relation to rights issues. The reason is that, in the case of a rights issue, the discount to market price at which shares are issued should be compensated for by the ability of existing shareholders to sell their nil-paid rights in the market. As a result, the rights issue is the preferred method of capital raising from a shareholder's perspective. However, from a company's point of view, it is potentially the least-efficient option available to it, particularly if a meeting of shareholders is required. Such a meeting will need to be called on not less than 14 clear days' notice (total 16 days), following which the Listing Rules require that a rights issue should remain open for acceptance for not less than 21 days (total 23 days), with the result that the period from announcement of the rights issue to the final date for payment for the rights shares can be 39 days or longer. The London Stock Exchange Rules require, by contrast, an open offer to be open for subscription for at least 15 business days.

Rights Issue Review Group Recommendations for Change

The Group considered what lessons could be learnt from the experiences of companies (in particular those in the financial sector) who sought to raise capital by way of a rights issue in 2008. The experiences of these companies highlighted various issues, including possible difficulty created by an adverse change in financial condition or prospects over the extended period of the rights issue timetable and the possible impact on share price of market abuse by way of short selling.

The key recommendations of the Group were:

Immediate actions

(a) the Financial Services Authority to consult on the reduction from 21 days to 14 days of the period specified by the UK Listing Rules, for which a rights issue should be open for acceptance. In Consultation Paper 09/4, the Financial Services Authority has, however, indicated a preference for specifying 10 business days both for rights issues and open offers;

(b) to work with the Department of Business Enterprise and Regulatory Reform ("BERR") on the implementation of the EU Shareholder Rights Directive. The implementation of this Directive with effect from August 2009, will lengthen from 14 to 21 days the notice period for shareholder meetings of companies whose shares are traded on a regulated market in an EEA state, unless they offer shareholders the facility to vote by electronic means accessible to all shareholders and have prior annual shareholder authority to convene meetings on not less than 14 days notice;

(c) the Association of British Insurers to review the guidance that limits the authority to allot shares to one-third of the company's existing share capital on the basis that a higher limit, (two-thirds is mentioned), might be acceptable for fully pre-emptive offerings subject to appropriate safeguards (including the need for directors to stand for re-election at the next annual general meeting if shares are issued representing more than one-third of the existing share capital). On 5 January 2009, the Association of British Insurers duly announced a revision to its earlier guidance, accepting as routine a limit of one-third together with a further one-third (making two-thirds in total) provided that in relation to the further amount,

its use is limited to fully pre-emptive rights issues only and its duration is limited to 12 months. Where an additional authority is taken and the aggregate utilisation by the company of its authority exceeds one-third in nominal amount and also, in the case of an issuance in whole or in part by way of a fully pre-emptive rights issue, where the monetary proceeds exceed one-third (or such lesser proportion) of the pre-issue market capitalisation of the company, then all board members wishing to continue in office should stand for re-election at the next annual general meeting;

(d) the Financial Services Authority to continue to maintain oversight of the conflict of interest regime with a view to reinforcing transparency between issuers and underwriters, particularly in regard to the issues raised by any intention or capacity of an underwriter to sell the company's shares short;

(e) the Financial Services Authority to facilitate the development by market participants of non-prescriptive guidance on the issues that a company could usefully consider when embarking on a capital raising by way of a rights issue; and

(f) the Financial Services Authority to take forward consultation on a new form of open offer that would provide shareholders with the prospect of compensation like a rights issue and be capable of being run in conjunction with the 14-day notice period for a meeting of shareholders to approve the allotment and issue of the open offer shares.

Medium and longer-term actions

Further proposals made with a view to additional significant changes for the longer term, included the possibility that:

(a) as part of the EC's review of the functioning of the Prospectus Directive, agreement might be reached on simplified disclosure requirements for rights issue and open offer prospectuses. At the moment, the requirements are the same in each case as for an initial public offering. The EC's consultation on this and other matters relating to the Prospectus Directive is currently underway and will end in March 2009;

(b) the Financial Services Authority might devise a system by which it will be possible to have conditional dealings in a rights issue ahead of a meeting to authorise the allotment of the new shares; and

(c) the Financial Services Authority might discuss the usefulness of further work to introduce alternative rights issues models that would be able to operate according to an accelerated timetable, along the lines of the Australian RAPIDS model, which follows a two-tier approach with an accelerated wholesale offering and a second longer offering period for retail investors.

Short Selling Regime

The Financial Services Authority is presently conducting a review of short selling practices, beginning with the publication on 5 January 2009 of its consultation on temporary short selling measures in Consultation Paper 09/1.

Short selling raises a specific concern in relation to rights issues because short selling by investors of shares in a company that has announced a rights issue may have the effect of driving the share price down to the rights issue price, thereby depriving existing shareholders of any nil-paid rights premium on the sale of their rights that might otherwise have been attainable but for such behaviour. If the price in turn is driven below the rights issue price, clearly this will negatively affect the take-up of the rights issue by shareholders and so mean that if underwritten, the vast majority of the new rights shares will have to be taken up by the underwriter.

On 18 September 2008, the Financial Services Authority introduced short selling measures in relation to shares of companies in the UK financial sector. These measures were introduced because of concerns about the potential for market abuse arising from short selling in extreme market conditions, and the consequent destabilising effect of this upon the companies concerned. The measures in question banned the active creation or increase in net short positions in the shares of the companies concerned and required market disclosure of significant net short positions in those shares. It is felt that that the circumstances that led to the ban on short selling have now changed and accordingly the ban was allowed to lapse on 16 January 2009. However, the market disclosure obligation has been extended until 30 June 2009 with one change, which is that once a disclosure has been made, additional disclosures will now only be required if a short position changes significantly, namely if any threshold of 0.1% above the 0.25% disclosure threshold is reached (whether through an increase or decrease), that is 0.35%, 0.45%, 0.55%, *etc*.

Proposals for longer-term options for the short selling regime are expected to be published by the Financial Services Authority by the beginning of February.

US Securities Laws Amended in Respect of Rights Offerings to US Shareholders

UK companies should also be aware that in October 2008, the US Securities and Exchange Commission (the "SEC") amended rules that apply to cross-border rights offerings. The amendments are the first significant revisions to the current cross-border rules adopted in 1999. The purpose of the amendments is to codify certain existing no-action, interpretive and exemptive positions previously articulated by the staff of the SEC, aimed at resolving frequently encountered conflicts between US law and non-US law, such as the laws in the UK. These amendments have the effect in some instances of allowing UK public companies to include US shareholders in rights offerings without triggering broad US regulation.

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