

6 Views of the main parties

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Introduction

6.1. This chapter gives the views of trade associations, banks, brokers, financial advisers and institutional investors who made known their views to us. Most of these views were offered in the first half of 1998, when market conditions were generally favourable, and should be read in that context.

Trade associations

Association of British Insurers

6.2. The ABI submitted evidence and attended hearings. The ABI's view was that the advantage of the present system lay in the surety of being able to raise capital, as it provided a guaranteed source of capital for companies regardless of subsequent market falls or volatility. These advantages were appreciated mostly by institutional investors, but the system was also good for private investors. A rights issue was relatively cheap. The alternative US book-building method led to fees of some 6 to 8 per cent of the issue.

6.3. Over the last 18 months, flexibility and choice of capital-raising had increased. Although currently there was something of a scarcity of rights issues, most rights issues since November 1996, and well over 75 per cent by value, had tendered for sub-underwriting with resultant lower commissions than the old standard rate. This increased flexibility was, in the ABI's view, clear evidence of markets working.

6.4. The ABI registered its concern that, although Professor Marsh's studies were interesting from a theoretical point of view, some of their claims were not justified. The ABI did not accept the presumption that there was empirical evidence for excess returns on sub-underwriting having been made in the past. This is discussed further in paragraphs 5.65 to 5.68. The actual sub-underwriting

experience of ABI members over a significant period of time, taking account of the lengthy bull market of recent years, did not support the supposition of excess returns.

6.5. The ABI believed strongly that the pre-emptive framework assisted capital-raising on the most cost-effective basis and noted that Professor Marsh himself had recognized that the underwritten rights issue process delivered cheaper capital-raising than those methods typically employed in markets where pre-emption rights were not observed. Deep-discounted rights issues provided an even cheaper route in terms of costs. ABI members would welcome additional choices or methods which preserved in substance the rights of shareholders generally, and book-built issues with rights of pro rata subscription for existing shareholders had been developed with this in mind.

6.6. On our provisional findings on complex monopoly situations, the ABI argued that it was not necessarily the case that standardization of contracts implied lack of competitiveness. Under traditional underwriting procedures, a standard fee was set but the level of the discount of the rights issue to the prevailing market price and the length of time for which sub-underwriters were on risk were the variable elements. There was no reason to believe that the standard fee level had been inappropriate to the optimum trade-off between underwriting cost and discounts of issue. Consequently, the ABI did not accept that the payment of a fixed fee necessarily represented a restriction or distortion of competition.

6.7. Although the use of standard fees might result in the direct costs of underwriting of share issues being higher than they otherwise would be, it did not necessarily follow that the underlying cost of capital would consequently be higher. The introduction of tendering for sub-underwriting had been beneficial to the overall competitive process, thus helping to ensure that companies could raise equity capital on the most cost-effective and competitive basis. It was difficult to prophesy the path that innovation might take, but changes should be demand-driven.

6.8. On the subject of deep-discounted rights issues, the ABI said that it would not have a problem if future dividend policy were to be based on a recognition of the scrip element at the point of announcement rather than the commencement of nil-paid rights trading. The current operation of CGT created potential problems both for private shareholders and for institutional investors such as life assurers which were assessable for this tax.

6.9. Rights of pre-emption whereby existing shareholders' holdings could not be diluted without their consent by the issue of shares for cash to outsiders provided a framework which guarded against the involuntary transfer of economic value to third parties. The pre-emption guidelines (see Appendix 3.1) were designed to provide assurance to companies that shareholders would routinely approve disapplication of pre-emption rights over a given proportion of share capital. The procedures for consultation provided for considerable flexibility which, in practice, ensured that equity capital raisings could be made on the most appropriate and cost-effective basis. Where a company believed it had a good case for disapplication of pre-emption rights in respect of a specific issue, it was entirely in order for shareholders to be asked to approve such an issue.

6.10. With regard to the effect of LSE and Takeover Panel rules, the ABI said that the timetable in a rights issue was dictated by a number of factors including the need for a sufficient period for the orderly completion of nil-paid rights trading and for documentation to be returned by shareholders. Any modification might have an adverse impact, in particular, in respect of private clients.

6.11. On barriers to entry, the ABI was not aware of the existence of any barriers to market entry for lead underwriters and brokers beyond the need to have the expertise and capital to be recognized as a credible operator. Innovation in market procedures, such as the introduction of tendering for sub-underwriting, might speed the ability of new entrants to become established in a changing market. The ABI did not believe there were any barriers which prevented potential sub-underwriters from accessing this market.

6.12. On the question of why sub-underwriting was so rarely undertaken by persons other than fund managers, fund managers were well placed to undertake sub-underwriting activity because they would generally find it easier than many other types of financial market participants to absorb stock which they might be called upon to take up to avoid the issue failing. They also had the ability to hold for the longer term.

6.13. The ABI did not believe that companies were inhibited from changing their financial advisers or brokers by fear of adverse market reaction or switching costs. On the question of whether there was a serious conflict of interest arising from the financial adviser and lead underwriter roles being undertaken by the same organization, the ABI thought there was potential for conflict of interest but in practice there were significant factors which might point in the direction of both financial adviser and lead underwriter being performed by the same organization.

6.14. We asked the ABI about hypothetical remedies. It was not in favour of mandatory tendering of sub-underwriting. It believed that companies themselves, acting on appropriate advice, should decide whether or not to make their issues subject to tendering of sub-underwriting. The case for tendering of sub-underwriting for larger issues was probably greater than that for smaller-size issues. It was not in favour of a cap on sub-underwriting fees as it thought this would lead to some rights issues being made at large discounts to the current market price; and the market should be allowed to determine rates. It agreed that the tender should be open to as wide a group of potential sub-underwriters as possible, but thought that whether the whole or only part of the sub-underwriting of a particular issue should be tendered should be a decision for companies to take on the basis of proper advice.

6.15. We asked about views on making share-issuing best practice available. The ABI said that the various elements of suggested best practice were helpful, but not ends in themselves. It and the NAPF had set out an appropriate framework in a 1996 paper (see Appendix 6.1). This could be developed further, but the ABI was nervous about interfering in the market and, on a matter such as pre-marketing of rights issues, felt that advice would depend on the particular case.

6.16. The ABI strongly opposed the hypothetical remedy of loosening the pre-emption guidelines. It believed that current practice already provided sufficient flexibility. On transparency of fees, it thought that advisers should specify distinct services but that it would probably be best to avoid enshrining requirements in rules. On the suggestion that the appointment of lead underwriters and of brokers providing underwriting services for share issues should be on the basis of competitive tenders, it was not convinced that this would reduce issue costs in practice. On the possibility of rules to deal with conflicts of interest, it doubted if explicit rules were necessary.

6.17. We asked for views on the remedy that brokers should be required to inform companies in advance of the identity of sub-underwriters. The ABI considered that companies should be able to ensure that all their major shareholders, within the constraints of credit risk, were offered the opportunity to participate in sub-underwriting. Companies might wish to mention other potential sub-underwriters to the lead underwriter and broker. It should be for the broker to perform the fiduciary duty of procuring sub-underwriters on the most advantageous terms for the company.

Institutional Fund Managers' Association

6.18. The IFMA made submissions and attended a hearing. It took the view, set out in a letter to the OFT in October 1997, that the traditional system had worked well and there seemed little case for disturbing it. One great advantage of the process was the speed at which sub-underwriting could be arranged. However, the IFMA hoped that, if there were to be variations in the levels of commission to the underwriter and sub-underwriters, it would be recognized that, occasionally, the variation could be upwards. Smaller companies got a very good deal from the traditional arrangements, whilst larger companies in the past two years had benefited from the partial tendering process. The various efforts at innovation in the past two years had been well supported by IFMA members.

6.19. The IFMA questioned the appropriateness of including IPOs for calculating share of supply. Its main reason for continuing to stand by the present system was that this seemed to be the only way of defending the long-standing principle of pre-emption rights. Alternative methods of capital-raising were not cheaper, either from the point of view of the company or for the recipients of the new shares. US and Continental methods seemed to involve much higher costs, 6 to 8 per cent, against the conventional rights issue cost of 2 to 2.5 per cent. It should also be noted that there had been a very long bull market in equities and it was not necessarily the case that the returns from underwriting would continue at the bull market level of the last 20 years or so.

6.20. On the topic of pre-emption rights, the IFMA believed that companies belonged to their shareholders. The existing arrangement whereby management was empowered to issue new shares to the extent of 5 per cent of the existing issued capital was entirely adequate for company needs and the IFMA would be strongly opposed to any proposals to extend this.

6.21. Fund managers did not nowadays sub-underwrite on their own account: any benefit derived from sub-underwriting flowed directly through to fund managers' clients. Sub-underwriting was not viewed as a particularly profitable exercise. The IFMA was not opposed to the deep-discount rights issue, but this did not give certainty and would not appeal to every company.

6.22. In the years since 1995, there had been a dearth of rights issues, by comparison with other periods. It was not right to judge the efforts at innovation by the issuing houses over such a short period, when there had been such a comparatively low level of activity.

London Investment Banking Association

6.23. LIBA made a submission and attended a hearing to discuss Professor Marsh's views. It said that its members had differing commercial interests in the way underwriting business was conducted in the UK. In 1996, in response to concerns expressed by the DGFT, LIBA took the firm view that there was no complex monopoly in existence. Nevertheless, it issued a notice to its members encouraging innovation in the underwriting market.

6.24. LIBA argued that, historically, it might well be the case that there was a strong degree of uniformity in the conventional pricing of underwriting and sub-underwriting services for rights issues. However, it had not been alleged that there was any collusion between underwriters as to the pricing of their services. In recent years, conventional pricing in relation to primary underwriting fees had not applied to flotations. In relation to rights issues, there was no sense in which underwriters' historic inclination to adhere to conventional pricing had prevented, restricted or distorted competition, since no underwriter or group of underwriters had either influenced or attempted to influence the terms charged by their competitors. During the era of conventional fees, these might have created expectations making it more difficult for a competitor to charge higher fees, but could not in any way have inhibited the charging of a lower fee. LIBA was not aware of any allegations that relationships between underwriters and their corporate clients incorporated any exclusive or prima facie anti-competitive features.

6.25. In response to our provisional findings on the existence of complex monopoly situations, LIBA said that in view of the evident discontinuity in market practice dating from the Stakis rights issue in October 1996, it was not entirely satisfactory to base a conclusion that a complex monopoly existed on figures for business practice averaged over the years 1995 to 1997 taken as a whole.

6.26. LIBA considered that the Marsh reports on the pricing of sub-underwriting were seriously flawed. The criticism of Professor Marsh's assessment was based on a detailed examination of the Black-Scholes model and specifically from considering what allowance needed to be made if some of the 'ideal conditions' assumed by Black-Scholes were not present in the real world. LIBA's criticism of Professor Marsh's use of the Black-Scholes model was that he had applied the model in the simplified form which Black-Scholes had noted held good only to the extent that certain 'ideal conditions' applied. In the circumstances of an option written to cover the risk that a rights issue was unsuccessful, several of the ideal conditions did not apply. Professor Black had himself pointed out that the allowance necessary to take account of the absence of some of the ideal conditions could have a dramatic effect on the value of the option and that this was particularly likely to be the case for an out-of-the-money option (such as an option to cover the risk of a failed rights issue). In one case identified by Professor Black, allowance for the relaxation of just one of the ideal conditions increased the value of the option 53-fold. In support of their argument, LIBA presented detailed arguments about the consequences of relaxing the Black-Scholes 'ideal condition' that no transaction costs would be involved in the construction of the hedge underlying the Black-Scholes model. These demonstrated that, even for a small rights issue, transaction costs alone could amount to three times the Black-Scholes value and argued that a still larger multiple would apply to a larger rights issue.

6.27. Another of the 'ideal conditions' assumed by the Black-Scholes model which LIBA believed did not apply in the circumstances of an underwritten rights issue, but the absence of which was harder to prove and the consequence of which was harder to quantify, was the assumed log-normal distribution of future prices. The views of option market practitioners were that the particular circumstances of a rights issue which had been badly received by the market created an expectation that the underwriters would have to take stock which they had not chosen to buy, and were therefore likely to be sellers of the stock in the future. This market expectation of substantial sales into a weak market meant that the log-normal distribution of future prices expected in efficient market theory did not hold, and that there was a 'fat tail' on the negative end of the issue. If the distribution was fat-tailed, the Black-Scholes model did not hold good. LIBA was convinced that the making of proper allowance for the relaxation of the 'ideal conditions' assumed for simplicity by the Black-Scholes model caused such large changes to the calculations that it was not appropriate to put any weight at all on figures which made no such allowance. LIBA provided some detailed notes in support of their views. These are reproduced at Appendix 6.2.

6.28. LIBA also argued that tenders had become the norm for the sub-underwriting of all significant rights issues. A study of all known rights issues for amounts in excess of £5 million from January to September 1997 showed that 47 per cent of all issues utilized a tender for all or part of the sub-underwriting; of the issues of £20 million or more, 76 per cent utilized a tender; and tender issues accounted for more than £1.1 billion, or 78 per cent of the capital raised. Special circumstances applied to several of the issues which did not utilize a tender; for example, in one of the issues existing shareholders had undertaken to subscribe for 64.9 per cent of the issue. It thus appeared that tendering for sub-underwriting was at present the market norm for all except the smallest issues. In general, small issuers tended to have limited liquidity in their shares and were not likely to be suited to book-build approaches to issuing capital.

6.29. The cost of raising equity capital in the UK was low relative to other financial centres. Unofficial surveys prepared by LIBA members showed London costs to be at the bottom of the range of international costs. This evidence tended to cast considerable doubt on any view that the technical monopoly, if it existed, had worked against the public interest.

6.30. Any issuer who felt any concern about a conflict of interest in appointing his financial adviser as underwriter was entirely free to appoint another underwriter. The reasons why in practice issuers chose to appoint their own financial adviser as underwriter were the following. First, a rights issue was normally part of a larger transaction, usually to finance an acquisition, in which the adviser might well have been involved in the negotiation. The fees for these wider roles would probably be much larger than those for arranging and underwriting the issue of shares to finance it. It was unlikely that the relationship with the client built up in this wider transaction would be put at risk by biased advice on underwriting. Second, to engage a separate adviser for underwriting, the issuer would need to give the additional adviser full information about plans, prospects, risk exposures and so on and give the adviser the opportunity to make a full assessment of the company. An underwriter with limited knowledge and experience of the issue was likely to have less confidence in that issuer and, therefore, would have a tendency to a more conservative view of price. Firms were understandably reluctant to make sensitive information more widely known than necessary. Third, retaining an additional adviser building up the necessary depth of understanding of the firm would be likely to add to costs. Fourth, there was a weakness in principle in separating advice from execution. The adviser who simply offered advice was not subject to the discipline of subsequently having to implement it, which reduced the confidence which could be placed in it. Conversely a firm brought in merely to execute an issue which a rival had recommended would not be under the same pressure to achieve the sale price which the rival had recommended as if the firm had made the recommendation itself.

The National Association of Pension Funds Limited

6.31. The NAPF made submissions and attended a hearing. It believed that pre-emption rights played a vital role in protecting the long-term interests of shareholders from having the value of their investment diluted involuntarily. Major US investors, such as CalPERS, had acknowledged the advantages that the application of pre-emption rights offered to London as a financial centre. Pre-emption rights did not need to hinder capital-raising and discretion was routinely given by shareholders to company boards to raise limited amounts of equity by non-pre-emptive methods.

6.32. There was a misconception that pre-emption rights affected the cost of capital to a company. This was incorrect because the discount in a rights issue did not affect either the cost of capital or shareholders' wealth. It made no difference to an existing shareholder whether new shares issued by way of rights were issued at a deep discount to the market price, at a modest discount or at the market price itself. A rights issue was 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 was fully recognized by institutional investors; however, many finance directors were reluctant to cut the dividend. The discount should only be of relevance to an underwriter, who decided at what price level a guarantee could be given to the company that funds would be available.

6.33. The NAPF contended that current UK market arrangements for issues with pre-emption rights met the important requirements of confidentiality, speed and certainty of funding that companies, issuing houses and other market participants required and expected. The provision of corporate finance was competitive and present UK practice was demonstrably cheaper than the costs of capital-raising in the USA and in other leading markets. Tendering had grown rapidly and had become the market norm where new issues were of sufficient size to attract significant institutional interest. The NAPF had encouraged its members to look carefully at all innovative proposals.

6.34. In bull market and strong economic conditions, there was a much lower incidence of capital-raising. Rights issues had not been prevalent in recent years and so flexibility and experimentation had not yet become fully evident.

6.35. There was a misconception in certain quarters that issues with pre-emption rights in the UK increased the cost of capital. As a result, the concept of book building was being promoted as an alternative to the traditional rights issues. The book-building mechanism did not guarantee shareholders the right to subscribe for their pro rata entitlement. Furthermore, evidence principally from the USA suggested that fees could be significantly higher than the cost of a rights issue. A book-building process which honoured the pre-emption rights of existing shareholders, known as the CBI Capital-Raising Method, had been devised but the NAPF had expressed a number of concerns about this process, not least the level of fees, possibly 4 to 7 per cent.

6.36. The NAPF said that it understood our assertion in our issues letter (see Appendix 2.1, paragraph 9) that, in a competitive underwriting market, fees would be expected to vary with risk. However, the amount of cross-subsidization inherent in the present system should not be overlooked. Furthermore, in seeking to provide more competition in the supply of underwriting services, it would probably be less straightforward to guarantee the issuing company that a set amount of finance would be provided on a particular date. The NAPF questioned the validity of the provisional conclusion (see Appendix 2.1, paragraph 12) that the complex monopoly situations identified operated in favour of lead underwriters, brokers and sub-underwriters. A substantial value of underwriting was now undertaken on the basis of tendering; and it was not unreasonable to charge a client for providing a very necessary degree of assurance and confidence that the risk of a new issue failure had been eliminated.

6.37. The public interest in relation to underwriting of share issues was represented by shareholders. Company directors, investment banks and other financial advisers operated as the agents of those shareholders.

6.38. The NAPF said that it was difficult to be certain whether the use of standard fees resulted in higher underwriting costs. It was quite possible for issuing companies to secure additional lead underwriting services within a standard fee and it was also the case that fees earned by advisers in other major capital markets were higher than in the UK. The use of standard fees, unlike book building, had provided issuing companies with financial certainty.

6.39. We asked the NAPF its views on hypothetical remedies. It was against mandatory tendering as it thought that issuers should still be able to choose the present system. A lower fixed fee might result in some pension funds refusing to sub-underwrite. The suggestion that pre-marketing of rights issues be encouraged was not feasible for price-sensitive reasons. The NAPF would not support a loosening of the pre-emption guidelines.

Banks, brokers and financial advisers

Albert E Sharp

6.40. Albert E Sharp stated that the market for sub-underwriting services for smaller companies (with less than £150 million market capitalization) was very limited. Because of this, it could prove to be extremely difficult to arrange sub-underwritings for smaller companies, as fund managers were reluctant to invest in companies at the smaller end of the market capitalization scale where there was a greater lack of liquidity. It would be impractical in most cases and impossible in many to put out the sub-underwriting process to tender. In those cases where a tender was possible, Albert E Sharp believed that the more complex structure was likely to result in sharply increased underwriting costs and higher advisory fees.

6.41. Because of the reasons stated in paragraph 6.40, the bargaining power of a smaller company with its institutional shareholders was relatively weak compared with that of a larger company. An increase in competition would possibly leave a smaller company vulnerable to the pricing and cost demands of potential shareholders.

6.42. Any steps taken to undermine the principle of pre-emption would be seriously prejudicial to the ability of smaller companies to raise equity finance. Pre-emption protected the position of the private investor but was also a key element in sustaining the interest of institutions in this end of the market. One of the particular strengths of shareholders having pre-emption rights to subscribe for new equity issues, particularly in the case of smaller companies, was that these shareholders did tend to participate in sub-underwritings. This was helpful in achieving a successful fundraising.

An investment bank

6.43. An investment bank submitted that the fact that rights issues and IPOs by UK companies were arranged predominantly by a group of UK banks, largely unchanged for many years, would suggest that a level playing field did not exist. An important reason related to the traditional UK fee structure for underwriting and, in particular, the reward to the lead underwriter, normally 0.5 per cent of the value underwritten. The risk in the primary underwriting process was negligible. Only by unbundling the cost of advice from the cost of raising capital would the current distortion of competition be removed. Relationship skills were very different from the transaction skills deployed in a capital-raising.

6.44. There was no automatic right of access to the sub-underwriting process. The placing of actual stock was often linked to the selection of sub-underwriters.

6.45. Underwriting costs were part of the cost of capital and a fixed structure did not make sense. The current UK domestic underwriting structure was not designed to encourage impartial advice; avoiding the UK route for some companies provided the optimum solution. Competitive circumstances in the global market place would ensure that capital was raised at the optimum conditions.

Another investment bank

6.46. Another investment bank believed that standard underwriting fees were a symptom of restrictive practices. These restrictive practices principally reflected the pre-emption rights system and it was this cause which should be addressed. It was unlikely that the changes resulting in the introduction of tendering would be sustained without further action by the competition authorities.

6.47. The use of methods of issuing shares other than traditional rights issues was unlikely to impact greatly on underwriting costs. However, this was likely to be more than offset by the benefits of a higher issue price for the shares, broader share ownership and increased flexibility. The current pre-emption guidelines prevented companies from availing themselves of a much wider range of possibilities in the structuring of equity issues, and of benefiting from much greater scope for competition.

6.48. The German or French models, each country having implemented a different approach to pre-emptive rights in recent years, served as important lessons. The USA, the largest equity market in the world, effectively abolished pre-emption rights some time ago. The principal barrier to entry for lead underwriters and brokers was the reinforcement of the house broker and house adviser relationship provided by pre-emption rights. The principal barriers to entry for sub-underwriters were the existing relationship between brokers and sub-underwriters; and the fact that international players were generally unable to comprehend the UK system and were wary of its lack of transparency. Additionally, in a US context, US investors were reluctant to take on a statutory underwriting role.

6.49. There might be some apparent conflict between the financial adviser and lead underwriter roles, but this was adequately addressed by the fact that business relationships, reputation and hence goodwill were dependent on a high level of trust between the bank and the client, underpinned in the financial markets by the principles of best execution and by the improved quality of advice which derived from the adviser's real contact and integration with the underwriting and distribution effort.

6.50. Commenting on the hypothetical remedies, the investment bank was not in favour of mandatory tendering or of a cap on sub-underwriting fees. It believed that market forces and competition should determine these issues. It considered that pre-emption rights should ultimately be abolished altogether, but that the most appropriate of the hypothetical remedies would be a relaxation of the pre-emption guidelines along the lines suggested in the issues letter (ie enabling companies to issue up to 15 per cent of their share capital non-pre-emptively in any one year).

Baring Brothers International Limited

6.51. Barings said that, when companies purchased underwriting, they did so because they chose to pay for the certainty it brought. Underwriting was a feature not only of rights issues but also of IPOs and cash underpinnings for public takeovers.

6.52. UK company law protected existing shareholders by means of the system of pre-emption rights. Though underwriting fees had traditionally been 2 per cent, they were not truly fixed since discounts varied according to the circumstances of the issue. In addition, it had now become the norm to tender sub-underwriting. An analysis of discounts to pre-announcement prices showed a wide variation, with a range from 5 to 20 per cent being normal but not exhaustive. Even if the OFT analysis when making the MMC reference were correct, many would argue that any cross-subsidy in favour of higher-risk companies was helpful in creating a deeper capital market which advantaged high-risk, entrepreneurial companies.

6.53. Barings believed that the fees charged for underwriting were highly competitive. Studies performed of the market pricing of similar put options demonstrated that underwriting fees were commercial but not excessive. The US book-building system lacked the confidentiality of the UK underwriting process and added to the cost, which was typically in the range of 6 to 8 per cent for an IPO and 2 to 2.75 per cent for a secondary issue. Whilst the company might feel it benefited from the tighter discounts which resulted from such a process, there was significant leakage of value to the financial intermediaries which was compounded for those existing shareholders unable to benefit in the share issue.

6.54. There had been constant innovation in the other major areas of the underwriting market. IPOs had for a long time incorporated an informal book-build process. Such a process could be conducted because speed, certainty and confidentiality were usually less important in an IPO compared with a new issue by a listed company. Other examples of innovations included trombone rights issues (see paragraph 3.34) and success-based underwriting commissions. The structure for

trombone issues allowed the capital-raising exercise to be conducted in parallel with the takeover timetable resulting in lower underwriting costs.

6.55. The market for UK underwriting was highly competitive. UK finance directors were invariably well informed about latest developments and current best practice.

6.56. Deeply-discounted issues created their own problems because of the taxable gains they created for non-participating shareholders who sold their nil-paid rights. There were also presentational issues because of the apparent fall in share price (which was normally associated with distress situations) and the reduction in dividends per share.

6.57. The question of conflicts of interest was more pertinent to the role played by distributors who took regular sales commissions during the year from institutional clients (that is, the company's shareholders) and then sought to arrange the sub-underwriting with the same institutions on behalf of the company. In order to protect against such a conflict and create pricing tension for the share issue, there was normally a division of responsibilities between the financial adviser (who demonstrated confidence in the transaction by acting as lead underwriter) and the broker (who arranged the sub-underwriting with institutional clients).

6.58. The relationship between a public company and its established financial adviser was marked by strict confidentiality. Splitting the role of financial adviser and lead underwriter would simply lead to a duplication of effort, increase the risk of leaks and introduce unnecessary uncertainty into the share issuing-process for a corporate client.

BBV LatInvest Securities Limited

6.59. BBV LatInvest Securities Limited said that it was a regular underwriter of share issues, primarily for Latin American companies. Latin American capital markets had almost uniformly adopted the book-building process for share distribution. This had led to a genuinely competitive market, with fees on jumbo privatization issues little more than 1 per cent but, on small complex issues, around 5 per cent.

