Underwriting services for share offers

A report on the supply in the UK of
underwriting services for share offers

MONOPOLIES AND MERGERS COMMISSION

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Presented to Parliament by the Secretary of State for Trade and Industry by Command of Her Majesty February 1999

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[1]These members formed the group which was responsible for this report under the chairmanship of Mrs D P B Kingsmill.

Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests.

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Part I

Summary and Conclusions

1 Summary

1.1. On 20 November 1997 the Director General of Fair Trading referred the supply of underwriting services for share issues to us. Our terms of reference are at Appendix 1.1.

1.2. When a company makes a share issue, it usually seeks to guarantee the proceeds by getting the issue underwritten. A lead underwriter undertakes to subscribe, at the issue price, to any part of a share issue not taken up by others, and it may lay off its risk with sub-underwriters.

1.3. There has been a long-standing practice of using standard fees for underwriting services. Lead underwriters charge issuing companies a fee of 2 per cent of the gross proceeds of the issue for an underwriting period of up to 30 days; they retain 0.5 per cent of this for their own services, pay 0.25 per cent to brokers for arranging sub-underwriting, and pay the remaining 1.25 per cent to sub-underwriters. In 1995 to 1997 standard fees continued to be used for rights issues, open offers, and cash underpinnings in acquisitions, although since October 1996 the sub-underwriting for many larger rights issues has been either partially or (rarely) wholly tendered, leading to some reduction in sub-underwriting fees.

1.4. We have found two complex monopoly situations to exist. The first concerns the supply of lead underwriting services at standard fees and is in favour of lead underwriters who use those fees. The second concerns the supply of sub-underwriting services at standard fees and is in favour of lead underwriters, brokers and sub-underwriters who use those fees.

1.5. The underwriting services provided by lead underwriters and brokers are part of a wider market for the services of corporate financial advisers and brokers. We have found that competition among financial advisers and among brokers is reasonably vigorous and we see no grounds to conclude that the fees retained by lead underwriters for their own services and those paid to brokers are higher than they would be in the absence of standard fees. Although we think that these fees should be more transparent, we do not find that the lack of transparency operates against the public interest.

1.6. We looked at three sources of evidence on sub-underwriting fees: the use of the Black-Scholes model to value sub-underwriting; data on sub-underwriters' actual returns; and the effects of tendering. The majority of us think that the problems of applying the Black-Scholes model to sub-underwriting are such that no conclusions can be drawn from it. We conclude from the data on actual returns that it is probable that some excess returns were earned by sub-underwriters in the 1986 to 1996 period. The outcome of tendering indicates that for many companies the use of standard fees resulted in sub-underwriting fees being higher than they otherwise would be, at any rate up to October 1996.

1.7. We considered whether the use of tendering since October 1996 meant that the use of standard fees has now ceased to have this adverse effect. We conclude that it has not, because we believe that, in the absence of further action, there will be times in the future when standard fees will be used for all of the sub-underwriting in cases where tendering

would result in lower fees or for too large a part of the sub-underwriting in cases where tendering of a greater proportion would result in lower fees.

1.8. The limited benefits of using standard fees are not sufficient to outweigh the adverse effects. We therefore conclude that the practice of using standard sub-underwriting fees operates against the public interest in that it results or may be expected to result in some issuing companies being charged higher fees than would otherwise be the case.

1.9. We examined the possible conflict of interest faced by financial advisers who also act as lead underwriters. In particular, we considered whether the lack of non-underwritten deep-discounted issues was a consequence of financial advisers advising companies against such issues because they wanted to earn an underwriting fee. We find that the lack of these issues is better explained by the preferences of companies, and that there are no other grounds for concluding that possible conflicts of interest attributable to the complex monopoly situations result in effects adverse to the public interest.

1.10. The application of shareholders' pre-emption rights in the UK is the subject of guidelines issued by the Pre-emption Group. We received many submissions both attacking and defending these guidelines. The guidelines are effective because institutional investors, who provide the bulk of sub-underwriting, choose to adhere to them. They do so not for reasons connected with earning sub-underwriting fees but because they want to protect their rights as shareholders. We conclude that adherence to the pre-emption guidelines is not a step taken for the purposes of exploiting or maintaining the second complex monopoly situation, nor is it an action attributable to the existence of that situation. That being so we can make no public interest findings about the guidelines.

1.11. We considered whether a relaxation of the guidelines might be a remedy for the adverse effect of sub-underwriting fees being too high. We conclude that it would not, as we do not believe that issuing costs would be lower, on average, for non-pre-emptive share issues. More fundamentally, we think that the pre-emption guidelines are primarily a corporate governance matter rather than a competition issue and should be considered in that context.

1.12. We discussed whether the tendering of sub-underwriting should be mandatory but rejected this possible remedy on the grounds that it would unduly restrict the flexibility of the market and the right of companies to choose the share-issuing method they thought was in their best interests. We think the most appropriate remedies are likely to be those which increase transparency and the information available to companies. We therefore recommend that:

(a) The Securities and Futures Authority Limited should issue guidance to corporate financial advisers reminding them of the application of the Financial Services Authority's principle on information for customers and recommending that they should advise their clients of alternatives to underwriting at standard fees.

(b) The London Stock Exchange should amend the listing rules to the effect that, when companies undertake an underwritten share issue in which less than two-thirds of the sub-underwriting is to be offered for tender, the directors should be required to explain to their shareholders in the offer document and in their annual report why they have chosen this route.

(c) The Bank of England should publish guidance for companies on share-issuing good practice. Among other things, it should encourage the use of tendering and explain when deep discounting is likely to be advantageous.

1.13. We also recommend that the Department of Trade and Industry should examine the scope for reducing the minimum length of the rights period, and that the Chancellor of the Exchequer should consider taking steps to amend the capital gains tax rules to remove a disincentive to the use of deep discounting.