Pre-emption rights

This article describes the background to, and discusses the main issues surrounding, the recent debate over the pre-emption rights of a company's shareholders. A group convened by The International Stock Exchange, including representatives both of users of the capital market and of institutional investors, has recently issued guidelines on the subject, which should greatly clarify acceptable practice on the disapplication of shareholders' statutory pre-emption rights. The article suggests that the practical effects of the new guidelines will need to be monitored in order to ensure that these remain relevant in possibly changing circumstances.

The arguments surrounding the preservation of shareholders' pre-emption rights—that is, the right of existing shareholders to have the first opportunity to subscribe to any new issue of shares in their company—and the circumstances in which these rights should be waived, have been simmering for a number of years. Matters were brought to a head in April of this year when, in the face of opposition from some major institutional investors, Fisons abandoned its plan for an international share placing equivalent to 5.5% of its authorised capital. Soon afterwards, C H Beazer halved a planned issue of American Depositary Receipts (ADRs) in order to bring the size of the issue back to 5% of its authorised capital. At about the same time, Barclays Bank obtained shareholder approval, though not without difficulty, for an issue in the United States and Japan of £210 million, equivalent to 4.9% of authorised share capital and 6% of issued share capital.

Before this, a number of UK companies had, with shareholders' approval, issued new equity in excess of 5% of authorised capital outside the existing body of shareholders; these included issues of convertible loan stocks, and share placings or issues in ADR form. There was, however, growing concern on the part of several major institutions that such issues threatened an unacceptable dilution of shareholders' interests, especially in cases where companies had made regular and substantial use of the various dispensations that had hitherto been allowed. This concern led the investment committees of the Association of British Insurers (ABI) and of the National Association of Pension Funds (NAPF) to reissue earlier this year guidelines on the circumstances in which their members would consent to a disapplication of their statutory pre-emption rights.

The regulatory background

Statutory pre-emption rights applicable to all companies were only introduced in the United Kingdom following the adoption in 1979 by the European Community of the Second Directive on Company Law. Before the implementation of this directive, the only pre-emption requirements in the United Kingdom were those specified by The Stock Exchange for listed companies. Effect was given to the directive in the Companies Act 1980 (now consolidated into the Companies Act 1985) which specifies that allocations of equity for cash must be offered first and on a *pro rata* basis to all existing shareholders; such rights offers must be made in writing and must remain open for twenty-one days. These pre-emption requirements can, within previously authorised limits, be waived in advance for periods up to a maximum of five years by a 75% vote in favour of a special resolution put to the shareholders at their annual general meeting. It should be noted, however, that statutory pre-emption rights do not apply to issues which are not wholly for cash, nor do they apply to issues of convertible securities, issues of equity warrants or vendor placings.

Acknowledging the case made in favour of greater flexibility in the face of the increased accessibility to foreign sources of equity by the growing number of multinational companies, The Stock Exchange relaxed its own pre-emption requirements in October 1986. Before that date, Stock Exchange rules had specified (more restrictively than the statutory provisions) that the waiver of pre-emption rights for issues wholly for cash required the passing of a resolution, albeit on a simple majority, at an extraordinary general meeting of the company on the terms of each and every non-rights issue, notwithstanding any general disapplication which may previously have been agreed by the shareholders. From October 1986, The Stock Exchange allowed companies, on a simple majority vote of shareholders, to disapply pre-emption rights for up to fifteen months. If no such general disapplication was granted, a vote was required on each non-rights issue. Under exceptional circumstances, The Stock Exchange could exempt companies from its own pre-emption requirements, although a company would, of course, always need to meet the requirements of the Companies Acts. Even though a vendor placing is, in practice, very little different in its effect from an issue of shares for cash, these Stock Exchange requirements did not apply to issues of shares other than for cash.

The major institutional investors have had established for many years investment committees designed to protect their common interests as shareholders, and these maintained their own guidelines on the disapplication of pre-emption rights. Their guidelines acquired greater significance when The Stock Exchange relaxed its provisions. Until earlier this year, the investment committee guidelines had specified that the disapplication of pre-emption rights would be allowed for only one year at a time and for a maximum of 5% of authorised share capital (or 6.67% of issued capital) in any one year. Under their more recently revised guidelines, the ABI proposed that their members would require a vote on the terms of each and every issue for cash involving equity or deferred equity in excess of 2.5% of authorised share capital, where pre-emption rights were to be disapplied. This dealt also with the previous anomaly under which, while issues for cash of 'straight' equity had been covered by the investment committee guidelines, cases involving the use of convertibles had not.