6.60. One country, Chile, had a similar system to UK pre-emption rights. It also had certain restrictions, some related to its own pre-emption rights, on companies' use of the international capital markets. This had led to a two-tier valuation system which led to smaller companies in Chile paying a higher price for capital than it warranted.

6.61. BBV LatInvest Securities Limited suggested that the UK system of underwriting and distribution of equities led to a higher cost of funds for issuers, the corresponding benefit being given to a core group of major UK institutions. Few Latin American companies gave even the most basic consideration to using the UK method.

Beeson Gregory Limited

6.62. Beeson Gregory Limited, which provided corporate finance advice and broking services to smaller developing companies, submitted that the hypothetical remedies resulting from the provisional findings in the issues letter (see Appendix 2.1) would, if implemented, add unnecessarily to the costs of smaller quoted companies raising equity finance in the UK. In particular, the remedy suggesting mandatory tendering of sub-underwriting of all issues would add possibly £50,000 of fixed costs to any small issue. Furthermore, if the sub-underwriting was tendered both up and down, there was a grave danger that the sub-underwriting commissions would increase for a significant number of equity issues by smaller companies. The remedy suggesting the separations of the role of financial adviser and lead underwriter would add possibly £50,000 or more to the fixed costs of any issue by a smaller company. Even on a £5 million issue, the sub-underwriting commissions would have to be reduced by over 1 per cent before an issuer saw any benefit.

6.63. Beeson Gregory Limited said that standard sub-underwriting commissions at the 2 per cent level had been to the benefit of the majority of smaller company issuers in that the commissions had not generally exceeded that ceiling. Disclosure of fees and commissions, and some of the detail behind those fees, together with encouraging better information about methods and costs of equity issues and better advice from non-executive directors, would help companies negotiate fees and commissions more effectively.

Cazenove & Co

6.64. Cazenove commented on provisional data circulated with the issues letter relating to equity issues in the period 1995 to 1997. It questioned the inclusion of IPOs and secondary offers of shares by listed companies for calculating share of supply, as such transactions would have been executed by way of a book-building process. The nature of 'underwriting' in a book-building process was quite different from that undertaken in a rights issue, a placing or an underpinning. It was not hard underwriting, which involved price risk, but little more than the acceptance by a financial house of counterparty settlement risk in relation to a distribution of shares. Moreover the fees charged for such transactions were not standard ones. In relation to the existence or otherwise of a complex monopoly, Cazenove also stated that substantial changes in underwriting practice had resulted from the introduction of tendering for sub-underwriting in rights issues in October 1996, and that underwritten share issues subject to tender were not subject to 'standard fees'.

6.65. The introduction of tendering for sub-underwriting in rights issues had generally provided companies with modest savings in issue costs. This had, however, occurred over an 18-month period during which the UK economy and stock market had enjoyed a period of sustained growth and interest rates had been low. These factors had resulted in high levels of corporate cash flow and the introduction of greater levels of debt and higher gearing, which had, in turn, resulted in low levels of equity issuance.

6.66. The operation of sub-underwriting was becoming less attractive to institutional sub-underwriters; over the last three years, the range of sub-underwriting refused as a percentage of that offered had, in the case of rights issues by Cazenove clients, been between 0 and 18 per cent. There was a growing perception among many fund managers that sub-underwriting fees earned were not worth the risk and the costs involved. Indeed this had already resulted in suggestions from institutions that the existing fee caps (normally 1.25 per cent) on sub-underwriting tenders should be increased. This was particularly so in relation to smaller companies.

6.67. Taking the UK-related factors outlined above, and accepting that the tender structure would remain in place, together with the reality of high comparative international commission levels, Cazenove believed there was a serious possibility that, on a medium-term view for UK plc taken as a whole, UK underwriting costs could rise. This could be particularly marked for smaller companies, typically defined as companies with market capitalizations of £350 million or less. This said, there would be companies for which underwriting and sub-underwriting costs might be expected to continue to decline.

6.68. Cazenove considered that Professor Marsh made several oversimplifications in his consideration of the option pricing that would be deemed equivalent to a sub-underwriting transaction. He assumed that a sub-underwriting could be replaced by a simple sold put option on the underlying stock. The key issues relating to Professor Marsh's approach were as follows:

- (a) In all but the very lightest of rights issues, the amount of new stock to be underwritten represented a significant proportion of the existing issued share capital of the company. Sub-underwriters were thus taking a much greater exposure to the company as a whole than would a normal writer of options in the London traded option market.
- (b) Traded options were available only on the largest and most liquid stocks in the London market. A consequence was that traders could easily cover their positions with physical stock, effect transactions using stock borrowing or offset general market risk by using stock basket

techniques. In smaller, less liquid shares, the lack of liquidity made such manoeuvres impracticable or impossible.

- (c) Long-term volatilities were inappropriate for a short-term underwriting. Professor Marsh chose to use 60-month volatilities, a measure which was rare in the professional options market. In the present economic climate, few commentators would consider that historic market conditions spreading over five years would be likely to be typical of market conditions at the present date. This was a serious failure in the academic reasoning of Professor Marsh.
- (d) Even in the options on the most liquid stocks, the implied volatilities were typically higher than the historic volatilities. In addition, the less liquid the underlying stock, the greater the inefficiency would be. Although traded options were not typically available on less liquid stocks, it was reasonable to assume that the difference between historic and implied volatilities would be even higher for smaller stocks.
- (e) At-the-money implied volatilities were typically lower than significantly in-the-money or out-of-the-money volatilities (the 'volatility smile' effect). Rights issues, being at a material discount, would involve the underwriting equivalent of an out-of-the-money put option. As a result, volatility values appropriate to the underwriting of rights issues should be higher.
- (f) Certain commentators on Professor Marsh's findings had expressed the view that the validity of the Black-Scholes model could be seriously questioned in the absence of an ability to hedge (given the lack of a realistic options market). Cazenove agreed. The derivation of the Black-Scholes model required an ability to produce a continuously adjusted equivalent portfolio. Moreover, in relation to a sub-underwriting at the point of a rights issue announcement, the underlying stock price process, giving rise to a log normal expected price distribution, upon which the Black-Scholes valuation was predicated, was probably not applicable. At the immediate point of a sub-underwriting, over the short term of the exposure, another form of stock price process (as an example a jump diffusion process) might well be deemed to be more appropriate, as one had to consider that there was non-negligible risk over any arbitrarily short time period within that risk exposure.
- (g) The Black-Scholes model was based on Markovian price theory, according to which change in the share price on one day was not influenced by the change in the share price the day before. In practice the expectation of supply of stock, which was created by the sale of the rump of the issue or by sub-underwriters being forced to take up stock, might cause the price process to become non-Markovian, with the effective risk element of the exposure growing more rapidly than the actual exposure itself. In short, there was real downside risk notwithstanding the fall in volatility during rights issues observed by Professor Marsh.

6.69. Cazenove said that there were a number of benefits resulting from the UK system for raising equity capital, part of which had included the use of standard fees, before the opportunity after November 1996 to reduce them by way of tender. These benefits were a structure for raising equity capital that worked effectively in good and bad market conditions; worked effectively for companies which required equity for both positive and negative reasons; enabled companies to raise equity capital quickly and with certainty; and, by international standards, was acknowledged to be very cheap in terms of issue costs.

6.70. Prior to entering into an equity transaction, financial advisers and corporate brokers agreed a terms of engagement letter with their corporate clients. These letters included a list of services to be provided and the fees to be charged for the provision of those services. Cazenove therefore believed that issuing companies had sufficient information about what services they were paying for; if they did not, they would ask, and any broker would be bound to provide any further information that they required.

6.71. In relation to whether the introduction of tendering had removed previous restrictions or distortions of competition and as to whether change would be sustained without further action by the competition authorities, Cazenove commented that the great majority of rights issues since the Stakis issue had operated a tender for sub-underwriting. The vast majority of UK companies were now

familiar with the possibility of operating tenders in rights issues. Financial advisers and corporate brokers also had duties to companies to give them the most appropriate advice in the light of circumstances. This would include advice in relation to the minimization of issue costs. Competition between advisers in the London market was intense. This, in itself, would ensure that pressure for change and innovation was maintained.

6.72. The pre-emption guidelines limited the amount of equity which might be issued on a non-pre-emptive basis and the discount at which it was issued. These guidelines existed to protect existing shareholders from excess dilution without their consent. They did not inhibit the use of any possible methods of issuing shares, but protected the interests of shareholders by ensuring that transactions involving the issue of a certain amount of equity were subject to shareholder approval. Shareholders of UK companies valued their pre-emption rights as a fundamental form of investor protection. This did not mean that they did not vote in favour of the issue of new shares to vendors or to third parties at a general meeting, if they were persuaded of the merits of a transaction.

6.73. Cazenove did not believe that underwriting was made necessary by either LSE or Takeover Panel rules. With regard to the length of the underwriting period, there was an LSE requirement for a nil-paid rights trading period to be a minimum of 21 calendar days. In the event that a share issue was subject to shareholder approval for reasons of issue size or class test reasons, provisional allotment letters (PALs) in relation to rights issues could be dispatched only after a vote had been held, because of the LSE requirement that conditional dealings in PALs could not take place. This automatically extended sub-underwriting periods from three weeks to five- or six-week periods. A full three-week extension seemed unnecessary if relevant documentation had been sent to shareholders well in advance of the rights trading period.

6.74. As for the impact of Takeover Panel rules on the length of underwriting periods, these were essentially set by the Panel's 60-day timetable and the requirements in relation to the certainty of funding and the need for a cash alternative in certain circumstances. While it could be argued that underpinning periods were longer than they need be, such underwriting (and the underwriting periods) remained at the discretion of the company concerned.

6.75. Issue costs in international equity issues were typically greater than in the UK. Equity issuance in poor economic and stock market conditions was harder in international centres than in the UK, which gained competitive advantage from its underwriting system.

6.76. Competition among banks and brokers had been very dynamic over the last five years. US and European banks had come into the market, while some UK merchant banks were creating broking divisions and accountancy firms had been undertaking corporate finance work. There had also been greater mobility of key personnel between organizations. Credentials in research and distribution were becoming more necessary for providing advice and winning mandates; this was blurring the distinction between financial adviser and corporate broker which, in turn, was resulting in increased competition.

6.77. The principal objective in arranging sub-underwriting was to achieve a broad distribution of risk to a range of creditworthy institutions which were long-term equity investors. These were the natural takers of sub-underwriting. The fact that such long-term equity investors were unlikely to hedge sub-underwriting positions during issue periods, and, in the event that an issue failed, might be prepared to hold the shares they had taken up, was likely to minimize price disruption during an issue and add to its likely success. Other financial sub-underwriters would have different interests to those of sub-underwriters who were long-term equity investors, and might be considered to be sub-underwriters of lower quality who might reduce the willingness of fund managers to participate in sub-underwriting or might increase the required rate of return to account for the increased risk.

6.78. There was a conflict of interest between the role of financial adviser and the lead underwriter in terms of pricing an issue for underwriting, but it was an obvious one. The lead underwriter and the corporate broker were always required by boards to justify and support with evidence their recommendation for an underwriting price. On the other hand the lead underwriter and the issuer had a mutuality of interest whereby they both wished the sub-underwriting to be distributed to good-quality investing institutions and for the issue to be a success. The common objective was to determine the best price consistent with good distribution and take-up. The public visibility of pricing,

resulting from market comment, press comment and other forms of scrutiny on the issue terms when announced, also helped to ensure that the inherent conflict was not abused. Management of any conflict of interest was typically effected by insulating the corporate advisory team from the credit function who had internal responsibility for underwriting risk. In addition, the SFA rules required that a firm should not unfairly place its interests above those of its customers and, where a properly informed customer would reasonably expect that the firm would place his interests above its own, the firm should live up to that expectation (General Principle 6).

6.79. On the question of whether there was a distinction to be made between the interests of shareholders and those of funds acting as sub-underwriters and, if so, whether fund managers faced a conflict of interest, Cazenove said that, while there would typically be significant overlap between the shareholders of a business and the sub-underwriters of an equity issue for that business, a distinction could clearly be drawn between the two groups. To the extent that the cost of sub-underwriting was low, a company and its existing shareholders would retain value within the business. A shareholder of a company who benefited as a shareholder from the minimization of issue costs might suffer as a sub-underwriter by receiving smaller sub-underwriting commission that resulted from the sub-underwriting allocation being scaled back as a result of additional demand in a tender. However, Cazenove did not wish to exaggerate this conflict of interest which was easily managed by most shareholders.

6.80. In relation to the relevance of the Financial Services Act to the role of underwriting, Cazenove commented that it had created a barrier to entry by requiring authorization of an investment business to carry out underwriting and broking of issues. It had also created potential responsibility to be undertaken by the lead underwriter for an issue and for the content of the listing particulars.

6.81. Cazenove commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It made three general points. First, as regards mandatory remedies, one of the principal competitive advantages of the London market was its flexibility. This enabled companies to structure appropriate financial solutions to specific circumstances. Conceptually, therefore, Cazenove did not believe that prescriptive mandatory remedies were in the public interest as they would both restrict future flexibility and also remove choice. Second, making an inevitably arbitrary distinction between large and small companies, or large and small issues, was unlikely to be practical. Institutional definitions of large and small companies were always subject to flux with the broad market capitalization threshold for small companies having increased from £250 million to £350 million in recent years. Whilst there were inevitable differences between large companies, mid-cap companies and small companies, they were not clear-cut. A public acknowledgement that raising capital for small companies should be subject to different 'rules' did not appear to be in the interest of those companies. The distinction between a large and a small issue was clearly subjective too and linked to both the absolute amount of money raised and to the weight of an issue. Third, as regards guidelines, Cazenove believed it was important that companies should be fully informed about possible methods of issuing equity capital. They should also be fully informed as to the most effective means of minimizing issue costs. It was for this reason that companies appointed financial advisers and corporate brokers. However, codes of conduct endorsed by official bodies such as the LSE or the guidelines of the ABI and the NAPF might result in the development of a mechanistic approach rather than careful thought about what was in the best interests of any individual company in a specific set of circumstances.

6.82. Cazenove believed that tendering in rights issues had to date been an effective method of reducing issue costs, albeit that any such reductions had typically been modest. Furthermore, tenders were now used in the great majority of rights issues. However, the fact that sub-underwriting capacity and the number of sub-underwriters had tended to contract over recent years, together with the end of a period of abnormally favourable market conditions, might result in the removal of the existing 'standard fee' sub-underwriting cap. The mandatory imposition of tenders or of sub-underwriting price controls would expose companies to an enforced mechanism which could undermine the success of issues or indeed the ability to hold them at all. A price cap would not work without a guaranteed supply of sub-underwriting. This might deprive companies and their advisers of the opportunity to exercise their commercial judgment in relation to the appropriate price for sub-underwriting given the risk involved.

6.83. In some circumstances, a better tender result could be achieved by not making the whole of an issue subject to tender. Ensuring at least some firm participation in the offer encouraged sub-underwriters to bid in the tender.

6.84. In relation to a mandatory requirement on companies which undertook an underwritten share issue not involving a tender to explain to their shareholders why they had chosen this structure, it was not clear to Cazenove why this should receive public exposure in preference to other board decisions of equal financial weight. A public statement of this nature might well show weakness to the market at a critical point, something which might not be in a company's best interest.

6.85. Cazenove believed that best practice in relation to share issues was often very difficult to define. Pre-marketing of rights issues was not always best practice. It involved putting some shareholders in a privileged position and, if an issue did not proceed, sometimes gave them unpublished price-sensitive information for a considerable length of time which debarred them from dealing in the market. A judgment on the necessity for and the practicability of pre-marketing needed to be taken by the company, its advisers and, given the requirement of shareholder consent, the shareholders concerned. In relation to the securing of firm commitments from shareholders to take up their rights involved the payment of a commission. In many cases, however, shareholders preferred initially to participate only as a sub-underwriter and therefore to retain the option to subscribe for shares over the rights issue period.

6.86. It had always been open to companies to seek financial advice from more than one source and it was normal for them to do so. It was debatable whether separation of the roles of financial advisers and lead underwriters was practicable or cost-effective. Some might argue that the additional costs, time involved and increased risk of leaks made such a structure unattractive.

6.87. With regard to the suggestion that companies be given the option to vary the period for which a rights issue remained open, there should be scope for shortening the period, but not to the extent that those shareholders relying on the postal system to respond to a rights issue were prejudiced. This was a matter which should be decided by regulators and not shareholders.

6.88. Cazenove believed that it would be inappropriate to include in the SFA rules provisions covering fees and remuneration with non-private customers, because this was a commercial negotiation. Clients had always been free to discuss a breakdown of fees between component services.

6.89. There was a limitation on the ability to make every issue appointment subject to a competitive tender because knowledge of a company was critical and confidentiality had to be maintained. The necessary due diligence exercises might make competitive tendering for financial advisers and brokers impracticable. In practice, the continuing appointment of advisers relied on their ability to demonstrate that they could execute business to a high standard.

6.90. On the proposal that the SFA should make rules to deal with conflicts of interest, Cazenove said that it might be appropriate in the engagement letter to disclose more specifically than at present the extent of such a conflict. It did not believe that detailed rules to resolve the conflict of interest were practicable, particularly in the context of dealing with a non-private customer.

6.91. On the proposal that brokers should be required to inform companies of the identity of sub-underwriters, Cazenove had not experienced any demand from companies to have this information. There were sometimes discussions on specific sub-underwriting propositions with issuers which were taken into account. The offers of sub-underwriting were based on the brokers' skill and experience in constructing what they believed to be most appropriate in achieving a successful distribution. Requiring the issuer to vet the proposition would amount to the issuer's assuming the responsibility and abrogating it from the broker. Cazenove did not believe that any public interest issue was served by requiring brokers to inform issuers of proposed sub-underwriters. It was unclear to whose detriment lack of this information was working or to whose advantage it would work, if provided.

Charterhouse plc

6.92. Charterhouse plc (Charterhouse) was of the view that the present system for underwriting issues by smaller and medium-sized companies, and in particular the fee structure that had evolved

and was evolving, was efficient and competitive. It was of the opinion that some of the changes suggested to the present system would operate to the severe detriment of smaller UK companies and of private shareholders.

6.93. On a failed rights issue, the net income earned by sub-underwriters was often very meagre. After allowing for net losses on underwriting allotments, the net profits from sub-underwriting fees were far from the excess returns referred to in the press. The cost of sub-underwriting commission was small in relation to the net proceeds of a sale and any reduction negotiated in the rate charged would have to be set against a reduction in the level at which the issue was priced.

6.94. Commission levels should not be considered in isolation. Clients and underwriters negotiated on the total fee charged in respect of the issue. In practice, where there had been some reduction in the underwriting commission levied, this would often result in a higher advisory or success fee being charged.

6.95. It was essential to consider the cross-subsidization that occurred within the underwriting market. A reasonable fee in regard to riskier smaller issues might be as high as 5 per cent or more. These companies were to a large extent being cross-subsidized by the fees earned on larger company issues. A non-standard fee system would make it prohibitively expensive for smaller and medium-sized companies (that is, those with a market capitalization of up to £300 million) to raise new capital.

6.96. The very limited use of deep discounting reflected the fact that deep discounts were not favoured by companies themselves owing to the lack of certainty in outcome. Certainty was required especially when a rights issue was connected to an acquisition. As for the allegation that financial advisers were not in favour of deep-discounted issues because they would lose underwriting fees, Charterhouse's experience suggested the contrary. At the smaller end of the market, the lead underwriter's fee of 0.5 per cent hardly compensated for the risk borne if the issue failed and for the hard sell required to the sub-underwriters.

6.97. There was very limited scope for the financial adviser to underprice an issue. Company directors were sufficiently financially sophisticated to make a proper assessment on the question of pricing the issue and setting the level of any discount. The vast majority of smaller to medium-sized issues were test-marketed to investors in advance of underwriting and this enabled the advisers and issuing company together to establish the optimum price for the company.

6.98. Sub-underwriters could and did refuse to take up an issue. It was easier to underwrite and sub-underwrite an issue by a FTSE 100 company because fund managers were under a self-imposed pressure to maintain their investment weightings.

6.99. Charterhouse was in favour of either the abolition or loosening up of the rules on pre-emption rights in order to make it easier to attract new investors and less costly for companies to raise additional capital.

6.100. Average underwriting fees in the USA ranged between 3.1 and 5.4 per cent depending on the size of the issue. Average underwriting fees in Germany ranged between 3 and 5 per cent. Within the UK, the cost of raising new capital by way of an underwritten issue was lower than would be incurred by alternative methods such as book building or bought deals.

6.101. UK companies wanted the contractual certainty, speed and efficiency that the present system offered. It might take a company five years to recover from a failed issue. The present system of underwriting did not operate against the public interest.

6.102. If there were to be change to the present system, Charterhouse would prefer to leave the parties free to negotiate the fees by reference to the size and relative proportion of the issue, its terms and the nature of the market. The risk that then arose was that the smaller to medium-sized company would suffer.

6.103. The procedures for underwriting and sub-underwriting in the UK had benefited the smaller companies greatly and given the UK a competitive edge over global counterparts. These interests should not be jeopardized.

Close Brothers Corporate Finance Limited

6.104. Close Brothers Corporate Finance Limited (Close Brothers) said that in general, where non-standard fees had been adopted through tendering for underwriting, costs had been reduced for the issuing company. However, this was against a background of a long period of buoyant equity market conditions. It was unclear whether this would necessarily continue into the future given the uncertainty as to equity market conditions which might, for instance, give rise to competitive tendering at a greater than 'standard' cost.

6.105. The introduction of tendering had removed restrictions of competition but this was an evolutionary process. There had, however, clearly been improvement from a company's perspective over the last two years. In such a competitive environment the evolutionary process would continue without external intervention. Close Brothers believed that tendering would develop further into the future. Whether this had a positive or negative effect for small or large companies would to some extent depend on the market conditions at the time and in particular whether the current structure, involving effectively a 'cap' on the underwriting fees payable, would persist. It was quite possible that competitive tendering might lead to the removal of such a cap and that therefore the costs for certain companies or (depending on market conditions as a whole) all companies might increase.

6.106. The process of sub-underwriting and the tendering thereof was essentially a mechanical one which the lead underwriter had little ability to influence. There was therefore no reduction in the lead underwriter's incentive to obtain sub-underwriting on the best terms. However, there was no logical reason as to why the practice had developed of scaling back the lead underwriter's 0.5 per cent commission as a result of the results of the sub-underwriting tender.

6.107. The evidence from overseas appeared to indicate that in many instances where other structures were used, including non-pre-emptive issues, the costs of the issue were significantly higher than in the UK. Undoubtedly the pre-emption guidelines inhibited the use of other share-issuing methods, although they could be relaxed in certain circumstances. The impact of this on the cost of issuing equity was unclear.

6.108. The sub-underwriting process clearly did not address the total population of potential sub-underwriters. However, generally a large number of institutional investors and other investment clients of the stockbroker arranging the sub-underwriting were contacted. In addition the sub-underwriting process generally took place after announcement and hence, should an institution wish to be part of the sub-underwriting group, it was free to contact the relevant stockbroker. In certain circumstances there were announcements in advance regarding the sub-underwriting process, but this tended to be for very large issues only. Clearly, there was a need to ensure that the sub-underwriter was able to stand behind the financial commitment and this therefore necessarily precluded the involvement of some potential sub-underwriters, given the timescales involved.

6.109. There was considerable competition between investment banks and other financial advisers, and the position of a financial adviser to a company changed frequently, as witnessed by Close Brothers' own recent experience of new client gains.

6.110. There was prima facie a potential conflict between the role of financial adviser and lead underwriter being undertaken by the same party. However, there was a considerable advantage to the issuing company that the lead underwriter role was undertaken by the person who knew most about the company and the transaction being undertaken and was therefore most able to provide advice on pricing. This advantage outweighed the natural conflict. Also in the negotiation of the underwriting agreement, the level of warranties and indemnities required from the company to the lead underwriter was affected by that lead underwriter's knowledge of the company and the transaction.

6.111. Commenting on hypothetical remedies, Close Brothers did not believe that it was appropriate to suggest legal restrictions on entering into a transaction between two sophisticated parties such as a PLC and its financial adviser. Clearly in certain circumstances a tender for the sub-underwriting would be appropriate but to suggest that this should be mandatory missed the point.

6.112. On the proposed remedy that companies be required to explain to their shareholders why they had not tendered sub-underwriting if that were the case, Close Brothers did not think that underwriting without tendering was so unusual a course of action to follow that it required a written explanation to shareholders. On the proposal that companies be required to seek advice from more than one source, Close Brothers said that the advisory relationship was built over a number of years on the basis of trust between a client and financial adviser and was therefore not simply a commodity product. Additional time would be required to seek guidance from more than one financial adviser and potentially also additional costs were involved.

6.113. The acceptance period for an equity issue was not driven by considerations as to the length of the underwriting, but by more fundamental concerns such as allowing shareholders the ability to take up the issue on a pre-emptive basis and time to consider the issues involved in the transaction in order to reach a conclusion at an EGM.

6.114. During the process of negotiation the make-up of any fee was discussed with the client. Close Brothers was unconvinced that any SFA requirement to split out such remuneration would provide any benefit to a client.

6.115. On the proposal for competitive tendering for the services of lead underwriters and brokers, Close Brothers believed that in most cases the need for an understanding of the client and issues of confidentiality would preclude competitive tenders.

6.116. Close Brothers agreed that clients should know which parties were acting as sub-underwriters to their share issue and invariably advised clients to obtain the sub-underwriting list.

