EQUITY UNDERWRITING MARKET STUDY

The ABI’s Response to the OFT’s request for views from institutional investors

General Comments

1. Our Association is pleased to respond to the OFT’s invitation of 18 August 2010 to comment on institutional investors’ views and experiences of the underwriting market. The ABI is the voice of the UK’s insurance, investment and long-term savings industry. It has over 300 members who manage investments of £1.5 trillion, including company shares accounting for approximately 15% of the UK equity market’s capitalisation.

2. Our members as institutional shareholders accordingly have a keen interest in ensuring that the companies they own are able to raise equity capital when required on appropriate terms. This will generally best be achieved, particularly when the funds being raised are significant in proportion to the company’s existing market capitalisation, by way of a rights issue. It has been a matter of definite concern to shareholders that the costs of equity underwriting have increased to a level that do not appear justified in terms of longer term precedent.

3. The OFT is aware that the Institutional Investor Council (IIC) which consists of institutional investors both within and outside ABI membership has commissioned Mr Douglas Ferrans to consider further some of the issues which are of interest also to the OFT in its present study. We expect that this Rights Issue Fees Inquiry (RIFI) will in due course reach some conclusions on some of the questions raised by the OFT and at this stage we do not feel well placed to respond at in detail to them. Other questions fall more properly for responses to be made directly by institutional investors based on their own direct experience and we hope that the OFT will find such responses helpful. We do to respond to the remaining questions and we hope our comments will be helpful. If it would be helpful for the OFT to follow up on any aspect of our response we would be very happy to discuss these matters further.
ANNEX
Questions for Consultation

Section 1: Core questions relating to institutional shareholders

Overview of the equity raising process

This section asks for a description of the role of institutional shareholders in the equity underwriting process. It also asks for your views on the effectiveness of the process and for any suggestions that you have for how the process could be improved. These questions ask for a high level overview – further questions on sub-underwriting are included in the section below. Through this section (and similar questions posed to other participants in the process) we aim to develop a stronger understanding of the process and its strengths and weaknesses.

1. Please provide a description of how institutional shareholders are involved in the process for carrying out a rights issue and highlight the points at which they have contact with other participants in the process and the decisions that they are involved in taking.

2. Please provide a description of how institutional shareholders are involved in the process for carrying out a placing and highlight the points at which they have contact with other participants in the process and the decisions that they are involved in taking.

3. Please provide a description of how institutional shareholders are involved in the process for carrying out an open offer and highlight the points at which they have contact with other participants in the process and the decisions that they are involved in taking.

4. Please outline how any changes that have been made to the process for carrying out a rights issue over the last ten years have impacted upon the role of institutional shareholders in the process. Please explain whether you consider these changes to be beneficial or not, setting out the reasons for your view.

5. Please outline how any changes that have been made to the process for carrying out a placing over the last ten years have impacted upon the role of institutional shareholders in the process. Please explain whether you consider these changes to be beneficial or not, setting out the reasons for your view.

6. Please outline how any changes that have been made to the process for carrying out an open offer over the last ten years have impacted the role of institutional shareholders in the process. Please explain whether you consider these changes to be beneficial or not, setting out the reasons for your view.
7. Please outline any further changes that you consider could be made to improve the process for carrying out rights issues. Please explain the reasons why you consider these changes would be beneficial.

8. Please outline any further changes that you consider could be made to improve the process for carrying out placings. Please explain the reasons why you consider these changes would be beneficial.

9. Please outline any further changes that you consider could be made to improve the process for carrying out open offers. Please explain the reasons why you consider these changes would be beneficial.

These are all questions where the ABI considers that the views of institutional investors based on their experience are best conveyed by them directly.

Sub-underwriting

This section asks for information on the sub-underwriting process. We are keen to understand how the fees for sub-underwriting are determined and how the market has developed in the last ten years.

10. Please explain what factors, in your view, influence the level of sub-underwriting fees. Please include your views on the impact of the following factors:
    - the underwriting fee for a particular deal
    - the level of sub-underwriting fees paid on other recent deals
    - market sentiment and attitudes towards risk at the time of the transaction
    - the riskiness of a transaction (please set out the relevant risk factors)
    - the discount to TERPs

We think that the level of sub-underwriting fees paid on other recent deals is quite clearly the dominant influence with 1.75% having become typical for rights issues over, say, the past three years. The other factors mentioned contributed in the first instance to the rise in fees which was almost certainly justified by the substantial adverse changes in financial market conditions associated with the Banking Crisis. However, we are not convinced that these factors have continued to be relevant to the same degree as those financial market conditions have ameliorated.

Although the discount on a rights issue is not a cost to the company the cost of underwriting should be indeed be lower other things being equal, as the discount to TERP rises. We see insufficient evidence of an appropriate trade-off being made and we are particularly concerned that the rise in overall fees has been accompanied by a rise in the prevailing level of discounts when, ceteris paribus, the opposite should have been the case.
11. Do you consider there to be a conflict of interest between institutional shareholders’ incentive to encourage companies they hold shares in to negotiate low underwriting fees when raising equity and their incentive to maximise the fee that they receive as a sub-underwriter on a deal? Please explain the reasons for your response. If you do consider there to be a conflict, what actions can institutional shareholders take to manage that conflict?