In spite of the general concern of institutional shareholders for their proprietorial rights, it is apparent that since the mid-1970s there has been a significant increase in vendor placings, with a concomitant fall in the proportion of rights issues within the total of new capital issues. Although such vendor placings have not been covered by the pre-emption guidelines, institutional investors have nevertheless been protected in some cases from suffering a dilution of their interests by the claw-back arrangements which they have sometimes insisted in recent years should be attached to vendor placings. The earlier ABI guidelines suggested that shareholders should be given a right of claw-back for issues of a significant size or which were offered at more than a modest discount to market price; the later guidelines were more specific, requiring full claw-back for vendor placings involving more than 10% of issued share capital or priced at a discount of more than 5% to the market value.

International comparisons

The Second Directive on Company Law issued by the European Community in 1979 required all member states to introduce legislation securing shareholders' pre-emption rights: as already noted, this was enacted in the United Kingdom in the Companies Act 1980. The directive specified that whenever the capital of a company was increased by consideration in cash, the shares must be offered on a pre-emption basis to shareholders in proportion to the capital represented by their shares, shareholders being given at least fourteen days to exercise their rights. The directive provided that, in respect of a particular issue, the right of pre-emption could be waived following a decision of a general meeting of shareholders; the pre-emption requirements could also be waived in advance for any length of time (in practice, the United Kingdom set a maximum limit of five years for this purpose). It would appear that not all other EC members have yet complied with the requirements of the directive and, even in cases where there is compliance, no time limit appears to have been placed on the waiver. In this respect, the United Kingdom seems to have moved ahead of and faster than other EC member states in implementing this directive.

In the United States, although pre-emption rights used to be upheld in certain states, they have not generally survived. Aggrieved shareholders who are dissatisfied with the fund-raising activities of a company can now seek redress through the courts only under their common-law or equitable rights as proprietors. In practice litigation has tended to be restricted to complaints relating to contested takeover bids. The absence of pre-emption rights in the United States has facilitated the widespread use of bought deals and the practice of shelf-issues, enabling equity to be raised swiftly and at short notice. But although contrast with US practice is plainly of interest, the absence of statutory or other formal pre-emption rights in the United States is only one aspect of a quite different approach to shareholders' rights. The stark contrast between US and UK practice is exemplified also in other areas, particularly in the field of contested takeovers, where the acceptable initiatives available to US company boards are much greater—and the regulatory protection of shareholders' interests are much less—than are provided in this country by the Panel on Takeovers and Mergers and other regulatory bodies.

While there has been much, often heated, debate on the subject, there has been little or no serious suggestion that shareholders' pre-emption rights in this country should be allowed to disappear as they have done in the United States. In what follows, therefore, it is assumed that the general case for pre-emption rights is sound, and that the only issues to be addressed are the need to identify the circumstances in which, and the extent to which, shareholders should be prepared to consent to waiving their rights.

The wider arguments

Any study of the subject requires a review of some of the potential costs and benefits. As regards costs, whenever new equity is issued outside the existing body of shareholders at a discount to the market price, existing shareholders will suffer some loss, the more so the deeper the discount. But loss may also be suffered by existing shareholders where, after a non-rights issue overseas, there is a flow-back of shares to the United Kingdom which might be expected to depress the market price. By contrast, any discount on the issue of new shares to existing shareholders does not entail such loss since the company issuing the shares remains wholly owned by the same body of shareholders. It is thus entirely understandable that shareholders should take into account these costs when considering a request for the disapplication of their pre-emption rights. Even in the absence of any discount on issue, some shareholders may be concerned about dilution of their voting power; but this is unlikely to be a major concern except in a few cases where an institution has an unusually large proportionate interest in a company.

Looked at from the viewpoint of companies' managements, there is no doubt that some of the alternative techniques now available for raising new capital—for example, placings or bought deals—have the advantage of being able to be put in place much more quickly than rights issues. But there is another important argument in favour of increased flexibility: this is that, with access to foreign sources of capital now greatly enhanced, the overall cost of capital to a company which is able to make an issue in foreign markets may be usefully lower to the company as an entity than if it is confined to making rights issues to existing shareholders. Of course, the costs (including any discount) of a foreign issue will not necessarily be less than those of a conventionally underwritten rights issue—and could well be more. But where foreign issue costs are lower, the ability of a company to compete with others that are similarly able to tap the world capital markets will tend to be greater than if it is restricted to making rights issues. Moreover, once foreign demand is stimulated, the share price may be enhanced, or at least stabilised, by the broader shareholder base, and existing shareholders will benefit from this. There may also be a useful, if more indirect, benefit through raising the profile of a company in overseas markets.