Credit Suisse First Boston

6.117. CSFB submitted evidence and attended a hearing. It said that the evidence from sub-underwriting commission tendering was that, in generally favourable equity markets, a number of issuing companies had been able to achieve reductions in the level of underwriting commissions which in a small number of cases had been quite significant. In some cases these significant reductions might have been achieved by increasing the size of the issue discount. There had been no instance to date of commission tendering resulting in a higher level of commission than the standard 1.25 per cent being payable by the issuing company. All commission tenders had to date been structured on a downwards-only basis from standard terms. However, in a number of rights issues the issuer and its advisers had decided not to offer a tendering process. This was usually because of concern that the offer of a tender on a downwards-only basis would have jeopardized the success of the sub-underwriting because sub-underwriters would have wanted to tender at levels in excess of standard terms. The market's experience of commission tendering to date did not support the contention that for all companies standard commission structures imposed a higher cost than would otherwise be the case. Indeed for some companies the use of standard terms might actually save an issuer commissions.

6.118. The view that the 'cost of underwriting' was solely the value of the commissions paid to underwriters and sub-underwriters was based on the view that issuers and shareholders were indifferent to the scale of the rights issue discount. In CSFB's view this argument took no account of the value to an issuing company of the demonstrable support from its advisers and institutional investors for issues of new equity at relatively tight discounts to the prevailing market price. In CSFB's experience, issuing companies were more willing to pay standard commissions and issue shares at a tight discount than to issue shares at a greater discount and reduce commissions through a tender.

6.119. It was instructive to consider the attitude to capital-raising in the USA, where new equity issues were not customarily underwritten. The announcement of the issue and its proposed size was

followed by an often extensive period of marketing by the issuer's investment bank. The issue price was determined following completion of the marketing programme and following a book-building process in which potential investors bid against each other for the new shares. The investment bank managing the issue assumed counterparty risk for those investors allocated shares following the book building until settlement. The fees payable to investment banks in connection with such issues generally exceeded the total fees payable in UK rights issues, even though the US structure did not require the investment bank to assume underwriting risk. These higher fees were a direct reflection of the value that US issuers placed on an investment bank's ability to maximize the issue price through the strength of its sales and marketing capability.

6.120. CSFB considered that there were a large number of issues raised by the studies by Professor Marsh and by Breedon and Twinn which led it to question the validity of Professor Marsh's findings. These were as follows:

- (a) Black-Scholes assumed that the rate of return of the underlying shares was distributed normally. This was known to be incorrect and indeed there existed a considerable academic literature on the so-called 'fat-tailed' distributions which seemed to be followed by real share price returns. Share prices seemed, in reality, to be prone to large falls more often than the Black-Scholes assumptions allowed which meant that the model underpriced out-of-the-money put options. A related point was that Black-Scholes assumed that stock prices moved only in very small increments. In practice prices could move in significant jumps, particularly downward. Furthermore, the model assumed, incorrectly, that the volatility of the stock price returns was constant over the life of the option. Changes in stock prices (not related to share splits or dividends) were inversely related to changes in the associated volatility, ie when a share price fell the volatility of the share tended to increase. Thus writers of out-of-the-money put options faced a compounded risk which was not accounted for in the Black-Scholes pricing. It was for this reason that out-of-the-money put options were worth more in the market than Black-Scholes would suggest. As a result, Professor Marsh's estimates of the excess returns to sub-underwriters were too high. These effects could explain a considerable part of the apparent *ex-ante* excess returns found in Professor Marsh's studies.
- (b) Black-Scholes was designed to value options on a small number of shares whereas sub-underwriting commitments typically represented a significant fraction of the issuer's share capital. The key argument was that, in practice, it would not be possible to buy an option covering the sub-underwriting commitment at or close to the Black-Scholes value.
- (c) Estimating volatility was difficult, particularly for those out-of-the-money put options that were analogous to sub-underwriting commitments. However, the key point was that the implied volatility of actual traded out-of-the-money put options was much higher than either the implied volatility of at-the-money put options or historical volatility. Thus out-of-the-money put options were undervalued by models using either the implied volatility of at-the-money options or historical volatility. All analysis of out-of-the-money traded put option volatility was complicated by the lack of liquidity and related large spreads of such options; however, this argued for caution in valuing such contracts.
- (d) It was expected volatility, not the historic outcome volatility, which was relevant to pricing options. The market looked more to short-run volatilities for a short-term transaction. Hedging a put option of size and 'out-of-the-moneyness' of a typical sub-underwriting agreement would in practice be impossible and indeed was not attempted in reality by sub-underwriters. However, this suggested that the Black-Scholes value for such put options was understated. Indeed the inability to hedge these positions surely could not mean that the Black-Scholes value was too low.

CSFB's conclusion was that Professor Marsh's work systematically undervalued the value of the sub-underwriting commitment by applying the Black-Scholes model.

6.121. CSFB said that the traditional UK rights issue structure had been and remained a highly effective mechanism for UK companies to access new equity funding. It had the advantage of being widely understood and accepted and therefore of being relatively straightforward for issuers to use.

Recent innovations, such as the introduction of sub-underwriting commission tendering and the application of book building, had increased the alternatives available to issuing companies.

6.122. Certain companies would continue to benefit from the use of standard underwriting fees, in particular when they sought to raise new equity in circumstances when they had a lower level of confidence that sufficient demand would exist from potential sub-underwriters to achieve a satisfactory level of cover. In such cases, the use of standard terms, familiar to investors, meant that the level of sub-underwriting did not become an issue of contention with potential sub-underwriters who were more concerned with the quality of the investment story and the size of the issue discount.

6.123. To date, all rights issues subject to tender had used standard fees as the basis of an initial allocation of sub-underwriting which was then subject to clawback through the tender by those institutions willing to take a sub-underwriting participation at a lower commission level. The advantage of this two-stage approach was that it required potential sub-underwriters to give a rapid initial response to the co-ordinating broker, thereby reducing the lead underwriter's market risk and creating a sense of momentum to the issue in the market which could be of considerable importance to the success of the sub-underwriting.

6.124. The effect of making an initial offer on standard terms was that the tender process was a downwards-only process, because the lead underwriter was committed to taking any residual sub-underwriting risk on standard terms. Tenders from potential sub-underwriters for a sub-underwriting allocation on the basis of commissions that were higher than standard commissions were therefore disregarded. To this extent the use of standard fees continued to be a benefit to the issuing company.

6.125. The tendering of sub-underwriting had the effect of creating another set of variables which complicated the decision-making processes for the sub-underwriting institutions. In circumstances where demand for sub-underwriting could be expected to exceed supply, the offer of attractive sub-underwriting stimulated competition and could drive commissions down through the tender process. However, with a small number of exceptions, which had either been issues with a strong investment story or a wide issue discount, the evidence to date from rights issues that had been tendered in generally favourable market conditions was that in practice there did not appear to be a significant amount of demand for sub-underwriting from institutions or other persons prepared to sub-underwrite at lower commission levels.

6.126. It was conceivable that in difficult markets it might be difficult to match the supply of new equity with demand for sub-underwriting and in such circumstances if tenders were to become obligatory then institutions would be likely to demand a change in the basis on which tenders had operated in order to enable them to bid at higher commission levels, perhaps at a level unacceptable to the issuer.

6.127. On the question of transparency of fees, the level of fees payable to the lead underwriter, corporate broker and sub-underwriters was clearly disclosed to the issuing company. Any issuing company was free to enquire about the basis on which fees and commissions had been calculated and in practically all cases did so very thoroughly. It was normal practice for financial advisers and corporate brokers to prepare letters of engagement which detailed the services that were to be provided to the issuing company in connection with a particular mandate.

6.128. In answer to our question about the extent to which tendering for sub-underwriting in the last 18 months had removed previous restrictions or distortions of competition, CSFB said that, prior to October 1996, sub-underwriters had competed for strong issues on the basis of their reputations as high-quality long-term investors and of their willingness to underwrite at a tighter discount. This competition had been subject to certain restrictions, namely the need for secrecy which meant that only limited numbers of investors were subject to pre-marketing, and the fact that, as regards quality, institutions competed on their past reputation rather than in relation to the specific issue. Since the introduction of tendering, sub-underwriting commission had become a new, third basis for competition.

6.129. Given the relative scarcity of issues since October 1996, further refinements were possible to increase the scope for competition between potential sub-underwriters through the tender. Under the structures currently employed, the level of competition was critically dependent on initial

allottees' assessment of the likelihood that there would be significant demand for sub-underwriting from persons not likely to be on the initial sub-underwriting allocation list, because in the absence of this it would not be in their interests to bid at lower commission levels, unless they wished to secure higher allocations. Effective competition might be increased by eliminating the initial allocation of sub-underwriting on conventional terms. This was because institutions would then have to take an active view of the likely level of demand for sub-underwriting at specified commission levels. However, this effectively increased the lead underwriter's market risk and was unlikely to be suitable in all cases.

6.130. In CSFB's view, the greater flexibility in fundraising techniques and methodologies that had arisen in the new issue market in the last 18 months, and of which commission tendering was one part, would continue to increase as a result of competition between investment banks and the increasing internationalization of the equity capital markets. In the competitive world of investment banking, corporates and markets tended to reward innovations that increased efficiency and lowered costs or that delivered solutions that met a client's particular requirements. Having established its own momentum, the tendering process was likely to be sustained without further action by the competition authorities.

6.131. Following the 1996 Stakis issue it had become customary for the lead underwriter to adjust the 0.5 per cent customarily received as an underwriting commission pro rata to the adjustment in the level of the sub-underwriting commissions achieved in the tender process. This practice had been welcomed in some quarters because it led to a reduction in costs to issuers. However, it had no basis in logic. It had arisen as a tactic to encourage the implementation of the tender process at a time when it was considered necessary for investment banks to share in the reduction in commissions payable. In reality, the lead underwriter and the sub-underwriter faced very different risks. The lead underwriter was committed before the transaction and associated fundraising was announced. The sub-underwriter only committed once the market had had time to react to the new information and the share price had adjusted accordingly.

6.132. In answer to our question why deep-discounted rights issues were not more widely used, CSFB said that essentially this was because of the widespread perception among both corporates and investors that discounts did matter. This was because issuers believed that a tight discount would be perceived in the market as a strong statement of the confidence of the underwriters and sub-underwriters in the company. Deeply-discounted issues were not subject to such discipline. Management usually maintained dividend per share, thus increasing the costs of servicing capital. In practice also shareholders who did not support an issue with further funds could find it difficult to realize full value for their nil-paid entitlements in the market. CGT charges could crystallize for certain shareholders. Finally, issuers needed certainty if the issue were to provide acquisition finance. Most UK equity issues were made to finance acquisition or specific investment projects.

6.133. CSFB argued that the market for nil-paid rights did not work in a fully efficient manner. This is discussed in paragraphs 4.35 to 4.37 and Appendix 4.1.

6.134. We asked what the effect on underwriting and other share-issuing costs would be of greater use of methods other than traditional rights issues. CSFB said that, in its view, greater use of non-pre-emptive issue structures as a result of any relaxation of the relevant legal and regulatory requirements would lead to a reduction in the costs of underwriting (in terms of the package of issue discount and commission), as there would be no need to underwrite over an extended period of time. This was because typically non-pre-emptive issues were placed at a small discount to the prevailing share price.

6.135. CSFB presented an alternative, proprietary method of issuing equity which combined the advantages of open pricing with existing shareholders' pre-emptive rights. It enabled a company to market an issue widely to potential investors. This was important because by accessing sources of capital supply beyond its existing shareholder base, a company might be able to lower its cost of capital. However, CSFB said that this structure was not suitable for every issue and had not yet been used in the UK although CSFB had employed similar structures in continental Europe.

6.136. On pre-emption rights, CSFB said that shareholders, while being willing to waive pre-emption rights in exceptional circumstances, preferred to retain them in order to have the choice whether or not to subscribe for shares. Shareholders were not prepared to waive their pre-emption rights unconditionally and in advance of the investment case being stated.

6.137. The methodologies used by US companies had important implications for UK companies and offered a different perspective on the issues being considered by the MMC (see paragraph 6.119). The absence of statutory provision for pre-emptive rights and the minimization of general market risk to underwriters, which were characteristic of the US approach, acted to promote the marketing of the issue to the widest potential investor base. This was very different from the UK fixed-price, pre-emption rights system which focused marketing on current holders and pressured underwriters to defray the risk they had assumed.

6.138. On barriers to entry, CSFB said that, for a lead underwriter, these were the availability of capital, the necessary regulatory authority and investment banking skills. To compete effectively as a lead underwriter, a financial institution needed a strong reputation in the market, credibility and relevant expertise. A broker needed a trustworthy reputation, market credibility, market distribution capability, research and analysis capability, and regulatory expertise. In order to act as a sub-underwriter, a person needed access to capital, no regulatory impediments and a good credit quality.

6.139. Issuers had a natural predisposition towards focusing the initial sub-underwriting upon the existing core institutional shareholder base, being those shareholders whom the corporate broker perceived as being long-term holders of the stock. Beyond this group the broker would typically have regard to those institutional investors that had a strong understanding of the investment case, had shown a propensity to invest in similar situations or had a strong track record of accepting the offer of a sub-underwriting participation. In practice the credit quality of potential sub-underwriters might lead to certain persons being excluded from the offer of sub-underwriting.

6.140. There were a number of factors that influenced the composition of a sub-underwriting allocation list and meant that sub-underwriting was in practice rarely undertaken by persons other than fund managers. First, the corporate broker acted as a matter of contract as agent for the lead underwriter. Having priced the issue, the lead underwriter's interest was in laying off its risk as rapidly as possible while minimizing its counterparty risk in the event of default. In practice the broker would also have a reputational interest in ensuring that counterparty risk was minimized. The best way of achieving this was for the broker to offer sub-underwriting to existing clients with strong credits and with whom it had a track record of dealing. Second, the lead underwriter's interest in a quick response from potential sub-underwriters meant that the broker would offer sub-underwriting to institutions which were used to receiving such offers and making rapid decisions and with which it had established lines of communication. Third, the issuer had an interest in the ongoing composition of its share register. Typically issuers would have a preference for institutional shareholders who had the means of supporting management's future ambitions and properly understood the dynamics of the company. Furthermore, the broker would be concerned to sub-underwrite responsibly.

6.141. On the extent of competition between investment banks, brokers and other financial advisers, CSFB said that the market was occupied by a number of different types of competitor. These were:

- (a) global investment banks providing a full range of investment banking products together with their own extensive, international, distribution networks;
- (b) traditional UK merchant banks, providing financial advisory and lead underwriting services but without their own distribution capability;
- (c) independent corporate stockbrokers which had distribution and access to underwriting capital although not part of an investment bank;
- (d) independent pure agency corporate stockbrokers; and
- (e) independent financial advisory boutiques.

6.142. These firms occupied different parts of the market, and sought to target those companies most likely to use their services and those which were capable of covering their costs and generating a reasonable return. Notwithstanding the recent wave of consolidation in investment banking which had created large, global firms, the market remained fragmented, with larger companies tending to use the services of the global investment banks for major international transactions and smaller companies utilizing the smaller niche players for certain specific services. Traditionally in the UK, firms competed for official relationships, that is, to be a company's financial adviser or corporate broker and named as such in the company's annual report. The named relationship bank or broker had a strong competitive advantage and normally took a leading role in the company's next corporate transaction. Increasingly, however, firms also competed for specific mandates.

6.143. A limited distinction could be drawn between the financial adviser and the corporate broker, in that, while a company could establish relationships with a number of financial advisers, the relationship between broker and company was more conspicuous to the public because the corporate broker formed the link between the company and its existing shareholders. Competition between brokers was most evident in the emergence of joint brokerships with corporate brokerships being shared with one, or possibly two, other firms.

6.144. Once a company had determined a particular course of action, it was relatively unusual for banks and brokers to compete directly to execute that action, other than on a flotation. This was because companies valued secrecy. In addition, in order for an investment bank to carry out its role properly in connection with an equity issue, it must have an in-depth knowledge of the company's financial position and prospects and of the dynamics of the market in its shares. It must also have credibility in the market in connection with that particular stock.

6.145. The direct costs of switching advisers were not usually significant, but might have an impact on the timing of any equity issue. A new financial adviser or broker had to be brought up to speed with the financial position and prospects of the company. Market reaction to a change of advisers could be more of an issue. Trusted advisers were often themselves trusted by investing institutions.

6.146. Underwriting fees had always been negotiable, from the perspective of the financial adviser and the corporate broker. The aggregate of advisory and underwriting fees had always been and would continue to be the subject of detailed discussion at the outset of preparations for a transaction.

6.147. On the question of whether there was a conflict of interest arising from the financial adviser and lead underwriter roles being undertaken by the same organization, CSFB said that any apparent conflict was neutralized by the reputational issues that attached to both roles and by the role of the corporate broker. The separation of the two roles would involve the duplication of many functions, and would increase costs. Moreover, the separation of the two roles would not reduce any conflict issues but rather institutionalize them by appointing two separate firms with differing interests. There was a real danger that such a 'solution' would actually make the position more difficult since the financial adviser, who would be charged to act in the company's interests, would offer advice without having the power to commit its capital to support its advice, while the lead underwriter would have pricing power without any responsibility towards the issuer.

6.148. On the question of whether there was a distinction to be made between the interests of shareholders and those of funds acting as sub-underwriters, CSFB said that, in its experience, institutions approached sub-underwriting in one of two ways. Many institutions, particularly those that were already shareholders in the issue, applied the same considerations to the decision whether or not to take sub-underwriting as they would in deciding whether or not to take up their rights. That is, they considered the strength of the investment case, the merits of any related acquisition and the valuation of the existing shares. There was no real conflict in the decision of such shareholders to participate in an issue as sub-underwriters. For such institutions the sub-underwriting commitment was a means of facilitating the strategic step that the company proposed to take. In such circumstances, the commission that the institution was paid to sub-underwrite was not significant when compared with the potential for capital appreciation (or the avoidance of a capital loss) that arose from supporting a particular corporate action. A second group of sub-underwriters, typically those that did not have an

existing shareholding in the company, would view the offer of sub-underwriting in terms of the assumption of an underwriting risk for which they should be remunerated. Those persons would, typically, look for a level of reward that was greater than was appropriate for the risk they were assuming.

6.149. We asked CSFB about hypothetical remedies (see Appendix 2.1). On the possible remedy of mandatory tendering of sub-underwriting fees, CSFB said that this would only be appropriate if issuing companies systematically paid more for underwriting and sub-underwriting services under standard terms than would otherwise be the case. In CSFB's view, this was not the case. If commission tendering were to become mandatory for all issuers then it would be very unlikely that tendering could continue to be offered on a downwards-only basis. As a result it would certainly be the case that some companies would have to pay more for their sub-underwriting. It was important to note that, in general, sub-underwriting tendering had been most effective where the new shares had been issued at a greater than normal discount to the prevailing market price. If tendering of sub-underwriting were to become mandatory, discounts could be expected to widen. Many issuing companies preferred a tight discount. There was no distinction between large and small companies in this respect.

6.150. On the proposal for a cap on tendering fees, CSFB said that the reason why in certain instances sub-underwriting fees were not tendered was because the issuing company and its advisers were concerned either that commissions would be greater than would have been the case had standard terms been used, or because tendering would itself jeopardize the success of the issue (see paragraph 6.117). Neither of these reasons would provide any support for the imposition of a commission rate significantly below the standard 1.25 per cent which had the considerable merit of being familiar to the market. The principles underlying tendering were that rates should be more closely aligned to the specific risks of a particular underwriting and that the price for this risk should be set by an open competitive process. These had gained wide (but not universal) acceptance. The imposition of a single commission rate was inconsistent with these principles.

6.151. CSFB believed there was merit in asking the OFT to continue to keep the situation under review. It was likely that increasing variety and innovation would be shown in the way new equity was raised in the future. However, this might not necessarily be reflected in the proportion of tendered sub-underwriting fees increasing as a proportion of the total sub-underwriting fees payable. Open-priced issues, for example, were not underwritten. In addition, in cases where issuers wished to minimize the issue discount of fixed price issues, the use of a tender might not result in more than a minor reduction in the overall level of commissions payable. This was essentially the pattern that had been seen, with a small number of exceptions, to date.

6.152. In CSFB's view, it was unlikely that it would be appropriate for the whole of the sub-underwriting to be tendered in all cases. The offer of 100 per cent tender might cause the sub-underwriters on the initial sub-underwriting list to choose not to respond to that initial offer because they might receive no benefit in terms of an allocation if other persons bid for the shares at lower commission levels. If the tender then failed to generate sufficient demand to cover the issue, the lead underwriter would be exposed.

6.153. In order for the tender to succeed the market must believe that there would be more demand for sub-underwriting than there was supply in order for institutions to bid aggressively in the tender. This factor would help to determine the proportion of sub-underwriting to be tendered for each issue. The feedback from pre-marketing was usually critical in the pricing of an issue and was often critical to the decision as to whether or not to proceed at all with the issue. While not binding, any indications of support given by key institutions had significant value to the issuer. Recognition of this value in terms of an allocation of sub-underwriting might be a prerequisite for that institution's continued support.

6.154. Two practical constraints limited the ability of brokers to open tenders up to all potentially interested parties. First, the pool of potential sub-underwriters was limited by the broker's assessment, as agent for the lead underwriter, of the risk that certain persons might default on any sub-underwriting liability. Second, it was important for market activities such as the offer of sub-

underwriting to create and sustain momentum in the market. It was in the lead underwriter's interest for the period during which the distribution of sub-underwriting was uncertain to be as short as possible. For this reason in practice the broker could not reach all potential sub-underwriting institutions in the short time available.

6.155. In addition issuing companies had a legitimate interest in the composition of sub-underwriting lists which influenced the decision as to how far to open up the commission tender. In particular they would usually be concerned that, in the event that shares were left with the sub-underwriters, they would behave responsibly in the market and would not exacerbate the impact of the failed issue on the company's stock market value. This concern might be addressed by entrusting the corporate broker to compile an initial sub-underwriting list of institutions that were natural long-term holders of the company's shares.

6.156. On the proposed remedy that lead underwriters should be required to inform issuing companies of the Black-Scholes 'fair value' of the underwriting for their issues, CSFB denied that the application of the Black-Scholes model did, in fact, produce a fair value of the underwriting commitment. Moreover the provision of this information would be of any consequence only if investors believed in it as a proper indication of the price of the sub-underwriting. If this consensus did not develop then the disclosure would be meaningless.

6.157. On the proposed remedy that financial advisers should be required to advise their clients who were considering share issues of the alternatives to underwriting at standard fees, CSFB said that making this a requirement would merely codify current good practice and would not move the debate forward. Moreover issuing companies were sophisticated buyers of financial products and were usually well aware of all recent developments.

6.158. On the proposed remedy that companies which undertook an underwritten share issue not involving tendering should be required to explain to their shareholders why they had chosen this route, CSFB said that in some circumstances a public explanation would be likely to prove to be more damaging to shareholders' interests than the incremental cost (if any) of the underwriting arrangements. Issuers might choose not to tender commissions on the grounds that they wanted the tightest possible discount; or they did not want increased sub-underwriting fees; or if the sub-underwriting was considered to be difficult.

6.159. On the proposed remedy that information for companies about share-issuing best practice should be made available, CSFB said that best practice could only be determined in respect of particular circumstances. The apparent advantages of deep discounting were more than outweighed by significant disadvantages. As for pre-marketing, it was not current market practice to try to secure firm commitments from shareholders to take up their rights in the pre-marketing phase. This was because shareholders were usually unwilling to commit to a specific course of action up to more than six weeks in advance without a commission. However, recent issues had successfully employed this tactic to shrink the size of the total underwriting and it was likely to be developed further in the future.

6.160. The proposition that issuers should, as a matter of best practice, seek advice from more than one firm was unlikely to be in the interests of either shareholders or companies. In practice this would impose further costs on issuers because work would be duplicated with no obvious benefit accruing to the issuing company.

6.161. On the proposed remedy that the appointment of lead underwriters and of brokers providing underwriting services for share issues should be on the basis of competitive tenders, CSFB said that the loss of value that might result from the leakage of plans for an equity issue might significantly exceed any savings resulting from a competitive process among advisers.

6.162. On the proposed remedy that brokers should be required to inform companies whose share issues were being sub-underwritten, who the proposed sub-underwriters were and how much sub-underwriting they would be offered, it was not general market practice at present for brokers to inform a company of the intended composition of sub-underwriting lists. This was because the arrangements between the broker and sub-underwriters were considered to be confidential and highly sensitive. In particular, sub-underwriters were generally concerned that companies did not become

aware of any difference between the sub-underwriting that they were initially offered and the sub-underwriting that they finally accepted. In addition, the broker acted as agent for the lead underwriter in the distribution of sub-underwriting. The lead underwriter might be unwilling for the issuing company to have a significant input in the composition of the sub-underwriting list.

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6.163. DrKB submitted that the use of standard fees combined with the use of a tendering mechanism when appropriate resulted, on average, in a lower cost of underwriting for the share issues of listed companies. The use of standard fees for the primary underwriter and the broker was largely irrelevant. The commission payable to the lead underwriter and broker, while nominally payable in connection with underwriting risk, was generally only part of a larger fee payable by the corporate client in connection with a transaction. In the case of issues by large companies, where the primary and sub-underwriting fees would represent significant sums in absolute terms, such fees would almost invariably be the subject of negotiation.

6.164. The selective use of sub-underwriting tendering over the last 18 months had resulted in reduced sub-underwriting commissions in every case of which DrKB was aware. However, the sample size was small and there were few examples of significant financings by large companies. In addition, over this period market conditions for equity fundraising had been good and the standard element of the fee had acted as a cap in the tendering process. There was insufficient evidence to establish across the full cycle whether standard rates would result in higher or lower rates being paid. Whilst a move from standard rates could result in lower sub-underwriting commissions in certain circumstances, average rates could well increase. In particular, rates could increase in difficult market conditions and for smaller companies. It was also too early to establish whether the recent reduction in returns on sub-underwriting had undermined the capacity of the market to underwrite.