Institutional shareholders’ overriding concern remains with the total cost of underwriting and the subtraction from shareholder value arising from fees that are higher than necessary. The potential for any conflict of interest was properly investigated by the Monopolies and Mergers Commission in its 1999 Report in reaching its decisions on what remedies were appropriate to ensure a competitive market environment. Since that time overall fees as a percentage of funds raised have risen as has the proportion of these fees retained by lead underwriters.

12. Please give your views on how the sub-underwriting market has changed over the last ten years. You may wish to comment on the following factors:

- changes in the number of sub-underwriters in the market
- changes in the type of institution making up the sub-underwriting market
- changes in sub-underwriting fees
- changes in the extent to which the risk involved in equity underwriting is borne by sub-underwriters

The natural sub-underwriters of share offerings are those institutional investors who already hold shares, or would hold shares at the rights price, in the issuer concerned. Although the proportion of the UK stockmarket accounted for by holdings of traditional long-only UK investing institutions has declined in recent years this has not prevented substantial equity issuance into the market by way of underwritten and sub-underwritten right issues in recent time periods.

To the extent that market risk during the course of a rights issue has increased, and we think it did so increase, this will have mainly, though not exclusively, increased the quantum of risk borne by the sub-underwriters. In addition we understand that the degree to which lead-underwriters have been assuming genuine risk in advance of sub-underwriting commitments being obtained (i.e. putting their balance sheets at risk) may also have diminished. Against this backdrop, the reduced share of fees being allocated to sub-underwriters seems unsupportable.

Relationships between institutional shareholders and other participants in the equity raising process

This section asks for information on the relationships between institutional shareholders and other participants in the equity raising market. We are keen to understand the nature of these relationships and how they impact upon outcomes in the equity raising process.
13. Please describe the relationship that institutional shareholders typically have with the companies that they hold shares in. Please include comments on the following, giving examples where possible:

- how often institutional shareholders meet with company management
- the extent to which companies engage with institutional shareholders prior to taking a decision on whether to carry out equity raising
- the extent to which companies engage with institutional shareholders once the decision has been taken to raise equity (including a description of when and if institutional shareholders might be made an insider on a deal)

14. Please describe the relationship that institutional shareholders typically have with corporate brokers both before and during the equity raising process. Please include comments on:

- the extent to which brokers engage with institutional shareholders prior to taking a decision on whether to carry out equity raising
- the extent to which institutional shareholders engage with brokers once the decision has been taken to raise equity (including a description of when and if institutional shareholders might be made an insider on a deal)

15. Please describe the relationship that institutional shareholders typically have with brokers (or investment banks more generally), in circumstances other than the equity raising process. Please include comments on:

- the various interactions that institutional shareholders have with brokers (or investment banks more generally)
- the services which brokers (or investment banks more generally) provide to institutional shareholders
- how often institutional shareholders meet with them and what is discussed

These are all questions where the ABI considers that the views of institutional investors based on their experience are best conveyed by them directly.

Different forms of equity raising and underwriting

This section asks for your views on whether there are alternative mechanisms for performing capital raising and underwriting these transactions. We are interested in your views on pre-emption rights and how they impact upon the equity raising process, and also forms of equity raising which do not require pre-emption.

16. Please give your views on pre-emption rights and how they impact upon the equity raising process. Please include comments on:

- the benefits that pre-emption rights bring to the equity raising process
- how shareholders benefit from pre-emption rights and the extent of these benefits
- the extent to which you believe pre-emption rights are an essential feature of successful equity raising
the extent to which (and the circumstances in which) institutional shareholders would be willing to waive pre-emption rights

Our views in this area have not changed since the MMC inquiry. Pre-emption rights are a fundamental protection of the interests of the shareholders of the company and, in practical terms, have been critical to providing a cost-effective capital raising environment. Traditionally rights issues have been low-cost compared to non pre-emptive issuance and, critically, the ability in the UK as compared to say the US, to undertake rights issues has helped bear down on the costs of other issuance processes that might be considered as alternatives. Pre-emptive rights are a fundamental attribute of ownership embodied in UK statute as well as European directive and underpin the governance process by which the expectations of shareholders as owners of companies can be expressed.

For the many institutional shareholders wishing to avoid dilution of their interest in the company pre-emption rights also ensure in a very practical manner that this can be achieved without risks and dealing costs. The undertaking of rights issues with market dealings in renounceable tradable rights provides optimum protection of the interests of share owners, a transparent market-based approach to the actual capital raising process while ensuring certainty of funding for companies through underwriting of the issue and/or the ability to undertake an issue at a deep discount without sacrificing shareholder value.