Such a broadening of the shareholder base can, of course, also be achieved through promoting foreign purchases of shares already in issue. Several British companies, including ICI and Glaxo, have followed this route in addition to issuing new shares in the United States. But it is argued by many market practitioners that foreign buyers are more likely to be attracted by a new issue of shares than by any promotional effort in the secondary market. The market intermediary may not, of course, be altogether disinterested since he may stand to earn more from arranging a new issue of shares than from the commission he would earn by acting as agent in the purchase and sale of shares already in issue. In any case, the fees paid to a foreign issuing house can be justified as payment for the use of its distribution network to sell the shares and to ensure that demand is stimulated.

It is perhaps worth summarising the kernel of the problem. While the issue at a discount of new shares outside the existing body of shareholders involves an immediate cost to existing shareholders, there may at the same time be some immediate savings in direct costs to the company itself, as distinct from its shareholders. Other things being equal, the cost savings to the company will feed through as a benefit to the company's shareholders, though admittedly only in the longer term. Looked at in this way, it can be argued that there is little difference in substance between a decision by a company's management to broaden its shareholder base through a non-rights issue of shares, albeit at an apparent short-term cost to existing shareholders, and other decisions, such as choosing to increase investment in plant and machinery or in research and development, which may depress short-term earnings and hence the apparent value of the company to existing shareholders. The common feature of all of these decisions is that, while they may temporarily disadvantage present shareholders by reducing what is available for distribution in the short term, they are nevertheless intended to bring greater benefits in the longer term.

There is undoubted concern on the part of some companies that the domestic capital market is too limited for their needs, especially in a phase when the volume of rights issues has been great. These companies have been discouraged by some institutions from overloading the market through too frequent rights issues. It is certainly noticeable that a number of the largest recent issues have in fact been placed internationally. If UK companies are to compete internationally, it is clearly of vital importance that they should not be held back from expanding as fast as they might otherwise be able, through restricting them to raising capital only in the domestic market.

Another objection which is sometimes raised to companies raising capital other than through a rights issue is that this dilutes the weighting of an institutional investment fund in those companies. Although an institutional investor may have made it an objective to hold a particular proportion of a company's equity, and may not want this to be reduced through the unilateral actions of management, it is not entirely clear what substantive damage is done by dilution, when control of the company is not at stake. It is always open to existing shareholders to restore their positions through subsequent market purchases, though admittedly not necessarily on terms as favourable as the issue price. The impact of such dilution is certainly a good deal less real than the impact on shareholders' interests of other decisions taken by company managements which are rarely subjected by shareholders to anything like the scrutiny which is reserved for requests for the disapplication of pre-emption rights.

The subject of shareholders' rights generally is plainly of great importance. Equally, however, the Bank has for long argued that the rights of proprietorship involve also responsibilities which have in the past been inadequately recognised and exercised by many institutional investors. At a time when there are encouraging signs of progress in improving the relationship and understanding between companies and their major institutional shareholders, the case for arriving at a reasonable accommodation in respect of pre-emption rights is a strong one.

While there is little doubt that there should be some agreed guidelines and limits, and, where necessary, clear procedures for consultation before specific resolutions are finalised and circulated to shareholders, it would also seem appropriate that there should be sufficient flexibility to enable a company, in which shareholders have confidence and which can present a good case, to make a somewhat larger non-rights issue than might be tolerable in other cases.

Underwriting

In any discussion of pre-emption rights, reference needs also to be made to underwriting arrangements and commissions—matters which have often confused and, in some respects, distorted the arguments about pre-emption rights. Most rights issues are underwritten, typically by those same institutions which are also the major shareholders in those companies. The maintenance of arrangements that involve underwriting by the institutions on attractive terms can, it is argued, fortify their interest in preserving pre-emption rights intact. Where a rights issue is underwritten by a company's shareholders, it is sometimes argued that underwriting commission is not a real cost to the shareholders as a whole, even though it appears real enough to the company's financial management. Nevertheless, within the body of shareholders, it must be recognised that there are winners and losers, with the smaller shareholders who are not invited to underwrite bearing the cost of the commissions payable to the larger shareholders who do underwrite.