6.165. DrKB said that there were a number of technical problems with Professor Marsh's work. These were as follows:

- (a) The Black-Scholes options valuation model assumed that it was possible to trade the securities underlying the relevant options to maintain a continuously hedged position. In practice, it was not possible to trade shares in the same way as, say, currencies, for which markets were open on a 24-hour basis. In any case, the liquidity of shares for all but the largest companies was too low to hedge large positions effectively.
- (b) In addition, the model did not take into account the fact that such trading might itself affect the share price. This effect might be accentuated by the very short period of the exposure which demanded much more significant hedging activities in the underlying share for a given movement in the share price.
- (c) Professor Marsh's analysis was based on assumptions about volatility that might not be appropriate. In particular, using figures for the historical volatility of a share during the 60 months prior to an issue might not be a good guide to its volatility during the period of an issue. First, historical share price volatility was not necessarily a good guide to current and future volatility. Secondly, the volatility of a share might well be affected by the rights issue itself (and any accompanying information released to the market on, for example, an acquisition or current trading). Furthermore, the model assumed that hedging activity by sub-underwriters would not itself affect the volatility.
- (d) The Black-Scholes model took no account of the size of the issue relative to the size of the company.
- (e) The model took no account of the cost of the capital devoted to support the risk incurred by sub-underwriters and the fixed costs of administration.

6.166. On the question of whether the use of standard fees had benefits for issuing companies, DrKB said that this enabled the sub-underwriting process to be completed quickly and efficiently. This helped to reduce the perceived risk of the process for primary underwriters. The use of standard

fees was advantageous to issuers when demand for new shares was low and the risks of sub-underwriting were perceived to be high. Non-standard sub-underwriting fees could have unwelcome public relations effects from the point of view of the issuing company. Issuing companies' principal concerns were for certainty of funds and minimization of the risk of a failed issue.

6.167. DrKB expected that tendering of sub-underwriting would continue to be a feature of the UK market. It was DrKB's policy that all rights issues (and, if applicable, other issues) should be structured with sub-underwriting tender offers if DrKB believed that this would reduce the commissions payable by the issuers.

6.168. DrKB highlighted a risk that, if tendering became more widespread, sub-underwriting fees would increase for certain categories of company which benefited from the traditional system of fixed commissions. It was also unclear how the appetite for sub-underwriting would be affected by the use of tendering for a large issue. Since tendering had been introduced, there had been only five cases of rights issues which had raised net proceeds in excess of £100 million.

6.169. So far, DrKB had offered between 33 and 50 per cent of the total sub-underwriting for tender. By limiting the percentage offered for tender and pricing one-half to two-thirds of the issue at the 'standard rate', the underwriter limited the risk to the issuer if the appetite for sub-underwriting turned out to be less than expected. It was not clear what effect increasing the proportion offered for tender would have on average commissions payable and whether this would serve to undermine the role that standard fees played in capping costs. There was concern that significant moves away from the traditional system (in terms, for example, of increased administration and increased complexity of decision-making expected to be associated with 100 per cent tendering) might cause some fund managers, who saw sub-underwriting as peripheral to their business, to withdraw from the activity. This could push up the cost of sub-underwriting and any significant delay to the sub-underwriting process would increase completion risk and consequently put upward pressure on lead underwriting fees.

6.170. The linking of the underwriter's fee proportionately to the sub-underwriting fee resulting from the tender process did not, in theory, provide the correct incentive structure. In practice, this did not affect DrKB's efforts to obtain sub-underwriting on the best terms.

6.171. On the question of why deep-discounted rights issues were not more widely used, DrKB said that it was very rare that certainty of funds was not a priority. In addition, for private and smaller shareholders there might be costs resulting from higher spreads (expressed as a percentage of the price of nil-paid rights), minimum dealing costs and capital gains tax disadvantages. In the recent rights issue for Bodycote, there was a coincidence of factors which made deep discounting an appropriate structure. In particular, Bodycote did not need the money to complete the deal.

6.172. Methods of share issuing other than traditional rights issues would, on average, result in higher costs to shareholders because the discount net of commission invariably represented a loss to shareholders in excess of the standard underwriting commissions, let alone the lower figure achieved through the tendering mechanism. The argument often used in favour of non-pre-emptive issues was that, unlike rights issues, they represented an opportunity to introduce new supportive investors to the register of a company which over time increased the rating of a company's shares. In DrKB's experience, it was very rarely, if ever, the case that significant investor interest could not be stimulated by management roadshows and satisfied through the secondary market. In any event, the international nature of capital flows inevitably meant that discrepancies in the valuation of companies did not persist and were very quickly arbitrated.

6.173. UK practices compared favourably in terms of cost, efficiency and certainty with those in other countries where pre-emption operated. The efficient operation of the UK underwriting system could represent a competitive advantage for UK companies competing for acquisitions abroad. The UK market had proved responsive in adopting international practices when appropriate; a good example was the widespread adoption of international issuing techniques for IPOs over the last five years.

6.174. As regards barriers to entry, any lead underwriter or broker needed to be duly authorized by the regulatory authorities. Otherwise, the most significant barrier to entry was the need to have credibility with the other parties in the process. A key part of this credibility was the ability to

provide payment certainty and a reputation for prudent sponsorship of issues. In addition, brokers and sub-underwriters needed to have established systems and relationships to enable them to administer and complete the underwriting process quickly and efficiently.

6.175. Sub-underwriting tenders were generally announced on the Regulatory News Service so that, in theory, anyone could submit a tender. However, the form of sub-underwriting letter normally used gave the broker the right to reject any tender application and, in particular, to reject tenders from parties that the broker did not consider to be 'normal sub-underwriting institutions'. This was necessary because the normal sub-underwriters' risk profile could change if a significant proportion of an issue were sub-underwritten with parties who might be forced sellers of shares in the event of a stick. The most logical sub-underwriter of an issue was an existing holder of shares who was already comfortable with the characteristics of the company. As a result, the most logical sub-underwriters were fund managers. DrKB commented that it had never been approached either directly or, so far as it was aware, indirectly by derivative traders keen to acquire the risk of a sub-underwriter.

6.176. Despite the increasing concentration of the investment banking industry, the level of competition was intense and companies often changed their financial adviser or broker. In addition, it was increasingly common for larger companies to have no financial adviser of record, but to have close relationships with several investment banks and to retain joint brokers.

6.177. Superficially, the combination of the roles of adviser and underwriter might be perceived as against the interest of issuers. In practice, the knowledge and familiarity that the financial adviser gained through its relationship with the company was crucial to the adviser's ability to price an issue on competitive terms and the confidence of sub-underwriters in the issue. The role could not sensibly be separated. Acting as underwriter carried with it an implication (at minimum) of sponsorship. As a result, an underwriter needed to be involved in all aspects of due diligence so that it was comfortable with the issuing company and the proposed transaction. Separation of the roles would lead to duplication by the underwriter of the work of the financial adviser. This duplication would lead to higher expenses for the issuer. In addition, an uninformed underwriter was likely to be more risk averse and therefore to price an issue less competitively.

6.178. DrKB commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It considered that it would be imprudent and premature to impose mandatory tendering or agree to impose it in two years' time. Prescriptive legislation could undermine the flexibility of the underwriting system and distort market innovation. DrKB agreed that sub-underwriting should be open to as wide a group as possible and was prepared to work with any sub-underwriter who was a natural holder of the equity and who could provide certainty of payment.

6.179. On the suggestion that companies which undertook an underwritten share issue not involving tendering should be required to explain to their shareholders why they had chosen this route, DrKB thought this might prove counterproductive. If an underwriter advised use of standard rates rather than a tender, this could signal to the market that the primary underwriter expected lower than average demand for the sub-underwriting risks. This, in turn, could have implications for the pricing and the perception of the company.

6.180. On the proposal that information for companies about share-issuing best practice be made available, DrKB commented that it was its policy to advise clients on the alternative methods of executing a fundraising. It advised the use of deep-discounted rights issues in appropriate circumstances, but took the view that this route was not applicable when certainty of funds was essential. As for pre-marketing, most equity issues were pre-marketed to ensure so far as practicable that the issue would be accepted by the markets, but not more than necessary in the interests of confidentiality. On the possibility of separating the roles of financial adviser and lead underwriters, this would lead to duplication of work and a significant increase in the cost for issuers.

6.181. On the proposal that companies be given the option to vary the period between the announcement of a rights issue and the final acceptance date, DrKB commented that this logic was sensible but that smaller shareholders might be disadvantaged. In practice, such measures were unlikely to reduce significantly the sub-underwriters' perception of the risks assumed.

6.182. DrKB did not see any reason why shareholders would wish to concede any further relaxation in their pre-emption rights which were a valuable and fundamental right of ownership.

6.183. It was very difficult to price underwriting and advice services separately. A rule requiring this would increase administration costs and result in an arbitrary allocation of fees.

6.184. Separation of the roles of financial adviser and lead underwriter and competitive tendering for the roles of lead underwriter and broker might result in higher costs for the reasons set out in paragraph 6.177. Most financial adviser appointments were made and retained on the basis of good client relationships and high-quality advice and ideas, rather than price alone. Confidentiality could also be a constraint.

6.185. On the proposal that brokers disclose the identity of proposed sub-underwriters, DrKB commented that intermediaries should be prepared to offer transparency to the extent permitted by their duty of confidentiality to other clients.

6.186. Generally, DrKB believed that the imposition of mandatory changes to the system of underwriting could accelerate the reduction in sub-underwriting capacity and thereby reduce the competitive advantage enjoyed by UK companies. Prescriptive regulation might quickly appear anachronistic as the market for sub-underwriting services evolved, either in response to changing perception of the risk or through the more international nature of the capital flows in the shares of UK listed companies. In practice, the commercial pressures were such that financial institutions were strongly incentivized to be innovative and to find methods to reduce the cost of equity fundraisings for their corporate clients. DrKB did not believe that there was any monopoly working against the interests of any other party in relation to underwriting services. Accordingly, the appropriate approach from regulatory authorities was to continue to encourage the development of a dynamic capital market, but avoid prescriptive measures that could, over time, constrain the ability of UK companies to access investment capital.

Ernst & Young

6.187. Ernst & Young viewed the standard 2 per cent underwriting fee as being against the public interest as it did not reflect the different risks inherent in underwriting different share issues. The principal reasons why different risks arose were:

- (a) the varying discounts to the current market price which were used in underwriting a rights issue (or different discounts to the estimated market price as in the case of a flotation); and
- (b) the inherent different volatility of different companies' share price, which were influenced, *inter alia*, by the company's sector, size, financial stability and quality of management.

It considered that companies wishing to have their share issues underwritten should be able to arrange competitive auctions among underwriters to obtain the best price.

6.188. Ernst & Young said that most companies which sought advice on share issues obtained that advice from their financial adviser who then also acted as lead underwriter. There was, in its opinion, an inherent conflict of interest between the two roles. It was therefore of the view that companies should seek independent advice as to the cost of underwriting or form their own view without the advice of the lead underwriter.

Fiske & Co Ltd

6.189. Fiske & Co Ltd submitted that the present system of standard fees for sub-underwriting effectively subsidized the smaller company sector, as the risks were invariably greater and the premium paid for ensuring that the money was raised modest. There were no real standard fees in the smaller company sector for lead underwriters and brokers; fees were set by negotiation.

6.190. In deciding on the identity of potential sub-underwriters there was one overriding requirement against which all others were insignificant, namely that the institution must be good for the money and willing and able to pay on the agreed day in the agreed form.

6.191. The people most opposed to deeply-discounted rights issues were the directors and shareholders and surely that decision should be theirs, not that of the Government or some regulator.

6.192. The tendering process involved additional costs, both for the raiser of capital and for the potential suppliers of capital. In the small company sector, it was not possible to deem most of the present system as contrary to the public interest.

Hoare Govett Limited

6.193. Hoare Govett submitted evidence and attended a hearing. It said that 'standard fees' were really a benchmark around which total remuneration was negotiated. In the past, for larger companies in bull market conditions, the use of standard commissions might have resulted in sub-underwriting fees being higher than would have been the case had the issues been tendered. For smaller or more difficult issues, the existence of standard fees might actually have lowered costs.

6.194. Hoare Govett did not accept Professor Marsh's contention that standard sub-underwriting fees produced excess returns and regarded both the theoretical Black-Scholes *ex-ante* approach and the *ex-post* analysis as flawed. It made the following points:

- (a) The Black-Scholes-based valuation was extremely sensitive to assumptions on volatility. The volatility of a stock during the underwriting period was probably inherently higher than the 60-month volatility on which Professor Marsh's initial analysis was based. Professor Marsh had subsequently assessed volatilities during underwriting periods and concluded that that volatility was actually less than he had assumed. However, this conclusion possibly reflected more the rather benign conditions during which his observations were made than the inherent volatility created by an underwritten issue. Most equity market practitioners would agree that underwritings increased potential volatility; in benign market conditions, when the likelihood that the issue would be fully subscribed was high throughout the underwriting period, this potential volatility might not be evidenced. However, in unfavourable market conditions where the likelihood of stock being left with the underwriters was higher, volatility was also likely to increase. For example, as soon as the share price came near to the issue price it frequently moved quickly to the issue price, and as soon as an issue was left with sub-underwriters the next price was frequently 10 per cent below the underwritten price. The volatility of stocks during the underwriting period, on which Professor Marsh's valuation exercise was critically dependent, could not accurately be predicted.
- (b) As an underwriter and sub-underwriter, Hoare Govett had in the light of Professor Marsh's contention enquired whether it would be possible to offset some potential liability, following the announcement of an issue, by buying put options. In the opinion of derivative traders it would be not possible to cover even a relatively small proportion of the liability in this way. If anyone was prepared to provide a put option facility in size at the prices indicated by Professor Marsh's theoretical model, there would be a considerable demand for this service.
- (c) The argument that returns were excessive on the basis of *ex-post* observation was flawed because it failed to take account of the cost of capital and the fact that the period over which returns had been measured had been an outstandingly favourable one for the stock market. The stock market had been in a virtually continuous bull phase since 1975, and against that background it was scarcely surprising that the incidence of loss had been lower than would have been the case had the market performed more normally. The average annual return generated from the stock market in the ten years to October 1996 amounted to 14.25 per cent, considerably in excess of the returns of 8 per cent assumed by the actuaries as the long-term rate (consistent with 2.5 per cent yield, 2.5 per cent gross domestic product growth, and 3 per cent inflation).

(d) Viewed another way, during the period October 1986 to October 1996 returns on capital invested in pure underwriting would have been similar to returns from investing the same capital in the stock market. It would appear that the average underwriting period in Professor Marsh's survey of 946 underwritings over the period 1986 to October 1996 was 40 days. On the assumption that these issues were evenly spaced so that money tied up was continuously used, a sub-underwriter could take on nine sub-underwritings a year which (on the basis of Professor Marsh's calculations) would have yielded a 6.8 per cent return. In addition, the sub-underwriter would still have been able to earn short interest rates on the money held to back potential liability which averaged 9.25 per cent a year over the ten years to October 1996 giving a total return of approximately 16 per cent a year. Given that underwriting opportunities did not occur evenly, it was unlikely that the annual return generated by underwriting over the period October 1986 to October 1996 would have been greater than the 14.25 per cent return derived from the stock market.

6.195. Companies were fully aware of services provided by advisers both in relation to a specific transaction and more widely. The introduction of tendering had created demonstrable competitive pricing of the sub-underwriting service. However, the last 18 months had represented an unusually favourable environment.

6.196. Companies were fully aware of the new practices and tendering was likely to become fairly standard for most larger issues. It would probably not be used where the issue was regarded as difficult and where sub-underwriters might be inclined not to participate at all if a complicating factor were introduced.

6.197. Competition for financial advisory work was intense and great marketing advantage was to be gained from producing innovative sub-underwriting structures. There was no danger that lead underwriters would be disincentivized by the practice of linking their commission to the outcome of the sub-underwriting tender.

6.198. Deep-discounted issues were generally believed to affect adversely the share price of issuing companies. Investors disliked being virtually forced to take up shares and the method was not suitable when the issuing company needed to be assured of certainty of funds.

6.199. Hoare Govett considered that the intellectual arguments in favour of pre-emption were well based and that those who argued against pre-emption did so largely from a perspective of self-interest. The pre-emption rights acted in the interests of shareholders by keeping down the cost to them of raising equity, compared with other methods such as placings.

6.200. The share-issuing methods adopted in the UK were relatively cheap compared with other major markets. Evidence suggested that the cost of issuing equity in the USA would be between 3 and 6 per cent and in Tokyo between 3 and 3.5 per cent. In many markets other than the UK, underwriting was only entered into at the end of a book-building process during which risk remained with the company, not the underwriter. UK underwriters provided UK companies with a greater degree of security for their fundings by assuming greater risk and did so for lower commissions.

6.201. On barriers to entry, Hoare Govett stated that the principal barriers for lead underwriters were having sufficient capital and the appropriate reputation. For brokers, the main barriers to entry were reputation and distribution capability. As for sub-underwriters, provided an institution could substantiate its financial capacity and meet other regulatory and compliance requirements, there was little to stop market entry for a new player. This was illustrated by the growing number of European institutional investors who participated in sub-underwriting UK issues. Sub-underwriting was principally undertaken by fund managers because they were the main purchasers of UK equity. In the case of some smaller company rights issues, it could be very difficult to procure sufficient sub-underwriters to cover an issue. The difficulty in procuring sub-underwriters provided evidence that institutions did not believe that underwriting gave them excess returns.

6.202. There was considerable competition among investment banks, brokers and other financial advisers. Companies often moved to a particular adviser for a specific deal. Changes of broker were

less frequent because the level of service received was more multi-faceted (equity research, syndication, sales and corporate broking). Switching costs were negligible.

6.203. Hoare Govett did not believe that a serious conflict of interest arose from financial adviser and lead underwriter roles being undertaken by the same organization. It was the broker who ultimately gave the most important advice in respect of pricing the issue. Companies were not in practice pushed towards a particular funding route in order for the financial adviser merely to generate higher fees.

6.204. Whilst there might theoretically be a conflict between shareholder and sub-underwriter, the fact that the same institutional investors tended to dominate both roles negated this in practice. Ultimately shareholders and sub-underwriters had a common interest in seeing a company undertake a successful funding.

6.205. In Hoare Govett's view, the system of regulation under the Financial Services Act offered non-private customers less protection than private clients, but achieved the appropriate balance taking into account the nature of corporate finance business. Increased regulation would serve to harm the efficiency of the London financial market and was unwarranted at present.

6.206. Hoare Govett commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It did not believe that tendering of sub-underwriting should be made mandatory. Most major issues would in future be tendered save in very particular circumstances. To remove a financial adviser's flexibility to cater to those circumstances would probably be disadvantageous. For smaller issues which, even in bull market conditions, were generally more difficult to sub-underwrite, the use of tender sub-underwriting would be more selective. To make the tendering of sub-underwriting for all smaller issues mandatory would be unlikely to result in material savings and might jeopardize some companies' ability to raise finance at all. To impose a mandatory limitation of sub-underwriting fees payable on such issues would merely serve to reduce the likelihood that an issue would be sub-underwritten at all. To dictate that the whole or a particular proportion of any issue should be tendered would be to reduce the flexibility which an adviser required in designing a fundraising appropriate to a particular company in particular market circumstances.

6.207. Advisers did discuss with their clients the alternative forms of issue and underwriting alternatives but in the final analysis the decision was often a matter of judgment where the adviser's expertise must prevail. The best solution was to ensure that companies were fully advised of the alternatives so that they could effectively discuss and test the adviser's recommendations.

6.208. On the proposal that companies which undertook an underwritten share issue not involving tendering should be required to explain to their shareholders why they have chosen this route, this was unlikely to be particularly helpful to those smaller or perhaps troubled companies which could not securely tendered sub-underwriting. These companies were likely to have to confess to their shareholders that, 'in the opinion of their advisers' or 'after pre-marketing', finance on the basis of tendered sub-underwriting could not be obtained. In fact such disclosure could lead to the failure of whatever issue such a company had been able to procure.

6.209. On the proposal that information for companies about share-issuing best practice should be made available, Hoare Govett generally supported the proposition but said that it would be a mistake to describe any method as 'best practice', as the best solution in any case was dependent on specific circumstances. As regards pre-marketing of rights issues, Hoare Govett had encouraged companies to seek firm commitments from shareholders when appropriate, but this did not necessarily equate to no, or even lower, sub-underwriting fees. It was difficult for any institutional shareholder to give a firm commitment without commissions when other shareholders were being paid to fulfil the same function.

6.210. It was more difficult than it appeared to separate the roles of financial adviser and lead underwriter without the risk of leaking potentially highly price-sensitive information or inflating the cost. In order to create competition in underwriting, the financial adviser might have to invite about three potential underwriters to tender. Underwriting was not just a commodity and those underwriters would invariably wish to undertake significant due diligence on the transaction. The introduction of additional parties and delay to the timetable of highly price-sensitive transactions would increase the

risk of leakage, whilst the underwriters as well as the financial advisers would need to be remunerated for the work undertaken and financial responsibility assumed.

6.211. Pre-emption rights were a fundamental shareholder protection which should be retained. There was already the facility for shareholders to waive these rights in specific circumstances but a blanket relaxation of pre-emption rights in respect of issues of up to 15 per cent in any one year would be against the interest of shareholders. There was even less reason for companies capitalized at over £50 million to relax pre-emption than for smaller companies where the cost of documentation associated with an offering was proportionately higher.

6.212. On the proposed remedy that brokers should be required to inform companies whose share issues were being sub-underwritten who the proposed sub-underwriters were and how much sub-underwriting they would be offered, Hoare Govett did not support making this mandatory. In certain circumstances it was able to tell corporate clients who the sub-underwriters were. In other cases it discussed the overall shape of the sub-underwriting list. However, on an issue which had not been extensively pre-marketed, there was little opportunity to do this in advance of the issue being announced. In any event Hoare Govett did not see what it would achieve in terms of increasing competition. The corporate broker's expertise was his knowledge of the capacity and preferences of particular sub-underwriters and companies would in practice not want or be in a position to second guess that expertise.

HSBC Investment Bank plc

6.213. HSBC submitted evidence and attended a hearing. It said that the standard underwriting fee structure offered speed, efficiency and certainty, but in any event the amount of total remuneration retained by the lead underwriters and financial adviser was subject to negotiation and varied according to circumstances. Indeed, fee negotiations centred on the total fee (covering all services offered) and not on individual components of the fee such as underwriting. There was considerable competition over total fee packages on offer and considerable negotiation over fees. In discussing total remuneration, HSBC and its clients took account not only of the direct financial risk involved in underwriting and the advisory, marketing and other work relating to the issue but also of the amount of work undertaken leading up to the relevant transaction. Gross fees in the UK were significantly lower than in other parts of the world.

6.214. HSBC did not use the Black-Scholes model for pricing equity market underwriting risk and did not believe any such general model could be devised. It made the following points:

- (a) Historic share price volatility might not be a guide to the volatility of the price during an equity offering, particularly if the offering was large and was to finance a major change in the company. Similarly, the market price immediately pre-launch might not be a good proxy for the 'base' price of the share post-announcement if the announcement contained new price-sensitive information. Specific share price and volatility of that price were the two parameters most important in option valuations, especially over the short term, and therefore a priori models did not match actual risk in the circumstances described. *Post facto* models could estimate the correct option pricing but, of course, these were not available either to underwriters or to sub-underwriters, both of whom had to make their decisions before or very soon after launch.
- (b) Theoretical models were based on efficient (ie fully informed and liquid) markets. The more information there was in the market in advance, in particular as to the reasons for the issue, and the smaller the size of the issue in relation to normal liquidity in the stock, the closer an option pricing-based model might approach to 'correct' pricing of underwriting risk. The market in the shares of very large companies might approximate to an efficient market and a properly constructed theoretical model might allow a reasonable quantification of underwriting risk for a relatively small rights issue for general corporate purposes by such a company. For large issues for an unexpected purpose (for example, funding of an unexpected major acquisition) by such companies, a degree of judgment was always likely to be required in evaluating the likely effect on share price and volatility of new information.

- (c) For any issue by smaller companies (the vast majority by numbers) there were many factors which affected whether there was an efficient market in the first place. These factors included size of company, liquidity in its stock, extent and quality of research coverage, reasons for the issue, recent financial track record, current financial position and prospects of the company and market sentiment, both towards smaller companies generally and towards smaller companies in the sector concerned.
- (d) Any evaluation of whether or not underwriting costs were 'fair' under current structures needed to take into account not just the theoretical fair price but also the practical evidence from alternative structures. The available evidence suggested that average total equity fund-raising costs in most other jurisdictions were generally higher than in the UK, even where the period during which underwriters were exposed to market risk was much shorter than in the UK. Furthermore, even for UK companies there was an increasing trend to international-style 'syndicated offerings' (in particular for IPOs and convertible issues) where overall fees were usually higher than for traditional rights issues although the underwriters were taking no price risk at all.

6.215. HSBC believed that issuing companies had sufficient information about what services they were paying for as this was typically contained in the engagement letter issued by the adviser and lead underwriter and broker. In addition, issuing companies were able to compare total fees with similar transactions and were sufficiently sophisticated and well informed to take a robust position in fee negotiations.

6.216. The introduction of tendering for sub-underwriting had intensified what was already a competitive market. Issues for larger companies had resulted in cost reductions due to increased competition for sub-underwriting. For smaller companies it had proved difficult to introduce tender offers probably because these companies preferred to pay a standard fee whose simplicity appealed to sub-underwriters of smaller company issues. In addition there was a risk of a higher level of sub-underwriting fee that might result from a tender for a smaller company equity issue. Lead underwriters and brokers had introduced flexibility in bid situations (for example, success-based fees) but the overwhelming requirement for confidentiality, speed and success might preclude introducing tenders to sub-underwrite cash underpinnings. Tendering for sub-underwriting commissions was introduced in response to demand from the market and its introduction was likely to be sustained where it was required from participants in the market and was applicable in the circumstances.