Our Members therefore see the pre-emption rights framework as an essential feature of successful capital raising. This framework by providing also that shareholders can disapply their rights ensures that the best interests of the company are secured and that issuance that can be made more effectively by alternative means is not prevented. Prevailing best practice as regards the way in which shareholders will provide such disapplications has been reviewed since the time of the MMC inquiry by the Pre-emption Group and recast guidance promulgated. The essential features have remained, though, reflecting the continuing validity of the principles as well as the balance that needs to be struck between flexibility in smaller capital raisings with low dilutive implications and larger issues with high dilution and potential value abstraction.

17. Please give your views on the impact of pre-emption rights on the cost of equity raising. Please include comments on:

- how pre-emption rights impact upon the length of the equity raising process
- the extent to which pre-emption rights significantly alter the cost of raising capital

Where a pre-emptive offer is made to shareholders this offering must be open for the requisite period under company law and, in the case of a rights issue, to enable rights trading to take place in the market. Both company law and Listing Rules have been amended to reduce this period, in essence from 3 to 2 weeks, and this has been a welcome reform. We think that further reductions will be difficult to achieve without qualitatively
changing the essence of the pre-emptive process but we remain ready to contemplate discussion on alternative issuance procedures. The Rights Issues Review Group considered various options but was not able to identify sufficiently promising avenues for further detailed work.

The key underlying cost difference between pre-emptive and non pre-emptive issues is the impact of the discount in the latter. The Pre-emption Group’s Statement of Principles makes clear that all endeavours should be made to restrict the discount to a maximum of 5 per cent. However, the measurement of this discount is as much art as science and pricing efficiency may vary considerably while appropriate levels of fees and discounts will be different according to the method of issuance i.e. the parameters will be different for a bookbuild than, say, for a ‘bought deal’ where the intermediary is taking the full pricing risk. However, as a generalisation the total cost in fees and discount is likely to be at least 5% and that total cost has also likely risen reflecting the same market conditions that have been advanced as reason for the increases in rights issue underwriting fees.

This still compares unfavourably with underwritten rights issues where fees for underwriting have risen to currently prevalent levels around 3.5%. The company also has obtained a genuine benefit through the optionality that the underwriting arrangement confers and this is a benefit that is not provided through the non pre-emptive placing and its associated fee structures.

18. Please give your views on the scope for wider use of non pre-emptive methods. Please include comments on:
- the extent to which non pre-emptive methods are an effective substitute for pre-emptive forms of equity raising
- how the frequency of non pre-emptive capital raising has changed over the last ten years
- your views on the use of non pre-emptive methods in the future

We have seen more examples of non pre-emptive issues that ought to have been structured as pre-emptive than vice versa. Over most of the last ten years the level of follow on equity issuance in significant size has been limited and such as has been undertaken has been modest in proportion to corporate capitalisations and better suited to issuance other than by way of a full rights issue.

19. Please give your view on whether there are alternative approaches to the traditional equity underwriting model. Please include comments on:
- the alternative mechanisms that exist
- the potential benefits that they may bring
- any possible drawbacks from these approaches
- any examples of where these approaches have been tried and details of the outcome.
We do not have any specific models to bring to the OFT's attention. Whether sub-underwriter offset should be made generally available remains a question to which further thought could usefully be given. The ABI is also aware of alternative models of underwriting that have been mooted in which the lead underwriting function as such can be assumed directly by the parties taking the sub-underwriting risk. As a generalisation investment banks that obtain substantial fees under current arrangements and to whom client companies will be reliant on advice at critical times such as when a need to raise capital arises, will have little incentive to pursue alternative structures that may be more cost-effective for listed UK companies.

Section 2 - Other aspects of the underwriting process

This section asks for more general views on the equity underwriting market, including factors which institutional shareholders may not directly be involved with. A response to these questions is not essential but we would, nevertheless, be pleased to hear of any views you have.

20. Please give your views on the extent to which there is effective competition between providers of equity underwriting services, including
- the factors which impact upon competition in this market
- the level of fees for primary underwriting
- the level of discounts to TERPs
- the extent to which underwriters’ interests are aligned with those of the companies raising equity capital

21. Please give your views on the extent to which companies are effective as purchasers of equity underwriting services, including
- the extent to which companies’ CEOs, CFOs and Board members have previous experience of raising equity, and the impact this has on their ability to make effective decisions
- the extent to which companies are reliant on information provided to them by the underwriter
- the extent to which companies make use of the views/knowledge of their institutional shareholders
- the extent to which companies have the incentive and ability to constrain the cost of equity underwriting

22. Please explain how the regulatory environment affects the provision of equity underwriting and sub-underwriting services. If you consider that the rules governing the process either facilitate or hinder competition, please explain why. Please outline and explain the reasons for any suggestions you have for improvements to the regulatory environment.
23. Please describe how the equity underwriting market has changed over the last ten years. Please include your views on:

- competition and structure of the market
- fee levels
- any other changes which have impacted upon the dynamics of this market

These are all questions best answered by institutional shareholders directly while further insight will, we hope, be provided in due course through the output of the IIC’s Rights Issue Fees Inquiry.

14/09/10

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