In fact, however, pre-emption rights and underwriting arrangements should be regarded as quite separate issues. But it would be undesirable for underwriting commissions to remain immune from the forces of competition which have swept away other monopolistic or cartel pricing arrangements in the City and elsewhere, including in particular the removal of the fixed commissions formerly paid by the institutions themselves on their Stock Exchange transactions. Underwriting commissions have already been squeezed in a number of privatisations and, to the extent that non-rights issues take place, these will introduce further competitive pressure. In addition, companies may become somewhat readier than in the past to undertake deep-discounted issues that are not underwritten, thereby maintaining the rights of existing shareholders but saving the cost of underwriting commissions. This may not be invariably to the liking of market intermediaries, who would themselves also lose commission in consequence. But a movement in the direction of non-underwritten issues by a number of major companies would introduce a healthy degree of competition and would put further downward pressure on new issue costs.

The new guidelines

Discussions on this subject have taken place over recent months between institutional investors, companies, The International Stock Exchange and other interested groups, in which the Bank has been involved to some extent. More importantly, in response to the general concern, The Stock Exchange convened a Pre-emption Group comprising representatives of the various interested parties to study the problems and recommend guidelines which would take account of the apparently conflicting interests of the parties involved. These guidelines have now been issued by The Stock Exchange and have been agreed by both the ABI and the NAPF who have participated in drawing up the new rules.

Broadly, listed companies will continue to require annual approval by shareholders of a resolution to disapply in advance pre-emption rights for the following year. Any non-rights issues made will be limited to a maximum in any one year of 5% of the fully diluted issued capital of the company, but with a further restriction limiting such issues to one-and-a-half times each year's entitlement in any rolling three-year period. The investment committees reserve the right to oppose annual disapplication resolutions in companies which have had an unsatisfactory record of complying with the new guidelines.

'Combination' issues, where part of an issue is offered on a pre-emption basis to existing shareholders and part for cash to non-shareholders, will not be opposed provided that the non-rights part remains within the 5% limit. Discounts on non-rights issues for cash, on the other hand, will be restricted to a maximum of 5% of the market price; in order to assist with the monitoring of compliance with this requirement, companies will be obliged to make full disclosure of the details of any discounts both to The Stock Exchange at the time of an issue and, subsequently, in their annual reports to shareholders.

The new guidelines recognise that there will be circumstances in which a company may with good reason wish to make an issue which exceeds the limits imposed by the guidelines. It is emphasised that such issues are not prohibited but that they will always require separate shareholder approval. The procedures which have existed in the past for prior consultation with the investment committees will continue. On the other hand, where a company has not sought an annual disapplication from the pre-emption requirement, but wishes to make a non-rights issue which is within the scope of the new guidelines, no prior consultation with the investment committees will be necessary, on the basis that their approval will not normally be withheld when the necessary resolution is put to shareholders.

On vendor placings, the new guidelines issued by The Stock Exchange reiterate the existing investment committee guidelines. Unless otherwise agreed following prior consultation with the investment committees, full claw-back must be offered to existing shareholders either if the vendor placing comprises more than 10% of the issued capital or if the discount on the issue exceeds 5% of the market price of the shares.

Perhaps more important than the precise terms and provisions of the new guidelines is the fact that they provide users of the capital market and their advisers with a degree of certainty over the likely reaction of major institutional shareholders to proposals put to them for the disapplication of their pre-emption rights. Inevitably, companies have rarely been able to be specific about the terms of a proposed rights issue when consulting the investment committees in advance. By the same token, the investment committees have, understandably, been unwilling to commit themselves without knowledge of the detailed terms. It was undoubtedly because of this uncertainty that some of the recent misunderstandings between company boards and shareholders arose.

The new guidelines should go some way towards allowing companies to broaden their shareholder bases and to make use of new issuing techniques in ways which should bring benefit to the companies as entities, while at the same time protecting the proprietorial rights of existing shareholders. It remains to be seen from the experience of future non-rights issues how the guidelines operate in practice and where the balance lies between the legitimate, if not identical, interests of companies and their shareholders. For this reason it will be of great importance that the effect of the new guidelines should be monitored. This The Stock Exchange has undertaken to do on behalf of the Pre-emption Group, which will continue in existence for the time being for this purpose.