6.217. Deep discounting was rarely used in rights issues because the existence of an efficient and relatively inexpensive sub-underwriting market in the UK tended to lead to the perception that any rights issues which has not actually been underwritten could not be underwritten. Deep-discount issues also tended to be unfavourably regarded by potential issuers because minimizing the discount at which any new shares were issued was often seen as a measure of corporate success. There was also concern as to the dividend policy to be followed after a deep-discount issue. In addition, both companies acquiring a business and the vendors of a business were not typically prepared to take the risk, when entering into a sale and purchase agreement, that funds to be raised by way of a non-underwritten rights issue might not become available in full. Deep-discount issues might also be particularly unattractive if the issuer had private shareholders with large holdings who were unable to subscribe further capital, as the sale of nil-paid rights might, first, result in significant dilution of their holding and, second, crystallize substantial tax liabilities for these shareholders and therefore result in even greater dilution. In addition, shareholders (including directors) wishing to participate in a placing of nil-paid rights before the official start of dealings in the nil-paid rights were further disadvantaged by the LSE rule which required that the price paid by those with whom nil-paid rights were placed must not be more than half of the calculated premium over the rights issue price.

6.218. The pre-emption guidelines inhibited to some extent the use of share-issuing methods other than traditional rights issues. In doing so, they thus restricted the natural process of innovation. In some circumstances, shareholders were willing to waive their pre-emption rights. HSBC said that normally, however, shareholders were reluctant to waive pre-emption rights and the high threshold required by a special resolution to waive those rights might prevent companies from seeking such a waiver. HSBC emphasized that it had no views on whether the pre-emption guidelines were against the public interest.

6.219. The LSE rules which made underwriting necessary or lengthened the time for which it operated were:

- Rule 4.21: In a rights issue the offer must remain open for acceptance for at least 21 days.
- Rule 4.24(a): In an open offer there must be a period of at least 15 business days from the date of posting of application forms to shareholders until the close of the offer.
- Rule 9.18: Unless shareholders permit otherwise, a company proposing to issue equity securities must first offer those securities to existing equity shareholders in proportion to their existing holdings.

The Rules of the Takeover Code which made underwriting necessary were:

- (a) Pre-marketing of an issue (before announcement) was limited normally to less than six institutions.
- (b) Under Rule 24.7 when the offer was for cash or included an element of cash, the offer must include confirmation by an appropriate third party (for example, the financial adviser) that resources were available to the offeror sufficient to satisfy full acceptance of the offer. In certain cases this confirmation could only be given if the cash alternative was underwritten.

6.220. The UK underwriting system provided facilities (in particular, firm price underwriting to support acquisitions or cash underpinnings) which were typically unavailable under the US system. The equity fundraising methods adopted in some other markets (in particular, the USA) were considerably more flexible than those in the UK. In some circumstances, this flexibility gave companies the ability to raise equity more quickly and at a tighter discount than was typical in the UK. However, the size of the discount under a traditional UK risk rights issue did not in itself have any effect on the cost of capital to a company. Average gross fees for equity-raising in the USA and most other major markets appeared to be higher than in the UK.

6.221. There were virtually no barriers to entry for lead underwriters, other than having a sufficiently strong balance sheet to underwrite. The absence of any real barriers was demonstrated by the ease with which US and Continental investment banks had entered the UK new issues market. Brokers were also operating in an environment with no significant barriers to entry as witnessed by the proliferation of small and not so small broking operations. There were relatively higher barriers for sub-underwriters because of the requirement to demonstrate capital adequacy and creditworthiness on application for sub-underwriting. Furthermore, in practice the issuer had an interest in ensuring that the sub-underwriter was a natural holder of shares in the company concerned in size.

6.222. In theory, conflicts of interest might arise between the financial adviser and lead underwriter, but in practice, companies were discerning buyers and had access to independent sources of advice to negate any potential conflict. More importantly, a financial adviser's reputation rested on giving clients high-quality independent advice. In addition there was overwhelming pressure on financial advisers to safeguard their good reputation and they normally did so by ensuring the keenest terms for a new issue. Separation of the roles of financial adviser and underwriter might appear attractive to issuers in theoretical terms, but this approach was neither practicable nor in issuers' overall interests. The approach had been adopted in a small number of privatization IPOs where potential underwriters for those sales had had the benefit of extensive research into the company and confidence that the sale would be supported by a large marketing budget. In addition, confidentiality and certainty had not been an issue and an extended period had been available for the underwriting opportunity to be marketed widely, because the target company was not already listed; and the transaction size had been sufficient to support the cost of a further set of advisers. None of these factors applied in UK market equity fundraising by companies which were already listed.

6.223. The system of regulation established under the Financial Services Act in respect of corporate finance business recognized that corporate finance clients had a relatively high level of financial sophistication and that it was in their interest that the dynamism of an extremely competitive market should not be stultified by unduly prescriptive regulatory requirements. The existing regulatory framework provided very adequate protection for a sophisticated client base and it was in

the interest of clients that constraints which inhibited flexibility in fundraising should be reduced, rather than the regulatory constraints being extended.

6.224. HSBC commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It stated that making the tendering of sub-underwriting fees mandatory would amount to imposing an artificial constraint. There was also no logic in introducing mandatory tendering for larger issues. Indeed for certain issues or under adverse market conditions, mandatory tendering could render sub-underwriting of certain issues impossible and, in some cases, was likely to lead to higher underwriting costs. Caps on sub-underwriting fees, and the requirement that all sub-underwriting should be tendered, amounted to artificial constraints that would create market distortions and in all likelihood render the sub-underwriting of certain issues impossible.

6.225. Any formal obligation on financial advisers to advise on alternatives to underwriting would be likely to result rapidly in the production of standardized and legalistic lists of alternatives which would be of little value to companies. In practice, financial advisers already discussed the alternatives with issuers, and finance directors were sufficiently well informed to be able to initiate a debate with financial advisers. Where this did not take place already, companies should be encouraged to discuss with their financial advisers all the possible alternatives to underwriting when considering share issues. In addition, companies should look to their non-executive directors, other advisers and current market practice in order to assess all the alternatives available.

6.226. A mandatory requirement to explain to shareholders the reason for not following a tendering route might result in standard boiler-plate explanations being included in the relevant documentation. Shareholders would be better served in seeking direct contact with companies to discuss and seek an explanation on the particular route chosen. Shareholders were already free to question companies on their actions and why they had chosen particular routes on a share issue.

6.227. On the suggestion that information for companies about share-issuing best practice be made available, HSBC supported this in principle and would welcome the endorsement of the CBI, the ABI and the NAPF. It suggested that the disadvantages of deep-discounted rights issues be explained as well as the advantages.

6.228. On pre-marketing, this was already being carried out as in the recent issue for Monument where firm commitments from shareholders to take up their rights were obtained. In that case, there was no issue of confidentiality as the intention to issue new equity had been made public. Any pre-marketing would need to be reconciled to the confidentiality, speed and certainty of funding required by issuers.

6.229. HSBC would encourage the greater flexibility that would be afforded to companies if they were given the option to vary the length of the period between the announcement of a rights issue and the final acceptance date. It suggested that institutional holders and private investors be canvassed for their views on whether shareholder approval should be sought to vary the length of the period during which a rights issue remained open. In setting the length of the period, regard would have to be paid to the position of private shareholders.

6.230. On the proposal that the guidelines on the application of pre-emption rights should be relaxed to enable companies to issue up to 15 per cent of their share capital non-pre-emptively in any one year, either for all companies or only for companies with a market capitalization of over £50 million, HSBC said that whilst this remedy represented a loosening of the current constraint, it still remained an artificial constraint based on the arbitrary figures of 15 per cent share capital and £50 million market capitalization. HSBC emphasized that it had no views on whether pre-emption rights generally were against the public interest.

6.231. HSBC would not support a requirement to analyse remuneration in a way which did not recognize the manner in which the services were actually provided. It aimed to provide a package of services to clients comprising either financial advice, project management and assumption of primary underwriting risk or marketing and distribution of sub-underwriting together with related administration, or all these services. It did not maintain separate accounts for the underwriting activity. It negotiated on the overall fee with the client covering the whole range of services provided and not individual fees for each component service. Competition took place in relation to the total fee and

there was considerable negotiation over the fee. It was not therefore appropriate to look at underwriting fees in isolation.

6.232. It should be left to the discretion of a company as to whether it sought tendering of sub-underwriting in respect of a particular fundraising. The appointment of lead underwriters and brokers was competitive in the current market. Companies were regularly courted by an array of advisers and were under no obligation to use their existing financial adviser or broker to provide underwriting services.

6.233. Rules from the SFA to deal with conflicts of interest were neither necessary nor desirable. Any theoretical risk was overcome through the action of a company obtaining third party independent advice from, among other sources, its non-executive directors, other advisers and general awareness of market practices. Companies had always displayed a considerable degree of sophistication and were fully aware of the implications of alternative methods of raising capital for the remuneration of all the advisers involved.

6.234. Information on proposed sub-underwriters and the level of sub-underwriting being offered was information which was proprietary to the broker and therefore not appropriate to disclose on commercial grounds. This proprietary information had been developed over a number of years and at considerable cost. It therefore constituted a legitimate competitive advantage for its owner (the broker) which it was not appropriate for it to be required to be disclosed. In any event there was no call for such a remedy as issuers were happy for the broker to act on this basis. In addition, brokers had an obligation to respect the confidentiality expected by sub-underwriters. While endorsing the general spirit of transparency, HSBC questioned what benefits the company would derive from knowledge of the proposed sub-underwriters for any particular share issue. As an alternative, companies could be encouraged to make suggestions to the broker to include certain funds (which were natural holders of the shares and could participate in size) in the sub-underwriting allocation.

J Henry Schroder & Co Limited

6.235. Schroders gave views as financial adviser and lead underwriter and attended a hearing. Although Schroders also acted as broker, as this was a relatively new line of business it had not played this role in a material number of the issues in the period under review and so was not commenting in this capacity.

6.236. Schroders believed that the provisional conclusion on the existence of complex monopolies set out in the issues letter (see Appendix 2.1) should be reviewed carefully in the light of the following comments:

- (a) It was not reasonable to base a conclusion on the evidence of issues in the years 1995 to 1997, since the first of a sequence of innovations in methods of capital-raising was introduced by Schroders only in late 1996. This meant that the sample from which the MMC's conclusion was drawn was dominated by issues made before Schroders' innovations effectively 'broke the mould'. The introduction of tendering had changed irreversibly the market's approach to commissions and a majority by value of new equity finance raised by listed UK companies subsequently had been at rates below traditional standard rates. Schroders believed it was, in part, a recognition of this fundamental change which led both the CBI and The Hundred Group to advise the DGFT against making a reference to the MMC.
- (b) Although consideration of fixed commission issues was increasingly academic for the reason given above, Schroders would contest the inference that the existence of fixed commissions implied that there was no pricing for risk. That was not the case. At a time when fixed commissions were the norm the pricing of an issue varied to normalize the risk for which the standard fee was charged. Thus difficult issues were priced at a wider discount than easy ones.

6.237. Tendering had so far served to reduce commissions payable for rights issues, with the quantum of the reduction being fairly well correlated with the level of the issue discount to the

prevailing market price at the time that the sub-underwriting decision was made. At the same time, it should be noted that the tendering process had been introduced and tested during a consistently rising market. Less favourable market conditions, including more volatile markets as well as falling markets, were likely to result in lower cost savings to issuers. Indeed, sub-underwriters could well insist on the ability to tender at above traditional commission rates in such an environment. The trend, through tendering, of arriving at commission structures which reflected the characteristics of individual issues would remove an element of cross-subsidization which probably existed under fixed commissions. The sub-underwriters' view that they should 'take the rough with the smooth' had probably meant in the past that weak issuers benefited. This was unlikely to continue and weaker issuers might well have to pay more than they did with fixed commissions.

6.238. Schroders did not feel Professor Marsh's analysis was soundly based from a theoretical point of view, in particular because of the implied assumption that cost-free hedging transactions over a significant portion of a company's equity could be executed (which they could not) and because of the assumption that historical volatilities were applicable to the period of an issue when, in practice, company-transforming news was often released at the same time. However, Professor Marsh's analysis had been overtaken by practical market tests. These had shown some support for his contention that commissions could be lower at least for good-quality issuers in benign market circumstances. What was important was no longer the theoretical work (which clearly was an important influence in promoting change) but the development of innovations which improved transparency in pricing.

6.239. Underwriting fees were transparent, since fees were, in principle, clearly for risk. As capital-raising options became more complex, it was likely that advisory fees charged for assisting with the judgment and project management would increase. In most cases both Schroders and its clients maintained an informal sense of whether its services over time were being fairly remunerated. If an equity issue came after a period of intense activity and related fees, both Schroders and the company would be less inclined to consider an additional charge relating to the issue itself over and above the underwriting.

6.240. Schroders would not accept the characterization of the market as it operated before tendering as subject to restrictions or distortions. Nevertheless, it felt that the introduction of tendering, together with experiments, such as in the case of Berkeley, on the trade-off between discounts and commissions, and new structures, such as Monument, involving a reduced role for primary underwriters where shareholders could themselves provide explicit support, had created an environment in which transparency and innovation were inevitable. This was a trend for which continued support from institutional shareholders would be forthcoming. The impact of tendering on lower-quality issues and on all issues in turbulent markets was not yet clear. Nevertheless, on average over a stock market cycle, Schroders believed the favourable effect on commissions would be sustained.

6.241. Schroders' decision in the Stakis issue to reduce its commission pro rata to the reduction achieved in the tender had been purely pragmatic to ensure that the innovation received a favourable reaction from sub-underwriters. It had no conceptual logic, since the risk the primary underwriter took was quite different from that taken by the sub-underwriter. The former underwrote blind, but the latter underwrote only when the market knew of the issue and had reacted accordingly. There was clearly a limit to the willingness of the primary underwriter to see commissions determined by the behaviour of others taking a different risk. It should therefore not be assumed that this practice would be maintained unmodified in future tender issues.

6.242. A variety of reasons had been put forward to explain why deep-discounted rights issues had rarely been used. The most important of these has been the dislike, by institutional investors, of a structure that demanded acceptance by investors on financial grounds regardless of the fundamental business case proposed. Other reasons included:

- (a) a desire not to crystallize a taxable disposal for certain classes of investor if they chose to 'tail-swallow' (ie sell some rights in order to take up the rest with the sale proceeds);
- (b) a concern that the trading pattern of nil-paid rights might, in practice, result in a loss of value to shareholders; and

(c) a subjective dislike of a structure that had, historically, tended to be used in distressed situations where underwriting was not available.

6.243. The operation of CGT did make a deep-discounted issue unattractive to some shareholders. In the Berkeley issue Schroders calculated the discount to be the widest which would be unlikely to give rise to this tax problem. Had the tax issue not existed, neither would this constraint on the issue price. The shareholders affected were those subject to CGT who did not wish to take up all or some of their rights. This clearly excluded tax-exempt investors. In most cases it would probably chiefly impact on small investors, often including the management who might wish to avoid this complication.

6.244. The LSE and Takeover Panel rules did not directly address the issue of whether or not there should be underwriting. The Takeover Panel's rules required a cash bidder to have the funds committed; so if a bidder proposed to provide cash by means of a share issue it would have to be underwritten at the time of the announcement of the bid. The use of cash funded in this way was the free choice of the bidder, not dictated by the rules. The LSE rules required a rights issue to be open for three weeks so that all shareholders (especially small shareholders who might be away or who might have to arrange finance) had time to consider and implement their decision on whether to take up their rights. If this period were shorter, the underwriting risk would be reduced and the commission should be lower.

6.245. In response to the question whether equity-issuing methods in other countries had lessons for the UK, Schroders commented that they showed a number of ways in which equity issuance could be made more remunerative for intermediaries and more costly for companies.

6.246. On barriers to entry, Schroders commented that to be a lead underwriter or a broker a candidate had to have the professional qualifications and experience to be credible to be appointed to the role. A new entrant who could show such qualifications in another developed capital market and had established an infrastructure to access investors in the UK market should be able to compete quickly. In the case of the lead underwriter, there had to be access to capital to meet fiduciary and regulatory requirements. A financial adviser had to have integrity, a willingness to put the client's interest first and an ability to develop a relationship of trust with a client. Apart from these qualities of character, a financial adviser needed technical competence in financial theory and in the rules and regulations affecting the matters where advice was required and experience of those aspects of legal and accounting matters which impinged on transactions. Access was also needed to a body of experience of transactions and of company decision-making at board level and skill in negotiation to be able to steer a project towards a successful conclusion. As success was reflected in stock market prices, an understanding was needed of investors and the market. Project management skills were also a requisite.

6.247. From an issuer's point of view, sub-underwriters who were natural long-term holders of the equity were to be preferred. If they were called upon to play their role by taking shares in an issue which was not fully subscribed, the company would much prefer not to see such holdings dumped on the market, with the consequent market disruption and the collapse in the price which would follow, while firm hands for the shares were found through the market mechanism. To be acceptable, sub-underwriters had to have access to adequate capital to take the risk and a credit standing which ensured that they would pay up if called upon to do so.

6.248. Traditional sub-underwriting had been relatively widely spread throughout the investment community. There might be some institutions which felt they had not traditionally had the share they were due. There might be other financial groups which from time to time would like to participate and felt excluded, perhaps because they could not be expected to be long-term holders of shares. However, fair weather underwriters were easy to find. The ones to be valued were those who would participate in good times and in bad. In some recent tendered issues the tender had explicitly been opened to all-comers. In the case of the Berkeley Group issue, few non-traditional sub-underwriters tendered and none tendered low enough to succeed in the tender.

6.249. Competition among banks and brokers was intense. Companies were not generally inhibited from changing financial advisers and brokers. The Monument issue was illuminating. The shareholdings were unusually concentrated and it was apparent to the company that shareholders

would be actively supportive of a rights issue, to the extent of committing to take up their own rights and effectively underwriting the rights of others. The company wished to design an issue taking advantage of this situation to reduce issue costs. In the light of recent innovations, it had asked Schroders for a view. Schroders was appointed to construct and administer the issue and to act as sponsor. A similar relevant case was the Berkeley issue. One reason why the company came to Schroders, with whom it had had no previous advisory relationship, was because of Schroders' reputation for innovative issues and the company's wish to take advantage of new opportunities to save on issue costs.

6.250. As in the case of many professional advisers, there was a theoretical potential conflict of interest for the financial adviser acting as lead underwriter. It resembled the conflict of a lawyer asked to advise whether a client should litigate. Interest in earning fees from the litigation represented a theoretical conflict which was not considered to be a real problem because the reputation for giving the right advice was more important than a single fee. A financial adviser could not risk the relationship with a client or, even worse, its reputation throughout the market by giving self-serving but erroneous advice in relation to an issue.

6.251. Schroders commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). Schroders had some difficulty in seeing who might need official protection, given the power of the customers in the market place and the competition in investment banking services. In particular it could not see any advantage in provisions of a nannying or prescriptive kind and doubted the need for them. It therefore approached suggested remedies with caution. Furthermore where the hypothetical remedies suggested that certain practices would have to be followed, it was unclear what procedures or disclosures would be envisaged, what auditing procedures would be required, and what penalties would be proposed for failure to comply.

6.252. Mandatory tendering of sub-underwriting fees, or a cap on such fees, would be too prescriptive. There might be good reasons from time to time for companies not to tender. They should be free to choose. Some issuers might not be able to achieve a successful sub-underwriting if the fee were capped. There might be future market conditions when this would not be the right commission for the risk.

6.253. With regard to the suggestion that the whole of the sub-underwriting should be tendered and the tender should be open to as wide a group of potential sub-underwriters as possible, Schroders commented that a general prescription applicable automatically to all cases, whatever their particular characteristics, was inappropriate.

6.254. On the suggestion that companies which undertook an underwritten share issue not involving tendering should be required to explain to their shareholders why they had chosen this route, Schroders thought this intrusive into a company's processes in a way that was not appropriate for the MMC or consequent legislation, although it would not object in practice.

6.255. On the suggestion that information for companies about share-issuing best practice should be made available, Schroders said that in principle this approach seemed appropriate. However, Schroders did not agree with the suggestion that encouragement should be given to the adoption of pre-marketing in all cases, since the circumstances where pre-marketing was appropriate depended on the characteristics of an individual issue.

6.256. Schroders did not accept that active encouragement should be given to separating the role of financial adviser and lead underwriter. Companies were already quite free to do so. However, most issuers did not find there to be a conflict of interest in practice and the value of deploying an established relationship was likely to be of overriding importance. There were also issues of confidentiality, practicality and cost involved in the question of whether or not to involve a second bank.

6.257. On the proposal that the guidelines on the application of pre-emption rights should be relaxed to enable companies to issue up to 15 per cent of their share capital non-pre-emptively in any one year, either for all companies or only for companies with a market capitalization of over £50 million, Schroders commented that this would represent the effective abolition of pre-emption rights. It doubted if shareholders would accept it. It was for them to comment, however. Opinion

should be canvassed from those representing the views of small shareholders as well as from institutions.

6.258. On the proposal that brokers should be required to inform companies whose share issues were being sub-underwritten, who the proposed sub-underwriters were and how much sub-underwriting they would be offered, Schroders was doubtful whether this sort of prior clearance would work except on an indicative and uncommitted basis. It was necessary for the broker to have discretion on the day to get the job done and in a tender the broker could not predict the outcome.

KPMG Corporate Finance

6.259. KPMG Corporate Finance (KPMG) said that, as an independent advisory house, it was a strong advocate of transparency in the provision of underwriting services and of competitive mechanisms in relation to commission and remuneration. It did not consider that underwriting fees were sufficiently transparent. Client companies often received little information about the nature of underwriting and the service they were receiving.

6.260. Tendering for sub-underwriting was a welcome development, but at best its introduction could only be moving things in the right direction for constructive change. Adequate progress towards full transparency would not be made without some form of intervention by the competition authorities.

6.261. Client companies ought properly to be entitled to receive objective advice from their financial advisers as regards share issues and the underwriting process. For client companies' stockbrokers, there was the potential for a conflict of interest emerging, in that they were additionally responsible for the distribution process. A potential conflict of interest issue also arose for whoever underwrote an issue; and, where underwriting was carried out by a financial adviser, that adviser's objectivity must inevitably be called into question, if it was also to be remunerated for lead underwriting services.

6.262. Commenting on hypothetical remedies, KPMG considered that mandatory tendering for sub-underwriting would be beneficial, subject to a sensible value figure being set. If that level was £20 million, it would have a continuing concern that many smaller companies tapping the equity capital markets would continue to be denied full transparency and the benefits of competitive tendering.

6.263. KPMG agreed that financial advisers should be required to advise clients of the alternatives to underwriting at standard fees; that companies should be required to explain to shareholders why they had not undertaken tendering of both underwriting and sub-underwriting; that information about share-issuing best practice should be made available; that the SFA should require lead underwriters to tell their clients what they charge specifically for underwriting services; that lead underwriters and brokers for share issues should be appointed on the basis of competitive tender; that the SFA should make rules to deal with conflicts of interest; and that brokers should reveal the identity of sub-underwriters.

Lazard Brothers & Co Limited

6.264. Lazards did not believe there was a complex monopoly in the supply of underwriting services. The London financial market was extremely and healthily competitive. While a 1.25 per cent commission might still be the standard by reference to which commission for sub-underwriting was negotiated, there was ample evidence that commissions were different in different circumstances. The development of the tender process for sub-underwriting in rights issues was a development which Lazards wholly supported. Some three-quarters of the capital raised by rights issues in the period January to September 1997 used the tender process to vary sub-underwriting commissions.

6.265. A company wishing to raise equity capital in the London market could use a variety of different techniques (with or without sub-underwriting tenders), including rights issues, deep-discount

rights issues and book building. In the book-building case, it was likely to be necessary for shareholders to be asked to waive pre-emption rights. In circumstances where this was in the best interests of the company and its shareholders, the shareholders could be expected to be supportive. Where they chose not to be so supportive, that was their right as shareholders and owners.

6.266. A company wishing to raise equity capital would take a decision on the most appropriate route in the light of particular circumstances. There might be a requirement for speed, secrecy and certainty, as in cash underpinning in the context of takeover bids, whereas in other circumstances it might be more appropriate to raise capital after a significant marketing effort. The more that speed, certainty and secrecy were required, the more likely it was that the more conventional methods of raising equity capital would be utilized. Cash underpinning for hostile takeovers was an area where secrecy was vital, but even in that area there had been variations to standard underwriting rates, such as structures where part of the fee was contingent on success.

6.267. Other markets, particularly in the USA, were significantly less favourable to companies seeking to raise equity capital. The US model offered only distribution rather than genuine underwriting, was more expensive at between 3 and 6 per cent and was, in practice, just as inflexible as between the pricing of particular risks by competitors. In UK rights issues, risk was adjusted principally through the issue price (to which the company was indifferent), and there was likely to be a correlation between the perceived risk of an issue and the use of a sub-underwriting tender.

6.268. Given the developments that had taken place in the London market over the last few years, and the many different ways of raising capital that were open to companies, Lazards could see no reason for seeking to regulate these activities further. Companies and their financial advisers were able to choose from a wide variety of options with differing commission structures, and to develop new options to suit particular circumstances.

Merrill Lynch International

6.269. Merrill Lynch made a submission and attended a hearing. It said that the UK system of issuing equity, by providing certainty and speed, offered a level playing field between companies of different sizes and sector in adverse as well as good market conditions. However, as equity capital markets increasingly internationalized, so the availability of capital was becoming a potential source of competitive advantage or disadvantage on an international scale, with the country of domicile and market of primary listing becoming drivers of competitiveness. With substantially larger pools of capital available in the international (in particular the US) equity markets, access to international investors was increasingly important for companies competing in an international arena. At the same time, UK investors had rights, as owners of UK listed companies, to protect their investments and attached special importance to pre-emption rights.

6.270. The UK system of financial commitment through sub-underwriting by a relatively concentrated number of significant UK fund-management houses had provided UK companies for many years with the benefits of speed and near certainty at a known cost. Many UK companies (particularly smaller or mid-cap companies) would think twice before too easily sacrificing these advantages. Advisers had also necessarily had to balance the benefits of support from existing shareholders, while also bringing into the equation the benefits of broadening the shareholder base and placing new shares with whatever investors were most keen to acquire them.

6.271. Cost was also an issue. Alternative fundraising structures to the traditional UK structure often involved a higher cost in return for assumed benefits of improved pricing and a broader investor base. It should be recognized that the introduction of new investors in a fundraising might alter the risk profile of the exercise and require a greater marketing effort, which entailed a higher cost, hopefully in return for greater benefits.

6.272. As a leading domestic and international house, Merrill Lynch had substantial experience of advising on and implementing fundraisings both under the UK system and alternative structures. There were features used in fundraising structures in markets other than the UK which had proved attractive to both issuers and investors. These included: the use of book building in 'secondary' or 'add-on' fundraisings; the pre-announcement of acquisitions or other deals requiring equity funding

and the marketing of the relevant investment case prior to setting and announcing the terms of the associated fundraising; and the participation of investors who were not existing shareholders on pricing terms which might be at a premium to those which existing shareholders would, if unchallenged, offer. All these features could be combined with the observation of pre-emption rights and additional flexibility introduced to the traditional UK structure, for example by way of a book-built rights issue, a pre-announced rights issue and a placing and open offer (perhaps in combination with a 5 per cent cash placing).

6.273. As a general principle, Merrill Lynch believed that greater flexibility in relation to issue structures was desirable and would allow companies to weigh their own needs against the costs associated with different structures.

6.274. Standard fees might have included some cross-subsidy for other services, for example for advisory fees, but had still on balance been lower than costs in most other international markets. Although the standard fee might appear large for a large stand-alone fundraising by a large company, it offered extremely good value for smaller companies. The use of standard fees had been advantageous for companies which would otherwise find it difficult to raise equity funds. The introduction of tendering had produced a significant saving in most of the issues where it had been used. It had also shown up quite different attitudes to sub-underwriting among institutional investors. Tendering was still developing and had not yet been tested in adverse market conditions.

6.275. The level of competition in the market was high, and ensured that fees, whether for financial advice or underwriting, were transparent to issuers. Companies did shop around for advisers and negotiated hard on fees. A financial adviser's reputation depended on the objectivity of its financial advice and it would lose far more than it would gain from forcing through an uncompetitive arrangement. At the same time, the value of advice from an institution which was unable to provide access to capital might be highly questionable. Because of the requirements for due diligence on the issuer and the investment case for the fundraising, splitting the roles of underwriter and adviser would increase the burden for the issuer.

6.276. Commenting on the hypothetical remedies set out in the issues letter (see Appendix 2.1), Merrill Lynch said that tendering of sub-underwriting should not be made mandatory, nor should a cap on fees be set; the market should decide these matters. On the proposal that companies should be required to explain to their shareholders why they had not tendered sub-underwriting, Merrill Lynch said that this would put vulnerable companies, which would be those most affected, in the glare of publicity and require them to make a potentially damaging statement to the market. As for making information about share-issuing best practice available, the competitive advisory market guaranteed at the moment that listed companies were well informed. Some relaxation of the pre-emption guidelines could have benefits. On the proposal that the identity of sub-underwriters be revealed, Merrill Lynch said that this was already relatively transparent.

Morgan Stanley Group (Europe) PLC

6.277. Morgan Stanley submitted comments on behalf of its client, The General Electric Company plc (GEC), and attended hearings. The view of both Morgan Stanley and GEC was that no particular method of underwriting was intrinsically superior to another but, rather, that UK companies should be free to choose the most appropriate method for their particular circumstances. The restrictions on choice embedded in the present system had had an adverse effect on the ability of UK companies to compete with international rivals (including those in most major continental European countries) who were free to source capital from the most cost-effective suppliers. By contrast, the existing UK underwriting system rendered domestic companies captive of a highly concentrated, solvency-orientated, institutional investor base which had become, in effect, the monopoly supplier of high-cost capital to UK industry. UK institutions had a high ratio of equity to debt in their portfolios, leading them to look to dividends to provide an income stream. This created a bias in favour of investments which produced dividends over those which produced capital growth.

6.278. For some share issues, but probably not for all, standard fees resulted in higher underwriting costs. However, the real point about standard fees was not their absolute level. The point was that they did not fluctuate, regardless of risk, the size and record of the issuer, the size and purpose of

the offering, and the investment case. Consequently, some issuers were paying too much, but more importantly, market forces were clearly not at work. The reality of rights issue pricing was that the discount was so large that the real risk (absent an extraordinary, October 1987-style event) was relatively small, leaving the commission as a disproportionate benefit for the risk assumed. In the international markets, on the other hand, there was wide differentiation in commission levels, ranging from a low of around 1.75 per cent to a high of approximately 7 per cent.

6.279. The point of Professor Marsh's study was not that it would necessarily be feasible to undertake hedging transactions in the magnitude envisaged, but rather that, in the absence of any better indicator, this methodology was the best available guide to the economic value of the implied option. The refinement to Professor Marsh's work commissioned under the Bank of England auspices (that is, the work of Breedon and Twinn) allowed for certain of the perceived shortcomings of the Marsh analysis but, nevertheless, still concluded that excess returns were earned. In any event, even if Professor Marsh was not correct, there was no justification for the invariability of underwriting and sub-underwriting fees under the present system.

6.280. The standard approach to fees created excess costs to companies, which had no choice but to pay a fixed commission of 2 per cent regardless of the company's size, the investment case, the issue, the issue size or the purpose of the offering. The trend towards tendering had so far produced a very narrow range of outcomes. In addition, to focus purely on commissions was to ignore the impact on dividends and hence on the cost of capital. In the UK, dividends were not usually adjusted downward to reflect the discount element of the new shares. Indeed, institutions discouraged companies, through the brokers, from making such adjustments. The present value of this cost, depending on the dividend growth rate and the discount rate used, could be several times the initial commission cost.

6.281. The present system did provide some advantages, including greater certainty in some situations. However, companies should be allowed to decide for themselves how important this was. For a major acquisition requiring equity up front, certainty had a value that a company might wish to pay for, even for a heavily discounted issue price. By contrast, a company seeking to raise equity to fund long-term organic growth would be far more interested in widely marketing its story in order to maximize the issue price.

6.282. The existing system facilitated large-scale acquisitions efficiently and cheaply through the cash underwriting mechanism. It was much easier in the UK system to arrange sub-underwriting with respect to an acquisition than for organic growth, particularly if the target was a public company, in which circumstances the issuer was given full value for its shares (compared with 15 to 20 per cent discount for a rights issue). However, the sub-underwriting income was allocated to a very small number of issuer shareholders (many of whom were also shareholders in the target, effectively providing unequal consideration to those holders) and was unavailable to the issuer's non-institutional investors. Furthermore, the issuer's shares were issued at the market price to the target company's shareholders (not the issuer's). This flexibility in the otherwise rigid application of pre-emption rights was not available when attempting to raise capital for organic growth, thus creating an inbuilt bias in favour of acquisition-related equity financing.

6.283. Defenders for the status quo argued that negotiated discounts and commissions would favour larger, financially stronger companies over smaller businesses that would be forced to pay higher commissions and discounts. However, this was a defence not of the current underwriting system but of cross-subsidies from larger to smaller companies, which was not a function that could or should be legitimately performed by institutional investors or brokers. Defenders of the current system also held that the lack of differentiation in pricing and commissions facilitated rapid institutional decision-making and sub-underwriting. However, this defeated the entire purpose of the capital markets, which was to allocate capital by comparing, differentiating and deciding. It was instructive that the US system, which did entail higher commissions for smaller, growth-oriented issuers, had been the world's most successful capital markets incubator for growth, technology and risk-oriented companies. Many non-US companies had preferred to access US capital markets over those in their home country, in spite of higher commissions.

6.284. There was a tacit understanding between many companies and their advisers. Under this understanding, companies recognized that the underwriting commission was beyond what was

actually earned but was nevertheless a mechanism to pay for the various services provided to the company in the previous period. Moreover, companies might pay for these services in a manner which had no impact on the company's profits (ie the expense was capitalized as a deduction from the equity proceeds).

6.285. Tendering only marginally addressed the restrictions and distortions embedded in the current system. The variability of commissions was still within a very narrow band. Tendering did nothing to address the limited group of institutions that were invited and technically able to participate in the sub-underwriting process. Also, tendering did not properly address the lead underwriters' and brokers' fees, in that the very underwriters and brokers conducting the tendering had a perverse incentive not to succeed. Morgan Stanley suspected that most of the tenders undertaken to date were for very small issues and that the tendering was done among a small circle of about five firms from within the sub-underwriters' group. For example, US mutual funds could not for legal reasons act as sub-underwriters, further restricting the pool of capital permitted to compete to supply capital on competitive terms. Moreover, this tendering was only in relation to the commission. There was still no competition over pricing, research, distribution, aftermarket support, etc, as there was now in many continental European markets. Morgan Stanley suspected that this tendering had been done primarily for demonstration purposes, prompted by scrutiny from the competition authorities.

6.286. On the question of whether the practice of linking the lead underwriter's commission to the outcome of a sub-underwriting tender reduced the lead underwriter's incentive to obtain sub-underwriting on the best terms, Morgan Stanley said that this did reduce the lead underwriter's incentive and was the exact opposite of the international system in which the underwriters were incentivized to maximize the price obtained for the company's shares by an arrangement whereby the higher the price obtained, the higher their absolute commission.

6.287. Morgan Stanley did not consider that the market for rights not taken up worked efficiently. This was one of the most arcane and least transparent parts of the entire system and, in view of its lucrative structure, was well protected by the brokers. In particular, the brokers had total discretion regarding both the allocation and price obtained for the 'rump'. This was used to favour the brokers' preferred client relationships and was an important part of the 'invisible glue' which bound the brokers and the institutions both to each other and to the present system. The losers in this were the mainly small shareholders on whose behalf the rights not taken up were placed.

6.288. The pre-emption guidelines clearly inhibited the use of anything other than rights issues by placing constraints as to size, pricing and commissions that did not apply to rights issues. These constraints limited the usefulness of the alternative methods and greatly restricted their flexibility. In turn, the effective limitation of choice compelled companies to deal only with their existing, concentrated shareholder base and precluded the introduction of competition into the supply of capital, and, therefore, increased both the cost of issuance and the cost of capital. There was little evidence that shareholders were willing, in advance of a general proposition, to waive their rights for widely-held public companies.

6.289. With regard to the impact of Takeover Panel rules, Morgan Stanley said that in reality it was the combination of the Panel rules and the bidder's typical wish to lock in its equity financing which necessitated the underwriting, rather than the Panel requirement in isolation. Underwritten cash alternatives raised more profound issues than the use of rights issues to finance offers. There was usually a significant overlap between the target shareholder register and the sub-underwriter group, which had the effect of delivering unequal reward to a select group of target shareholders.

6.290. The present system had a number of built-in barriers to entry. The brokers maintained a 'list' of sub-underwriters which was the standard group of participants in most issues. Brokers actively monitored the relationship between commissions paid to institutions from rights issues and equity-dealing commissions received by the broker from the institutions and favoured institutions that generated the most commissions for them, making it very difficult, for example, for a non-UK institution that did not generate much commission to 'break in'. It was also a system that was very much in equilibrium and therefore difficult for a new entrant to differentiate for the benefit of the other institutions (for example, by offering to underwrite for a lower price). This was because the decision regarding whom to approach for sub-underwriting was made by the brokers and not the companies. The brokers were normally unwilling even to disclose to the companies the identity of the sub-

underwriters. Thus, for example, if there were an institution which was willing to take the underwriting commitment on more favourable terms for the company, the concentrated nature of the mainstream underwriting population made that willingness moot since, unless there were sufficient other underwriters to cover the entire issue at that commission level, the lower pricing was irrelevant.

6.291. A company had to notify the LSE if replacing its financial adviser, which was then public knowledge and had to be explained. There was a presumption that changing advisers (in the absence of some manifest turmoil or personnel changes) was evidence of some underlying problem or dispute. This created a friction cost of changing named advisers. In practice, UK companies almost always selected their named financial adviser and broker to serve as underwriter and broker respectively.

6.292. In Morgan Stanley's experience, financial advisers and brokers were not willing to negotiate about underwriting fees.

6.293. Morgan Stanley commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It said that mandatory tendering would be a useful step, but only a partial remedy. Tendering would open the market to only a small circle of firms; would be for commissions only; and would relate only to sub-underwriting rather than lead underwriting. The capping of sub-underwriting fees would be impractical. Continued monitoring by the OFT would not be a useful remedy.

6.294. Morgan Stanley vigorously supported the loosening of the pre-emption guidelines. This would have a dramatic impact on the ability of UK companies to raise capital at competitive rates. It proposed that the limit be raised to 25 per cent, rather than 15 per cent. UK companies could already issue up to 25 per cent of share capital for non-cash consideration, and the rules for cash issues should be brought into conformity. In addition, the relaxation should apply to all companies, not just larger ones. In Morgan Stanley's view, the proposal that brokers should disclose the identity of sub-underwriters would bring significantly greater transparency to the sub-underwriting process. Companies should also be told how much sub-underwriting was actually paid. Furthermore, institutions should be required to disclose how much they had been paid for sub-underwriting and how these proceeds were allocated.

6.295. Morgan Stanley provided us with the results of a poll, jointly commissioned by itself and GEC, on the views of finance directors on options for raising capital. The summary of results stated:

- There was a clear and unmistakable groundswell of opinion among leading finance directors that the present options available for raising capital were too restrictive. The restrictions were inappropriate to the competence of company boards, and put Great Britain at a competitive disadvantage. The vast majority of finance directors would welcome the MMC investigation, currently focused on underwriting services, being extended to encompass all the restrictions on listed companies' ability to raise capital.
- 71 per cent of finance directors, rising to 81 per cent among the FTSE 100 companies, believed that boards' access to a variety of capital-raising options should be less restricted than at present. Half, and 61 per cent among the FTSE 100, believed the current restrictions gave a competitive advantage to other countries where greater flexibility existed.
- More specifically, three-quarters of finance directors felt the ABI/NAPF guidelines on the issue of shares for cash represented a real restriction on their choice of action. The vast majority wanted to see some loosening of the 5 per cent a year guideline; the favourite choice of FTSE 100 companies would be 25 per cent.
- There was some sympathy for the argument that a guideline was necessary to protect the interests of existing shareholders. On balance, though, that argument for the 5 per cent limit was rejected—by a two-to-one margin among the FTSE 100. There was almost unanimous agreement that the boards of large companies were competent to take such decisions.
- Taking everything into account, four out of five finance directors would support the MMC's remit being extended from the charges for underwriting services to a broader review of restrictions in the ways listed companies could raise capital. It was clear that this desire reflected widespread frustration over the present workings of the system.

6.296. Morgan Stanley added that an additional remedy in this inquiry would be to permit companies to purchase and hold in treasury for subsequent resale a significant proportion of their issued share capital, as proposed in the DTI's May 1998 Consultative Document on share buybacks. However, pre-emption rights should not be applied to the resale of such shares, as they were not issues of new shares. This would give UK companies significantly greater flexibility and discretion in the management of their capital structure and would weaken the monopoly on supply of capital currently enjoyed by the beneficiaries of the status quo. There was no reason to believe that the directors and management of UK companies would behave less responsibly with regard to the sale of treasury shares than they would with regard to any other transaction, including the issue of shares for non-cash consideration. Indeed, unlike the issue of shares for consideration other than cash (for example, asset sales), the cash consideration received in exchange for the resale of treasury shares would be fully transparent.

Noble & Company Limited

6.297. Noble & Company (Nobles) said that the standard underwriting cost of 2 per cent did not constitute a monopoly. Any company which so wished could use a non-underwritten structure or negotiate different underwriting terms. Industry standards existed in many other aspects of financial services (for example, brokerage commissions on stock exchange deals and life insurance sales). It was useful to have an industry standard which did not vary in turbulent times or with the size of company.

6.298. A forced variation from the industry standard was likely to lead to lower underwriting charges for large companies and higher underwriting charges for small companies. Increased underwriting costs could have the effect of making access to financial markets considerably more expensive for smaller companies.

6.299. The maintenance of the status quo was in the interest of smaller companies, while larger companies might be better placed to seek alternative strategies, such as a bought deal, and were usually able to obtain finer discounts due to their greater liquidity.

6.300. The best interests of the client were served by focusing on the total costs of issue. Here there was another 'industry standard' of a maximum of 4 to 5 per cent. In this respect, the UK was believed by Nobles to be among the cheaper places in the world to raise money.

6.301. Nobles added that, when it had received or shared in commissions as a lead underwriter, in each case the client had negotiated fees strenuously in the full knowledge of the fees of the lead underwriter and broker.

Panmure Gordon & Co Limited

6.302. Panmure Gordon & Co Limited submitted that the current underwriting commission structures meant that smaller, less attractive companies were subsidized in their fundraising by larger, more liquid companies which found it relatively much easier to raise equity capital. In reality, were the current system to be abolished, the costs of underwriting for the majority of companies would, in all likelihood, increase.

6.303. With respect to competition among brokers and other advisers supplying services in relation to underwriting, the system encouraged by the LSE was that each company retained a corporate stockbroker. A company was free to change its broker at any time and typically would 'beauty parade' a small number if it were dissatisfied with the present incumbent or where specialist skills might be required for specific transactions. The changing of advisers by companies was not infrequent and, if anything, appeared to be on the increase. Investment banks and brokers would often provide a range of advisory services to companies over extended periods for no (or uneconomic) fees in the expectation of an element of 'catch-up' of fees for corporate transactions when they

materialized. Thus a fee looked at in isolation might appear high but might represent a reward for additional services which had been provided over extended periods of time.

6.304. London provided a highly efficient financial market place. With the arrival in London of increasing numbers of new, powerfully capitalized international firms, competition to act on behalf of leading companies was increasing as was innovation in methods of sub-underwriting. Methods of hedging and monitoring risk had also become much more sophisticated enabling greater amounts of risk to be undertaken for relatively less reward. However, there still remained a large disparity in the way that large companies, such as FTSE constituents, and smaller companies, with market capitalizations of, say, £100 million or less, could approach the underwriting market. Competition was certainly working effectively at the smaller end of this spectrum and was steadily increasing at the larger end.

Peel, Hunt & Company Limited

6.305. Peel, Hunt & Company Limited (Peel Hunt) said that it was highly unusual in the small company sector for an issue to be primarily underwritten before a significant degree of comfort was obtained that the issue could be sub-underwritten. Accordingly, it was usual, where companies had a market capitalization of below £100 million, for fundraisings to be carried out via a book-building exercise.

6.306. The financial adviser sought a total fee for the transaction, and if the underwriting fee were lower, the advisory fee would be higher. Small companies might well be charged more if there were no standard underwriting fee. Companies were always keen to have the fees explained in the fullest detail.

6.307. Tendering of sub-underwriting would not be used for issues of £50 million or under, except in circumstances where the demand for the shares was likely to be exceptional.

6.308. Small companies preferred the open offer method to rights issues, because the discount under LSE rules was limited to within 10 per cent of the mid-market price at announcement as against the norm of 15 per cent for a rights issue, and in addition the company received the proceeds of the issue 21 days earlier as there was no nil-paid dealing period. Peel Hunt believed that the LSE and Takeover Panel rules were restrictive. It believed that the rule allowing 5 per cent of share capital to be issued pre-emptively, restricted to 7 per cent over three years, should be changed to 10 per cent a year, by resolution at the company's AGM.

6.309. Shareholders were generally unwilling to waive all their pre-emption rights, but were happy with a partially pre-emptive issue. In small companies, the major institutional shareholders would normally always be invited to be a placee in the non-pre-emptive placing.

6.310. Underwriting was not made necessary by LSE and Takeover Panel or Personal Investment Authority rules. The necessity was caused by the practical consideration of receiving all funds raised at a particular time.

6.311. The most important barrier to entry was the need to be registered by the SFA or IMRO. This could only be achieved if infrastructure and suitably qualified people were in place. In addition, lead underwriters must have the infrastructure to advise companies, the balance sheet to be able to undertake the underwriting and a reputation in the market. The brokers must have the ability and contacts to organize the sub-underwriting and thus would need to have a relationship with the potential sub-underwriters. This could only be achieved over time. Potential sub-underwriters needed to have regard to past deals involving the broker and to be suitably qualified under SFA rules. Companies would generally prefer that if the stock were left with the sub-underwriters, these holders would be prepared to hold the stock and continue to be supportive.

6.312. In the smaller company sector, there was generally a shortage of potential investors and underwriters and, therefore, any credible potential participant was considered. However, the SFA rules on private client brokers being able to allow their clients to participate in underwriting were very restrictive.

6.313. Companies did not usually engage specialist small company brokers without arranging a formal competition; and client companies regularly reported to Peel Hunt that they were being approached by competitors. This seemed to indicate sufficient competition.

6.314. Financial advisers and brokers to small companies had very much a personal relationship with their clients, and stuck with them through good times and bad. Unless the adviser or broker performed well below the company's expectations, there was usually no good reason for change. Switching costs were not usually material.

6.315. Companies were to a great extent dependent on their financial advisers and brokers in relation to share issuing and underwriting. All fees were negotiated and the underwriting fee was only one element of the total fee that a company would pay to its financial adviser and broker.

6.316. In the small company sector, it would be unusual for an organization to take the role of lead underwriter without a detailed knowledge of the company and its financial state. This could only be achieved with free access to the directors over quite a long period of time. There was thus little possibility that the role of lead underwriter would ever be undertaken by some organization other than the financial adviser without a significant additional fee being paid to allow the work to be done to get comfortable with the company.

6.317. Peel Hunt commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It considered that, where issues were below £50 million, tendering of sub-underwriting should not be made mandatory as this would add time and cost which could be little afforded by such companies. It was not in favour of setting a cap on sub-underwriting fees, as it considered that the quantum of the sub-underwriting fee should be an expression of risk to the sub-underwriter. It thought the OFT should continue monitoring for two years. It supported tendering the whole of the sub-underwriting for large companies and issues. Heightened awareness of options available would be beneficial to companies, but the tendering option would not be applicable to small companies. Pre-marketing was already standard practice as far as small companies were concerned.

6.318. Peel Hunt said that, in virtually all rights issues for small companies, the company needed to have an EGM as it would not have enough authorized share capital to make the rights issue. It considered that the length of time for dealing in nil-paid rights should not be varied as shareholders needed enough time to take up their rights.

6.319. Peel Hunt agreed that the pre-emption guidelines should be relaxed, but thought the limit should be 10 per cent (rather than the suggested 15 per cent) if the company was capitalized at less than £50 million, for the reasons given in paragraph 6.308.

6.320. On the proposed remedy that the appointment of lead underwriters and of brokers providing underwriting services for share issues should be on the basis of competitive tenders, Peel Hunt said that this, for small companies, was far too time-consuming and expensive.

6.321. On the proposed remedy that brokers should inform companies of the identity of sub-underwriters, Peel Hunt said that this was done on a regular basis throughout the course of an issue and the final allocations were usually discussed with the company.

Robert Fleming Holdings Limited

6.322. Robert Fleming Holdings Limited (Flemings) said that it believed in a flexible and competitive world and felt this was what the market was providing with regard to underwriting services. It did not believe there was a monopoly in the supply of underwriting services. Competition for financial advisory appointments was intense and active. Companies received numerous unsolicited approaches and ideas from aspiring financial advisers. The introduction of tendering for sub-underwriting had spread rapidly since 1996. Flemings was not aware of any underwriter or group of sub-underwriters influencing or attempting to influence the terms charged by their competitors.

6.323. Increasing flexibility in the structure of rights issues had led to market-driven differentiation in commission structures. Competitive tendering for sub-underwriting had now become the market norm for all except very small or very difficult issues with active competition between advisers on the structure of tender agreements. The market mechanism seemed to be thoroughly effective.

6.324. With competitive tendering for sub-underwriting now a regular practice for all significant rights issues, the cost of both primary and sub-underwriting had fallen sharply. The cost of raising equity capital in the UK was low relative to that in other financial centres.

6.325. The OFT press notice containing the terms of reference stated: 'The fees charged allowed sub-underwriters to make substantial profits'. This statement failed to recognize that sub-underwriting commission was passed on in its entirety to investment clients who were, in most instances, already shareholders in the issuing company. No benefit from sub-underwriting commission accrued to the fund management institution.

6.326. Action to dismantle the sub-underwriting mechanism would, at a stroke, undermine the rights issue mechanism. This was important because rights issues represented a key component of the position of shareholders as the owners of companies, represented by the principle of pre-emption rights. Underwriting addressed the fact that shareholders had no obligation to take up their rights, and thereby provided companies with the certainty of access to finance.

Rowan Dartington & Co Limited

6.327. Rowan Dartington & Co Limited said that, as the financial services industry had increasingly come under regulation, there had been a growing tendency to assume that traditional practices were designed to provide an easy living for practitioners rather than the product of a long period of evolution in a competitive environment. The Financial Services Act had had the effect of increasing cost for the smaller private investor and reducing the level of integrity among financial service practitioners.

6.328. Underwriting was only necessary because the financial service industry was compelled by special interest groups to handle fundraising for corporate clients in a manner which was far different from that which the industry would prefer. The two circumstances that gave rise to underwriting predominantly were rights issues and IPOs. In the case of rights issues the insistence, predominantly by institutional investors, that they should have the opportunity to subscribe to all issues of new shares for cash by companies in which they were invested, pro rata to their investment, prevented the financial services industry from using methods of fundraising for company clients which were more in those clients' interests and would not require underwriting, namely direct placings for cash. Similarly, although far more public offerings could now be executed by way of placings or book building, nonetheless there was still a clamour from the financial press for offers for sale under the fallacious idea that this would allow the general public more access to supposedly success-guaranteed new issues.

6.329. The problem brought about by rights issues and offers for sale was that the issuing broker was not able to predetermine before making the issue that there was adequate support for it. Whatever efforts were made to establish with existing shareholders their likely attitude towards a rights issue, the broker was never in a position of absolute control so that a degree of the subscription was problematic. In an offer for sale the situation was much worse since the broker had little control over any part of the initial take-up. The underwriting mechanism in consequence arose to ensure that funds were subscribed.

6.330. The broker's relationship with sub-underwriters was crucial for the development of corporate business. The maintenance of sub-underwriters' goodwill was in large measure conditional upon a track record of their rarely, if ever, being stuck with stock which they did not necessarily want as an investment. If in the judgment of the broker there was a serious risk of a rights issue not being subscribed or an offer for sale being unsuccessful, the broker would not normally proceed with that mechanism. However, so long as institutional investors were able to sustain their pre-emption rights and so long as naive pressure from the financial press and the public relations attitude of the

Government imposed offers for sale on the industry, underwriting would have to remain as the only viable method of ensuring success because in those cases the broker was unable to predetermine the degree of support.

6.331. The assumption that, if a standard fee scale did not exist, companies would be able to negotiate lower fees was extraordinarily naive. Exactly the same result would be forthcoming as had happened as a result of the abolition of commission scales. The really big companies with worldwide investment which were making major fundraising exercises would be able to negotiate the underwriting down but the smaller companies which effectively were cross-subsidized would almost certainly pay more because if an issuer had to negotiate on each and every occasion with a whole range of sub-underwriters, they would be likely to seek to price the risk more accurately, which in many cases would mean a sharp rise in costs. Moreover, common sense and natural justice suggested that only one rate of sub-underwriting should be paid. The task of negotiating with each and every sub-underwriter was simply unacceptable for an issuing broker, who would expect a very substantial increase in fees for having to take on such an unnecessary and time-wasting task.

Singer & Friedlander Limited

6.332. Singer & Friedlander Limited (Singer & Friedlander) commented on the points raised in the issues letter (see Appendix 2.1). It said that the use of standard fees had not resulted in underwriting costs being higher for small companies. Tendering of sub-underwriting might increase costs for small companies. The pre-emption guidelines probably raised the cost of issuing equity. Shareholders were generally unwilling to waive pre-emption rights other than in dire straits. Most of Singer & Friedlander's issues were non-pre-emptive. Competition among investment banks and brokers was intense to get business.

6.333. On hypothetical remedies, Singer & Friedlander was not in favour of mandatory tendering of sub-underwriting for smaller issues. This would raise costs and there was no guarantee of substantial take-up. A cap on sub-underwriting fees below current prevailing rates would severely limit the ability of companies to raise funds. On the proposal that tendering should be open to as wide a group of potential sub-underwriters as possible, Singer & Friedlander said that companies would be well advised to avoid unsophisticated sub-underwriters or ones which were not part of the investment community. It did not agree that information for companies about share-issuing best practice should encourage companies to separate the roles of financial adviser and lead underwriter, as it would be difficult to get the City to agree to this as best practice. Nor did it agree that appointments of lead underwriters and brokers should be on the basis of competitive tenders. Issues of confidentiality and price sensitivity arose and cost was not the only issue when choosing a broker.

6.334. Singer & Friedlander did not consider that the SFA should make rules requiring financial advisers and brokers to disclose to their clients the remuneration that could be earned by alternative methods of raising capital. It would be better to encourage companies to ask questions. As for the proposal that brokers disclose the identity of sub-underwriters, this already happened in practice.

Speirs & Jeffrey Ltd

6.335. Speirs & Jeffrey Ltd (Speirs & Jeffrey) said that it believed there was some form of informal cartel in the underwriting arrangements for share issues, but it was not at all sure that it operated against the public interest. In particular, it was very important to judge what was happening over a long period of time. For much of the time underwriting was unnecessary, but it became very necessary when conditions suddenly deteriorated, for example as had happened in 1987.

6.336. There was a danger of paying too much attention to this matter. The cost of underwriting was basically very low and was a small part of the cost of raising capital which in fact could be raised very cheaply in London. Whereas the direct costs, for example, in New York were less, the indirect costs were almost invariably far higher.

6.337. Speirs & Jeffrey therefore took the view that there was no need for any further investigation.

6.338. A related question was that of pre-emption rights, as there was a school of thought which argued that the underwriting problem would go away if pre-emption rights were abolished. Speirs & Jeffrey was entirely opposed to this idea. Pre-emption rights lay at the root of the UK corporate and stock exchange system. It would be the thin end of the wedge which would do down private clients to the benefit of large institutions if pre-emption rights were weakened any further.

Sutherlands Limited

6.339. Sutherlands stated that the vast majority of smaller company issues were underwritten and sub-underwritten on a standard commission structure, and there was little opportunity for reducing commissions while liquidity in that sector remained a concern. Any restrictions placed on the quantum of underwriting commissions should not be applied to smaller companies.

6.340. There was a significantly smaller pool of institutional investor interest in smaller companies, and this was perceived to increase the potential risk to sub-underwriters as, if they were required to subscribe for stock in an issue, they might be able to resell it only into an illiquid market at an indeterminate price. The conclusions reached by Professor Marsh in his study of sub-underwriting returns were based on option modelling which assumed levels of share liquidity which were generally inapplicable to smaller companies in the London market. The level of risk to sub-underwriters in the case of smaller companies arguably justified commissions which were higher rather than lower than the standard rate prescribed.

Warburg Dillon Read

6.341. Warburg Dillon Read (Warburgs) commented on the points raised in the issues letter (see Appendix 2.1). Warburgs said that lead underwriting and broking fees were ostensibly charged at a standard rate, but the percentage represented by other fees (financial and strategic advice, project management and so on) tended to vary in inverse proportion to the size of the transaction. From the underwriters' standpoint, the discount was a very real factor in assessing the risk underwritten, and this applied to all underwritten equity issues, including rights issues. The fair value of underwriting was a function of both fees and discount. However, in practice, discounts were often similar for both large and small issuers.

6.342. On the question of whether equity-issuing methods in other countries had lessons for the UK, Warburgs said that the costs of equity-raising in the USA, where non-pre-emptive issues were the norm, were generally higher on account of the greater marketing effort conducted following the launch of issues, and not because of higher underwriting fees (which were in respect of settlement risk only, ie 'soft' underwriting). The US system enabled companies to raise equity finance from a wider range of potential investors, which was of particular benefit for higher growth/higher risk listed companies with short track records. This was because they were not forced to go back to existing shareholders (who might be averse to further exposure to such stocks) for additional finance.

6.343. In addition, offering shares to all potential investors rather than just to existing shareholders enhanced the supply/demand dynamic for the issuer's shares, which tended to lift prices rather than depress them.

6.344. Warburgs believed that Professor Marsh's findings were flawed, for the following reasons:

(a) Professor Marsh used put option prices as the fair value proxy for the sub-underwriting fees. This was the same as saying that cost meant fair value. If sub-underwriters were only compensated at the break-even level, they would soon cease sub-underwriting.

(b) It was important to differentiate between the return distribution of the underlying stock and the return distribution of sub-underwriting to the sub-underwriters. Sub-underwriting was left-

skewed, meaning that large losses to the underwriter were possible, and Professor Marsh underestimated the importance of this factor. It was also important to understand that the purported 'excess' return had a large negative skew (the mean returns were less than the median returns). Generally, sub-underwriters focused more on the downside risk for each issue than on the maximum fixed returns.

- (c) Share prices in the short term were typically leptokurtic, meaning that either they did not move or they moved in jumps. This was why the stock option markets normally produced volatility term structures that were inverted (ie higher in the short term and lower in the long term). The cost of hedging leptokurtic price movements was understated using the Black-Scholes option model.
- (d) Liquidity issues were also underestimated. Placing large blocks of stock into the market place with minimal price disruption was difficult, and required a strong distribution capability (for example, equity sales force) which was costly to maintain.

6.345. The use of standard underwriting fees might benefit issuers of low quality or high volatility at the expense of issuers of high quality or low volatility. If smaller companies were forced to adopt the tender route for lead or sub-underwriting, they would either have to pay higher fees or issue their equity at deeper discounts, or both.

6.346. Warburgs said that its engagement letters separately itemized the lead underwriting, broking and advisory elements of the total fee, although the pricing of the fee taken as a whole was given closer consideration than its component parts (for the reasons set out in paragraph 6.341). Given the desire to keep things simple, the fee in respect of advice was typically the main variable. A more rigorous approach to pricing the component parts of the fee was one possibility, although it was important to remember that the fair value of underwriting was contingent upon, among other matters, the discount. Lead underwriting of an equity issue was an event which precipitated the reward, at least in part, for all the previous advisory work, ideas, market information and general client service which the financial adviser and broker often provided in the absence of any formal fee arrangement (such as a retainer). This 'catch-up' element was often built up over a period of years, and could run to many tens of thousands of pounds and more for a single client.

6.347. Tendering of sub-underwriting had heightened the competitive environment. However, this had come in the middle of a bull market, which had continued largely unchecked since 1995. In more difficult markets, tendering was likely to lead to higher fees, and might make some deals difficult to complete. As the tender process gained wider acceptance, the capping of tenders at 1.25 per cent (as currently imposed in most cases) would become increasingly hard to justify. Warburgs therefore believed that the tender mechanism would continue to gain acceptance until one company found itself paying more than the standard rate. Only at this point would the system be properly tested. At the moment, those who risked paying more than the standard rate did not utilize the tender process. Warburgs' recent experience had shown (for example, among others, the Pressac and JJB Sports rights issues, July 1998) that even when the tender route was adopted, sub-underwriters could be resistant to tendering at levels below standard rates.

6.348. Tendering was likely to become more common in the future. The likely result of this was that, on average, underwriting costs for large and high-quality issuers, whose shares were less volatile, would fall, while costs for smaller and lower-quality issuers would rise. Mandatory tendering implied either deeper discounts or higher fees, or both, for many small and mid-cap companies.

6.349. In response to the question whether the practice of linking the lead underwriter's commission to the outcome of a sub-underwriting tender reduced the lead underwriter's incentive to obtain sub-underwriting on the best terms, Warburgs said that it was in the interests of financial advisers to win repeat business from their clients, and they were therefore highly incentivized to provide them with high-quality advice in all areas, including underwriting. Any attempt to earn higher fees by advocating inappropriate structures would be short-sighted, and ultimately result in lower fees for financial advisers. In addition, some tenders in which Warburgs had recently been involved had had an arrangement whereby the broking fee was subject to an upwards ratchet in the event of a successful tender.

6.350. In response to the question why non-underwritten deep-discounted rights issues were not more widely used, Warburgs said that this method could be a viable funding route when certainty of funds was not required by the issuer, despite the exacerbated dilution effect that deep discounts had on shareholders who chose to sell their rights nil paid. Such circumstances, however, were relatively uncommon, as rights issues were usually connected to acquisitions, where vendors required certainty of funds, or urgent working capital requirements. Deep discounting did not provide the certainty which underwriting gave. It was important to remember that deep discounts, while reducing the underwriting risk, did not guarantee that shareholders would subscribe for the new shares. Deeply-discounted issues were not of themselves any more attractive to shareholders; rather it was the heightened prospect of dilution inherent in a deeply-discounted issue which made investors more likely to subscribe for the new shares. Furthermore, this might be a marginal consideration only for many shareholders, who might take the view that they did not wish to provide any more equity finance to the issuer, irrespective of the discount and dilution of control. Less significant drawbacks were the possibility of incurring CGT on the proceeds from the sale of nil-paid rights; the dislike of the adjustment of dividends to take account of the scrip element of the issue; the fact that a deep discount would lead to a lower share price; and the stigma that deeply-discounted offers were sometimes associated with distress situations.

6.351. With regard to LSE and Takeover Panel rules, Warburgs advocated a reduction of the 21-day rights issue acceptance period, which was based on historical postal timetables, to about ten business days, thereby reducing the period of exposure for underwriters, and thus lowering the fees required to compensate for this risk. In the case of share exchange takeover offers, a reduction in the timetable might not be possible as the City Code on Takeovers and Mergers, produced by the Takeover Panel, had a number of requirements dictating timetables which ensured fair treatment of all shareholders and encouraged disclosure of information.

6.352. On barriers to entry, lead underwriters and brokers needed to meet the requirements of the regulators as well as experience and market credibility. Lead underwriters also required balance sheet strength. Brokers needed distribution and risk management capabilities and strong relationships with investing institutions. Sub-underwriters needed to be an acceptable credit risk and to have a reputation as a natural investor in equities. This did not preclude smaller firms from playing an active role. In the last year there had been a number of changes to the ownership of key participants in the industry, and the competitive position had changed considerably.

6.353. The investment banking business was highly competitive. Even where there was a formal relationship in place with existing advisers, most companies would be offered products and ideas by other investment banks and brokers which were often rewarded for their efforts with a mandate. Some major firms in the UK investment banking market had chosen to exit due to the competitive nature of the business and the poor returns earned from their participation in it. Many smaller firms, however, continued to thrive, and the major accountancy firms had also entered the corporate finance market in recent years.

6.354. Splitting the roles of financial adviser and lead underwriter was not advisable, because inviting tenders for lead underwriting would lead to an unacceptable widening of the group of insiders. Splitting these roles also implied additional costs arising, particularly from the need for the lead underwriter to rely on the financial adviser's due diligence which would open up a litigation risk.

6.355. Where tensions could arise was when the adviser sought to influence the pricing of an equity issue where it was lead underwriter, but not broker. Pure advisory houses were not competent to advise on pricing and were ultimately dependent on the broker's knowledge of investing institutions and market sentiment. However, they might argue for a deeper discount than that advocated by the broker, so as to lower the risk they were underwriting. Integrated houses could advise on all aspects of a transaction, and were more prepared to take proprietary risk (though tighter pricing for the same fee, for example) on account of being prepared to be left with stock in the issuer, the trading of which was part of their everyday business.

6.356. On the question of whether there was a distinction to be made between the interests of shareholders and those of funds acting as sub-underwriters, Warburgs commented that there was usually a strong correlation between the sub-underwriting list and the share register, which militated

against conflicts of interest, because fees earned in this way were, effectively, a cost to the shareholders themselves. With regard to the private shareholder base, which was not offered the opportunity to earn sub-underwriting commissions, it should be noted that, quite apart from the logistical impossibility of offering sub-underwriting participation to all private shareholders, it was questionable whether FSA rules allowed private shareholders to be offered this type of risk.

6.357. Warburgs commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It believed that tendering should be encouraged, but that mandatory tendering would not be in the interests of many small and mid-cap issuers. The imposition of a cap on sub-underwriting fees at the proposed level of 0.5 per cent would make the procurement of sub-underwriting, and the issue of new shares, problematic for a significant proportion of issuers. Warburgs favoured an extended monitoring period, together with wider publicity for the pros and cons of tendering and deep discounts. This would have the added benefit of enabling the impact of recent events (for example, proposals regarding the buying in of treasury shares) to be evaluated.

6.358. On the proposed remedy that companies which undertook an underwritten share issue not involving tendering should be required to explain to their shareholders why they had chosen this route, Warburgs thought that this was the most practicable of all the proposals put forward and that an appropriate statement could be incorporated into the relevant associated documentation (listing particulars and circulars).

6.359. On the proposed remedy that pre-marketing of rights issues should be encouraged, Warburgs said that it was already common practice to pre-market to a limited number of institutions with a view to securing soft commitments. Pre-marketing to a significantly wider number would increase the risk of leaks and insider dealing and the creation of a false market in the shares. Institutions were prohibited from buying or selling shares in the issuer once they had been brought inside during pre-marketing and so many were unwilling to participate in the pre-marketing process.

6.360. Institutional shareholders would very likely be resistant to any erosion of their pre-emption rights. Any relaxation of pre-emption rights would require strict regulation of discounts so as to safeguard existing shareholders' value being diluted. Warburgs questioned the proposed minimum market capitalization above which pre-emption rights could be relaxed (see Appendix 2.1, paragraph 17(k)), as the benefits of attracting new shareholders might be greater for smaller companies than for larger ones.

6.361. On the proposed remedy that brokers should be required to inform companies whose share issues were being sub-underwritten who the proposed sub-underwriters were and how much sub-underwriting they would be offered, Warburgs said that the tailored lists drawn up for each new issue were a product of its experience with, and knowledge of, its institutional client base, and it considered the information to be proprietary. It was already quite common, however, for a verbal overview to be given to the issuer, which had the benefit of conveying the information while minimizing the likelihood of its being disseminated more widely.

Williams de Broë plc

6.362. Williams de Broë plc (Williams de Broë) attended a hearing and said that, in the smaller company market place, fee standardization was much less common than at the bigger end. Fees covered both advisory and distribution roles and needed, in aggregate, to recompense advisers for their work and expertise. The institutions probably regarded the commissions on larger issues as compensating for inadequate commissions, in relation to the risk involved, on smaller issues. Standard fees had the advantage that companies were able to compare their position with others in order to ensure that they were not being overcharged. Fundamentally, companies did not feel that fee levels were too high. They usually enquired in advance what the fees were going to be.

6.363. The market was competitive, certainly for IPOs. Issuers took into account when selecting financial advisers and brokers not only costs but also quality of advice and sector knowledge. A broker would not take on a small company unless there was a prospect that deals would be concluded successfully.

6.364. In charging companies, Williams de Broë distinguished between, on the one hand, advisory and documentation fees, and, on the other hand, distribution fees. Sometimes distribution fees were split between underwriting and marketing, but not always. Companies regularly asked for quotations from different advisers, certainly for IPOs. In situations where companies had had an ongoing relationship over a number of years with their financial adviser, the fees charged for a transaction would often include an element for work done over the preceding months or years but which had not been previously charged because no transaction had resulted.

6.365. Williams de Broë thought that tendering had not been greatly tested and that the issues where there had been tendering had been issues which were likely to go pretty well anyway. Sub-underwriting costs had generally not been reduced by much as a result of tendering. Smaller issues would probably take the standard fee approach.

6.366. With regard to pre-emption rights, the owners of the company ought to decide whether or not they wished to give up pre-emption rights, and generally would be averse to giving a waiver except on a case-by-case basis and depending on the particular circumstances. However, the time involved in getting shareholder approval for waiving pre-emption rights was rather long. The 21-day period during which a rights issue had to remain open could be reduced.

6.367. On the question of whether there were any difficulties about entering the sub-underwriting market, Williams de Broë said that, generally, entry was easier than ten years ago. It was relatively difficult to place sub-underwriting for companies which were capitalized at less than £30 million.

6.368. There was potential for a conflict of interest if the financial adviser was also acting as lead underwriter, but the financial adviser had a conflict in any event as to whether or not to effect a transaction, arising from the practice of success-based fees.

6.369. On hypothetical remedies (see Appendix 2.1), Williams de Broë was not in favour of tendering of sub-underwriting being made mandatory. The tendering of sub-underwriting involved a degree of additional work which would lead to potentially higher fees which might make it uneconomic for small companies to use tendering. A cap on sub-underwriting fees would not be logical as the results of tendering ought to be able to produce higher than standard fees as well as lower than standard fees. On the suggestion that companies should be required to explain to shareholders why they had not opted for tendering, Williams de Broë thought it might not be appropriate to make these discussions public. On pre-emption rights, Williams de Broë thought these should be retained in some form but it believed that the 5 per cent limit was too restrictive and should be increased to 15 per cent subject to the size of the issue being no greater than, say, £5 million (or a limit set by the Secretary of State from time to time).

6.370. Williams de Broë was in favour of permitting companies, with the agreement of their shareholders, to vary the length of the period between the announcement of a rights issue and the acceptance date. It had doubts about requiring the appointments of lead underwriters and brokers to be on the basis of competitive tendering; this would be costly and would not always be feasible because would-be tenderers would not know the company. As for the proposal that the broker should inform the company in advance of the identity of proposed sub-underwriters, Williams de Broë said that in practice this often occurred. The right of final decision as to who was offered sub-underwriting must lie with the broker and primary underwriter.

Institutional investors

3i Asset Management Ltd

6.371. 3i Asset Management Ltd believed that there was no monopoly in the supply of underwriting services. It agreed with criticisms that had been made of Professor Marsh's analysis and thought that the MMC should not rely on this evidence. The costs of raising capital in the London market, after taking into account all fees and commissions, were lower than in other major financial centres, especially for smaller and medium-sized companies. The underwriting system had the added advantage of certainty for the fundraiser. In addition, it was now the norm for sub-underwriters to tender for participation in underwriting offers which had further lowered costs.

A pensions fund manager

6.372. A pensions fund manager stressed that existing pre-emption rights should not be eroded further. While it accepted that shareholders might not wish to take up rights issues and in an individual company might decide that external offers were acceptable, it was unable to agree to any further extension of the current 5 per cent exemption. It managed its funds on behalf of the beneficiaries of the pension schemes, its clients, and, as such, their interests were paramount. It would wish to be allowed participation in all issues where its clients were existing shareholders, allowing them to make the appropriate investment decision at the time of offer, based on the terms offered.

6.373. Shares were owned either by individuals or corporations. The larger the holding, the more likely that the shareholder would have a portfolio of shares managed by a regulated fund manager. For the most part, therefore, fund managers tended to hold the great majority of shares in most companies and in larger sizes. It would be uneconomic to offer sub-underwriting to holders below a certain level of holding, or, most likely, given the proportional allocation they would receive, for those holders to consider the offer. That was why most sub-underwriting was offered to fund managers. The pensions fund manager was unable to see any way of changing this situation without either considerably raising the cost of capital or removing the rights of existing shareholders to participate and maintain their holdings.

Avon Pension Fund

6.374. The Avon Pension Fund said that in practice there had been very few occasions on which it had participated in underwriting. In the context of the remits given to its investment managers, the level of commission received (provided that it was perceived to be sufficient to compensate for the risk involved) was unlikely to be a critical factor.

AXA Sun Life Investment Management Limited

6.375. AXA SLIM said that the use of tendering in the sub-underwriting process would clearly reduce the standard fee in the short run. In the long run, it was possible that fees might go higher to reflect a changing investment climate.

6.376. AXA SLIM commented in detail on Professor Marsh's analysis. It made the following points:

- (a) The distribution of market returns was not distributed normally as assumed in the Black-Scholes formula. The leptokurtosis apparent in the return distribution had a significant impact on option prices. There was widespread evidence of this in the relationship between implied volatility and both historic and realized volatility. ('Historic' here related to the volatility obtained from periods preceding the pricing of the option and 'realized' related to out-turn volatility until expiry of the option.)
- (b) The divergence between Black-Scholes estimated values and market pricing for options was generally greatest for deeply out-of-the-money put options.
- (c) The use of historic volatilities was inappropriate as volatility during the rights issues was typically elevated.

- (d) The Breedon and Twinn study considered a biased sample of companies that had traded options. These tended to be for larger, more liquid companies.
- (e) No proper account of bid-offer spreads was included. The adjustment to the Breedon and Twinn study was likely to underestimate the spread for smaller companies which tended to have much higher bid-offer spreads on underlying equity. Furthermore the rights issue was far greater in size than normal lot size and the spread could be expected to widen to several hundred per cent of its normal size even where the risk was split among many parties. (The market impact of hedging the position would increase with the knowledge of the overall size of the rights issue.)
- (f) The use of the preceding day's closing price was inappropriate. The systematic price behaviour was a major breach of the assumptions underlying the Black-Scholes formula.
- (g) The actual level of losses incurred as measured by Marsh (1997) might be a better measure of the underlying risk. The appropriate level of losses to consider were those including the 1987 crash. (The most likely time for a large number of rights issues was when equity valuations were high and the greatest amounts of outstanding sub-underwriting would occur when markets declined from such a high point. This was coincident with the most likely scenario for an equity market crash and the volume of outstanding sub-underwriting would be a contributory factor.) The high level of volatility evidenced by over 50 per cent of the total loss emanating from one year out of ten also needed consideration.

6.377. Any system involving tendering for sub-underwriting would require considerable analysis of each company by each potential sub-underwriter. This was incompatible with the timescale over which underwriting was currently accomplished. There was a danger that such analysis would be regarded as too difficult or that the depressive effect on the share price created by the furore of sub-underwriters' analysis would become much larger than at present. There would be a tendency to delay bids to the last moment to assess the full extent to which the price was depressed. To protect against exploitation of investors and issuing companies by the underwriting community, it might be better to ensure that other methods of issuance, particularly to existing shareholders, were preserved and fostered. The fact remained that, despite the existence of other methods of issue, many companies believed the insurance offered by underwriting was worth the premium.

Baillie Gifford & Co

6.378. Baillie Gifford & Co (Baillie Gifford) said that it regarded underwriting as a fringe activity in which it would participate only if it could do so on clearly attractive terms. It accepted underwriting on behalf of clients when the issue was of stock it would be prepared to buy for clients at the issue price or when the terms of the issue were sufficiently attractively pitched that the underwriting commission offered seemed generous in relation to the risk of a stock that would have to be sold at a loss. This selective attitude meant that Baillie Gifford was almost certainly offered less than its fair share of the underwritings that arose. If there was indeed a cartel in underwriting (and Baillie Gifford had no strong views on this), then the basis for the cartel was probably the strength of the relationship between the major underwriting houses and their dependable providers of capital. Such providers were unlikely to commit freely to a new entrant and, for a company, the cost of raising new capital was of much less significance than the knowledge that the issue would succeed.

6.379. One of the features of the underwriting system as it currently operated was an element of cross-subsidization of inefficient users of capital by efficient ones. In theory this concern could be met by determining the level of underwriting commission through a Dutch auction and it was encouraging that there had been examples of such auctions. However, Baillie Gifford would like to see the auction process extended further to allow for the elimination of the underwriting commission altogether and to permit some bidding up of the issue price in a process akin to a book-building exercise.

6.380. The most obvious alternative to underwritten issues was the deep-discount issue which was not underwritten. These could be very effective, but they carried a greater risk of price instability than traditional issues. The other obvious alternative was the US-style issue, which was effected at

around the prevailing market price. However, the higher fees more than offset the attraction to existing holders of having new shares sold at the market price rather than at a discount. A further drawback in the case of US-style issues was that they involved the sacrifice of pre-emption rights. In most cases, Baillie Gifford would not consider this sacrifice an important one, but it was aware that other UK institutions attached much greater importance to the preservation of pre-emption rights.

Barclays Global Investors Limited

6.381. Barclays Global Investors Limited (Barclays Global Investors) commented on the points raised in the issues letter (see Appendix 2.1) and attended a hearing. It said that standard fees had probably increased costs for low-risk, larger companies but almost certainly benefited smaller, less liquid companies.

6.382. The excess on fees for sub-underwriting was not as great as suggested in Professor Marsh's report, for the following reasons:

- (a) When looking at returns from sub-underwriting, one must look at it from a risk-adjusted basis, which Professor Marsh had not done, both in terms of size of the company and size of issue. There was a higher probability of losses occurring with a smaller company.
- (b) Professor Marsh did not fully understand the costs involved in undertaking sub-underwriting, which significantly restricted the profitability of sub-underwriting.
- (c) While hedging the sub-underwriting exposure might help, the cost involved would be high. Also the effect of all funds short selling would be to depress the share price. This would increase the likelihood that underwriters would be left with 'stick'. More importantly, most funds in the UK were not able to short-sell securities.
- (d) Using Black-Scholes to price sub-underwriting commitments had inherent dangers. The main one was what risk-free rate to use. The other was that of volatility. When companies raised finance, this mostly involved a material change to the company's size or business, which by its very nature made historical volatility data redundant.

6.383. The tendering of sub-underwriting had balanced the risk with the reward, that is, the fee level. Most of the underwriting for larger issues was now tendered, and underwriters were competing against each other. However, the additional risk attached to smaller companies and the smaller monetary values involved restricted the scope for further extension of tendering in these cases. If smaller companies were to retain access to low-cost capital, then potential underwriters must receive an adequate reward for the greater effort needed to analyse smaller company issues.

6.384. Pre-emption rights were an important part of shareholder rights and therefore should not be given up lightly. If a deal was attractive enough, shareholders generally agreed to adjust pre-emption rights.

6.385. On the question of whether there was a serious conflict of interest arising from the financial adviser and lead underwriter roles being undertaken by the same organization, Barclays Global Investors said that confidentiality might be a key requirement in a deal and so another party involved increased the risk of information leakage. If the financial adviser and lead underwriter were separate organizations, there would be a doubling of costs because both parties would need to do research and analyse the company.

6.386. As regards the hypothetical remedies set out in the issues letter (see Appendix 2.1), Barclays Global Investors said that tendering of sub-underwriting fees was becoming the norm in most issues, but there would still be cases where standard fees would reduce the cost of raising finance for a firm. Putting a cap on fees had some merit, but it was unclear whether the definition of 'sub-underwriter' would be the fund manager or the underlying clients. Further monitoring was justified.

6.387. On the suggestion that companies be required to explain to their shareholders why they had not undertaken tendering of sub-underwriting, Barclay Global Investors said that shareholders had a duty to question the level of fees paid and check that alternative routes and advisers were considered. On the suggestion that pre-marketing be encouraged in order to secure firm commitments to take up rights issues, Barclays Global Investors said that firm commitments could not be given. If the stock price fell below the issue price, it would be wrong for a fund manager to take up the rights on behalf of clients.

6.388. Barclays Global Investors would not support the loosening of the current pre-emption guidelines.

BG Pension Funds Management Limited

6.389. BG Pension Funds Management Limited said that, for well-established companies offering shares at an attractive price in a stable market for sound business reasons, standard fees might be higher than could be achieved through negotiation. However, in less favourable circumstances, the standard fee was likely to generate greater support for the issue. The regulatory authorities should continue to let the process of tendering for sub-underwriting evolve.

6.390. Traditional sub-underwriting commissions, when compared, for example, with the expenses of book building, appeared relatively low. Mandatory tendering was unworkable and might make it more expensive for many companies to sub-underwrite. Flexibility was desirable and a prescriptive approach should be avoided.

6.391. BG Pension Funds Management Limited would not support any relaxation in the guidelines on pre-emption rights. Those rights held greater value than any notional fee reduction which might allegedly be achieved by their diminution.

Boots Pensions Ltd

6.392. Boots Pensions Ltd said that its portfolio of stocks and shares was managed, on a discretionary basis, by SIM. The trustees' management agreement with SIM did allow for sub-underwriting to be undertaken on behalf of the fund, but with certain provisos (see the discussion of the standard discretionary IFMA agreement, paragraph 3.13). SIM's sub-underwriting activity on behalf of the fund was carried out in line with current best practice and within NAPF guidelines.

Britannic Assurance PLC

6.393. Britannic Assurance PLC said that it was in the general interest that companies should have available as efficient, cheap and robust a method of raising capital as possible. Changes had recently been introduced which appeared to have improved the system, but changes should not be introduced which raised the costs or otherwise made more difficult the process of raising capital. Owners of shares should continue to have the right of first refusal when it came to the issue of further shares in order to avoid an involuntary or arbitrary dilution of their investment.

6.394. As investors, Britannic Assurance tended to underwrite only those shares which it would be prepared to hold in the longer term. It did this as a service in the expectation of some modest overall profit in return. It would not be prepared to underwrite if it expected not to be able to make a profit because of its fiduciary duties to those on whose behalf it invested.

6.395. The present underwriting system was cheap and efficient and, in particular, safeguarded the rights of shareholders as owners. The book-building system, at least in its present form, appeared unable to safeguard these rights and any loss of pre-emption rights might well cause, in the longer term, an increase in the cost of capital (to compensate for the reduction of the rights of ownership). The book-building system also appeared to involve costs of 6 per cent or more, a much higher figure than the comparable costs under the present system. The discount at which shares were offered pro

rata to existing shareholders was not a cost to the company and its shareholders, and dividends could be adjusted to reflect any bonus element.

Commercial Union Investment Management Ltd

6.396. Commercial Union Investment Management Ltd (Commercial Union) was fundamentally opposed to any disapplication of shareholders' pre-emption rights. Rather than suggesting that the pre-emption guidelines should be relaxed, it considered that they were already too loose and should be further tightened. The notion that book building was a cheaper method of raising equity was a total illusion caused by the fact that new shares appeared to be issued at a higher price than under the traditional method, whereas there was in fact a transfer of value from existing to new shareholders. This particularly disadvantaged the small personal shareholders who would not be given the opportunity to participate.

6.397. Commercial Union would therefore prefer that companies moved to issuing shares by way of deeply-discounted rights. The resolution of the taxation concerns surrounding such issues would be of considerable assistance in allowing this.

6.398. In the absence of standard underwriting fees, the cost should arguably fall for companies whose share price volatility was low, but might well rise for those whose share price volatility was high. In general, this would imply potentially higher costs for smaller companies, and lower ones for the largest companies. With regard to Professor Marsh's work, sub-underwriters did not necessarily apply the theoretical pricing of an issue in the decision to participate, but rather used their experience and judgment to determine their stance. If fee rates were forced down to levels which in the judgment of sub-underwriters did not provide adequate compensation for the risk run, sub-underwriters would simply cease to participate in the market, thereby removing the guarantee of the shares being successfully issued.

6.399. On the hypothetical remedies set out in the issues letter (see Appendix 2.1), Commercial Union would not object strongly to the use of mandatory tendering, but this would have to allow upward tendering as well as downward and result in higher costs for smaller companies in particular. The suggestion of a cap on underwriting fees appeared to have no merit or logic whatsoever. Commercial Union would be in support of continued monitoring by the OFT, but said that two years might yet be an insufficient period for further monitoring if the trend of companies' buying back rather than issuing equity persisted.

6.400. Commercial Union had doubts about the proposal that the whole of the sub-underwriting should be tendered. If all the sub-underwriting were on a tendered basis, it would have to be on the basis of a placing with potential 100 per cent clawback if the success of the issue were to be guaranteed. This somewhat increased the lottery element as far as the sub-underwriter was concerned and effectively turned into a blind auction for the whole issue.

6.401. On the proposal that the identity of sub-underwriters be disclosed in advance, Commercial Union said that the identity of sub-underwriters was, so far as it was aware, of no interest to issuing companies.

Cornhill Insurance PLC

6.402. Cornhill Insurance PLC said that while competitive tendering would reduce the underwriting bill for some companies it would undoubtedly increase it for others, perhaps especially for those with weaker balance sheets and less satisfactory trading records, in short those who might need an issue to survive. From a sub-underwriter's point of view, one failed issue could wipe several months of commission earnings overnight and under a tendering system the sub-underwriter might simply withdraw from higher-risk issues, with damaging consequences.

Foreign & Colonial Management Limited

6.403. Foreign & Colonial Management Limited (Foreign & Colonial) believed that many issuers benefited from the present methods of supply of underwriting services because they could raise capital cheaply and efficiently. If mandatory tendering were to be introduced, the present system would no longer be available as a choice. This would be a disadvantage to many issuers (and indeed Foreign & Colonial believed the current system to be cheaper and more efficient than any proposed alternative). There were circumstances where tendering the whole of the sub-underwriting would not be appropriate.

6.404. There was merit in the proposals that financial advisers should be required to inform their clients of the alternatives to underwriting at standard fees, and that companies which had not undertaken tendering of sub-underwriting should be required to explain to their shareholders why they had chosen this route. As for disseminating information about share-issuing best practice, what constituted best practice might prove to be a matter of opinion. The advantages and disadvantages of tendering for sub-underwriting should be explained so that the issuer could make an informed choice.

6.405. Deep discounting should be encouraged where the company concerned wished to avoid underwriting fees and circumstances were suitable for its use. As for encouraging the pre-marketing of rights issues, Foreign & Colonial said that there were circumstances where this would be inappropriate.

6.406. Foreign & Colonial was opposed to any relaxation of the pre-emption guidelines.

6.407. On the proposal that the identity of sub-underwriters and the amounts sub-underwritten should be disclosed to companies in advance, Foreign & Colonial saw no great harm in the proposal, but thought that the requirement should not be binding.

Guinness Flight Hambro Investment Management Limited

6.408. Guinness Flight Hambro Investment Management Limited said that the US example showed that non-standard fees failed to produce a system with a lower cost of capital. The use of standard fees had the benefit that it allowed a company easily to factor the cost of a fundraising into its relevant financial projections. There was not yet enough evidence to judge whether the introduction of tendering for sub-underwriting had removed previous distortions of competition. It was certainly making investment institutions think more dynamically of capital-raising structures. Tendering was likely to develop further, particularly for large liquid issues.

6.409. Shareholders were highly unwilling to waive their pre-emption rights. They were probably the best control over management.

Hermes Pensions Management Limited

6.410. Hermes Pensions Management Limited (Hermes) (previously PosTel), which manages most of the assets of the British Telecommunications and Post Office pension schemes, said that within the current environment the present system did provide new capital to companies at costs which compared favourably with those experienced in other jurisdictions. The conventional fee had undoubtedly been too inflexible, in that there was no correlation with risk. One of the reasons that Hermes had been reluctant to be highly active in the more recent tendering process was a question of tax. The Inland Revenue had been claiming that sub-underwriting by pension funds was a trade and therefore subject to tax. Hermes' clients had recently appealed to the Special Commissioners, who had ruled in the trustees' favour, but the High Court had allowed the appeal of the Inland Revenue against the decision (see paragraphs 5.48 and 7.206). Hermes was considering a reference to the Court of Appeal. Hermes had a strong preference for deep-discounted non-underwritten issues.

6.411. The most important issue at stake for Hermes' clients was the question of pre-emption. Those who opposed pre-emption tended to be investment banks whose ability to earn large fees on

bought deals was constrained. It was shareholders who owned companies and it was nobody's business but shareholders' to tell companies to whom their shares should be issued. Any issue which waived pre-emption would force Hermes' clients to buy more shares in the market place simply to maintain their relative exposure to the company, and also would threaten a change of effective control over which existing shareholders would have no power. Shareholders had been content to allow small waivers of pre-emption rights, but Hermes would strongly resist any attempt to force it to give up its clients' critical ownership rights.

Imperial Investments Limited

6.412. Imperial Investments Limited (Imperial Investments) said that the use of tendering for underwriting had demonstrated that for issues in large liquid stocks the underwriting costs were reduced compared with the standard fees charged previously. However, the appetite for tendering declined quite quickly in the case of medium-sized and smaller companies.

6.413. The system of tendering for sub-underwriting had reduced the costs incurred in issuing new equity by large companies, but not small companies. The process of tendering was now well established for large companies and pressure from the directors of these companies should ensure that the system endured. However, tendering of sub-underwriting was unlikely to filter down to small companies where there was some evidence that it was becoming more difficult to sub-underwrite new issues.

6.414. The key deterrent to deep-discount rights issues was CGT. The pre-emption rights for shareholders were fundamental and Imperial Investments would oppose any move to increase the current limit.

6.415. Commenting on hypothetical remedies (see Appendix 2.1), Imperial Investments said that it would favour allowing a period of further evolution to take place prior to an additional review at a later date. Tendering for larger issues was likely to become more extensive, and the prospect of a further review would maintain the pressure to provide a competitive service. However, for smaller companies, underwriting even on a fixed fee basis was often not available and could only be organized if a small number of supporters each came in for a significant tranche of the total issue. Care should be taken that any requirements or restrictions that were brought in did not stifle the smaller end of the market.

Ivory & Sime PLC

6.416. Ivory & Sime PLC (now part of Friends Ivory & Sime PLC) said that the argument for having issues of shares underwritten seemed to be based on the premise that issues had to be made at, or very close to, the prevailing market price. This required underwriters to be in place in order to guarantee that the company seeking to raise funds would be able to do so. This argument was weak. For the vast majority of cases a deep-discounted rights issue would be more appropriate. Such issues did not need to be underwritten, other than in the most extreme cases, such as a rescue-type reconstruction.

6.417. A deep-discounted rights issue was equivalent to a rights issue at par combined with a large scrip issue, the only difference being that there was no requirement that it be underwritten. Underwriting of equity issues was a cost which could, and generally should, be avoided. Traditional underwriting was simply a transfer of wealth from shareholders to underwriters, while the much-touted alternative of book building meant a transfer of wealth.

Legal & General Investment Management Limited

6.418. Legal & General Investment Management Limited (Legal & General) submitted evidence and attended a hearing. It said that the use of standard fees levelled out the cost of fundraising. The

removal of standard fees was likely to lead to lower costs for some larger companies and higher charges for some smaller companies. Standard fees had the benefit that they avoided the negative connotations of a company needing a high fee to sub-underwrite an issue and also led to a greater level of certainty about the direct cost of fundraising.

6.419. Legal & General believed that the fees paid for sub-underwriting would in the long term exceed losses incurred on issues which failed. It did not view a headline profit of 50 to 90 per cent of the fees received as necessarily indicating that fees were too high. Legal & General's clients sustained losses on BP in 1987 that exceeded several years' gross fees, and it was this 'catastrophe' risk that it viewed as more important than estimates of risk based on the average volatility of share prices. Legal & General sub-underwrote on behalf of its clients and therefore it was those clients who earned and received the sub-underwriting commission. Typically these clients were existing shareholders in the company. The absolute level of fees was therefore far less relevant than if third parties were involved in sub-underwriting and the fees were paid to non-shareholders.

6.420. The tendering of sub-underwriting had given sub-underwriters the ability to bid for more sub-underwriting if they found the issue attractive. There had been few issues involving tendering so far. Some companies wished to use standard fees and others did not; companies were not restricted to one particular method. There had been a dearth of issues involving sub-underwriting in the last year and so there was little evidence to judge whether the tendering method would prove to be a more successful method of fundraising. The change in ownership of issuing houses and the establishment in London of new stockbroking firms was likely to lead to innovation in the market for new issues. This was likely to happen without further action by the competition authorities as companies were under continual pressure to seek the most efficient source of finances. Major issues, say over £100 million, were more likely to use the sub-underwriting tendering process than small companies. The fees for large companies would fall while some smaller companies might experience higher costs.

6.421. Commenting on the hypothetical remedies set out in the issues letter (see Appendix 2.1), Legal & General felt that, because of the dearth of issues and relative stability of markets, the OFT should monitor the use of tendering for sub-underwriting for a further two years. If a cap was set on sub-underwriting fees, that was likely to lead to more issues being declined by Legal & General, which might restrict the ability of some companies to raise finance. Legal & General commented that the suggestion that a cap be set on sub-underwriting fees wrongly focused on one element of the cost of fundraising in isolation; the discount at which shares were sold should also be incorporated. The proposal that all sub-underwriting be tendered to as wide a group as possible would, Legal & General believed, destabilize the process of fundraising in London.

6.422. On the proposal that companies which undertook a share issue not involving tendering should be required to explain to their shareholders why they had chosen this route, Legal & General believed that such an explanation would be too bland to be useful. On the proposal that information for companies about share-issuing best practice be made available, Legal & General said that it was already common practice to encourage tendering for sub-underwriting and explain the advantages of deep-discounted rights issues. Pre-marketing of rights issues would be difficult to achieve within a short space of time and in secrecy, while encouraging companies to seek financial advice from more than one source was unnecessary.

6.423. Legal & General strongly opposed any proposal to loosen pre-emption rights. These were vital to the protection of shareholders. The existing system of major shareholders acting as sub-underwriters worked in the public interest because it involved the maximum retention of a company's assets by existing shareholders with little leakage to non-shareholders.

6.424. On the proposal that brokers should be required to inform companies who the proposed sub-underwriters were, Legal & General said that it supported this proposal, but public disclosure of the information might be unfair to the brokers as their client list was vital to their business.

M&G Group PLC

6.425. M&G Group PLC (M&G) submitted evidence and attended a hearing. It said that in general the use of standard fees might result in the cost of underwriting being higher than it otherwise

would be in cases of issues by larger listed companies. This was on the grounds of comparative perceived risk. Negotiation of fees could lengthen or complicate the underwriting process; where time was of the essence, standard fees could in this sense be a benefit to issuing companies.

6.426. The relative scarcity of capital raising over the last 18 months, particularly by large companies, meant that tendering had had only a marginal influence to date. Tendering was likely to develop further, and would probably lower the cost of underwriting for large issues on average but raise the cost of underwriting for small issues on average. Rescue rights might also see an increase in underwriting costs.

6.427. The pre-emption guidelines did inhibit the use of share-issuing methods other than rights issues but it was also true that the traditional method was cost competitive by international comparison and was wealth neutral for existing shareholders. It also allowed small shareholders to participate in the issue. M&G had waived pre-emption rights on occasion in the past when presented with a good case which was in the interests of shareholders, but believed it was vital that shareholders were required to vote away pre-emption rights in each specific circumstance where the issue arose before it could take place.

6.428. On barriers to entry, M&G said that sub-underwriting opportunities were in general proportionate to funds under management and the percentage of equity already held in the company in question. As to whether there were any potential sub-underwriters who were not given the opportunity to participate by brokers, opportunities were sometimes restricted to domestic investors for practical reasons of timescale and time zone. On occasion large private investors might also be excluded. Some years ago, in the mid-1980s, a pension fund based outside London had been able to participate in sub-underwriting issues by companies where it had an existing shareholding simply by asking the brokers to the issue, even though it had not previously been on their sub-underwriting list and had no other dealing relationship with that particular broker. In response to the question why sub-underwriting was so rarely undertaken by persons other than fund managers, M&G said that its funds sub-underwrote on behalf of hundreds of thousands of underlying investors. It was difficult to think of another person who could spread the reward of sub-underwriting as widely as a fund management group operating on behalf of investors. Fund managers acting on behalf of many investors would appear to be the natural first port of call for sub-underwriting.

6.429. M&G did not believe there was a distinction to be made between the interests of shareholders and those of funds acting as sub-underwriters in general. To the extent that the sub-underwriters were shareholders in the company, then there was no conflict (the more sizeable the fund management group in terms of funds managed, the more likely this was to be the case). Offering sub-underwriting to a community of shareholders should certainly reduce any conflict of interest.

6.430. Generally, M&G believed that tendering operated well in a rising stock market but could transfer excessive power to the sub-underwriters if there were few willing participants. Sub-underwriting on standard terms involved excessive risk unless the fund manager was a buyer of the shares of the company concerned at the issue price.

6.431. The cost of equity (risk-free return plus an equity risk premium) should not be confused with the cost of raising equity (expenses such as underwriting commissions, etc). The secrecy involved in issuing equity was not of fund managers' choosing and was not directly connected to pre-emption. If companies and their advisers were willing to issue information publicly before a takeover were completed, then a more open discussion of the transaction could take place. This would also make tendering for the underwriting much easier and might lead to a broadening of the participants in this process.

6.432. It was incorrect to allege that existing shareholders could demand an extra return for being required to buy more shares. Extra return could be demanded only in non-pre-emptive issues. Disapplication of pre-emption at an EGM was not a cumbersome requirement. It had been argued that, in non-pre-emptive issues, shares could be sold at a premium, but the price was often attractive only in the short term, as was instanced by the case of Colt Telecom, where the expenses of the issue were unattractive at 5.5 per cent. Supporters of pre-emption simply believed that to avoid an involuntary transfer of wealth, existing shareholders should have either first refusal or the right to

vote on the disapplication of pre-emption rights once they were in possession of up-to-date information.

6.433. The UK system could benefit from more competition, openness and innovation; this would allow some companies to reduce the cost of raising equity. Fund managers were willing to play a part through the tendering process for sub-underwriting, but the initiative on disclosure and driving down underwriting and advisory fees must come from companies themselves.

6.434. In relation to hypothetical remedies (see Appendix 2.1), M&G commented that providing capital to companies which had a properly argued case was an important responsibility, particularly for large shareholders such as itself. The current UK system of underwritten rights issues had proved to be a robust provider of capital for many years in good times and bad. The shareholders benefited from the low cash costs of UK underwriting, some of which was returned to shareholders through sub-underwriting, and a rights issue was wealth neutral for existing shareholders. The way forward had to be through educating the boards of companies about choices available to them. The tendering process should be monitored for a further period.

6.435. Asked about the proposed remedy that brokers should inform companies in advance of the proposed sub-underwriters, M&G said that it was quite in favour of that as the principle that the sub-underwriters should largely be the shareholders would then become transparent.

Mercury Asset Management Ltd

6.436. MAM said that it received no financial benefit for sub-underwriting and undertook it as a service for its clients. It was therefore in a position to put forward an unbiased view of what it believed to be in the interest of its clients who were the owners of the companies concerned.

6.437. The system of underwriting in the UK had successfully provided capital over many years in varying economic conditions. Those who were pressing to import US methods and to have more flexible fees needed to demonstrate that it would remain possible for the small company to raise capital in adverse market conditions at reasonable cost. It was by no means clear that a complex monopoly situation operated against the public interest. The simplicity of a standard structure in circumstances where quick responses were essential might be considered to justify some effective subsidy by larger issuers of smaller ones.

6.438. MAM was a committed believer in the principle of pre-emption rights for shareholders. Those pressing for other methods of raising capital appeared unwilling to accept the right of shareholders to retain control over their own companies. The suggestion that the current 5 per cent limit on non-pre-emptive issues, which was already at the outer edge of acceptability, should be raised to 15 per cent would, in MAM's view, represent an unwarranted expropriation of the rights of shareholders.

6.439. However, MAM had no wish to preserve the traditional structure if improvements could be made without sacrificing shareholders' pre-emption rights. It had initiated innovative sub-underwriting structures, and supported in appropriate cases deeply-discounted rights issues with consequential reductions in nominal dividends. It had in the past arranged on behalf of a number of clients sub-underwriting of an entire issue, for example Cairn Energy in June 1996, and cut the fee to 0.5 per cent in return for Cairn Energy raising the price. In mid-1996, MAM and PPM had jointly offered to sub-underwrite a substantial part of an issue for less than the standard fee, but were turned down by the broker concerned.

6.440. In summary, a case had not been made out for Government action, especially in view of the paucity of rights issues in the last 18 months. Tendering and other improvements would develop naturally and therefore the position should merely be kept under review for a further two years without any prejudgment of possible action at the end of that period.

National Mutual Life Assurance Society

6.441. National Mutual Life Assurance Society did not dispute the lack of competition in underwriting, nor did it dispute the current inefficiency and consequent overpricing for underwriting services. It believed that the current methods of capital-raising were both inefficient and archaic and urged the MMC to examine the unavoidable delays between the announcement of a capital-raising issue and the receipt by a company of those funds. This delay was caused principally by the strict application of pre-emption rights. The concept of pre-emption was archaic and the principal reason for the high cost of issuance both via underwriting commissions and the discount required by investors, to compensate for the risk of an adverse market movement.

6.442. The current system removed the ability of shareholders and potential shareholders to examine in advance the worthwhileness of the issue since the company was guaranteed funds once the issue was underwritten. National Mutual Life Assurance Society believed that company managements should be subject to the scrutiny of shareholders at all times and particularly when capital was being sought. It therefore believed that companies should announce their desire to raise funds and potential shareholders should bid via the market for the shares to be issued. This would promote better scrutiny of management and for successful issues reduce the cost of capital. As a *quid pro quo*, companies should be given the ability to manage their capital bases efficiently via share buy-backs and issues. The MMC should also look at the relative efficiency of corporate bond issues where there were no pre-emption rights available to existing holders.

Norwich Union Investment Management Limited

6.443. Norwich Union Investment Management Limited (Norwich Union) submitted that historic returns to sub-underwriters had not been excessive. Over the ten years to 1996, data showed a theoretical Black-Scholes value of 0.4 per cent. Over the same period, sub-underwriters earned 0.76 per cent primarily for putting their capital at risk.

6.444. There were clear cycles in financial asset prices and the corollary of the introduction of tendering for sub-underwriting fees was that although fees might fall at the moment, in other market conditions they were likely to be higher. Indeed, in certain market conditions it might prove impracticable to underwrite any issue under the tendering process for a reasonable cost (for example, sub-underwriting in Korea in the current environment).

6.445. Pre-emption rights were a fundamental principle which must not be undermined. The loss of pre-emption rights would undermine current ownership rights; reduce the accountability of management to its existing shareholders; provide scope for an entrenched management to manipulate control of the company; and ultimately result in an increase in the cost of capital, as shareholders would demand a higher return to compensate for the weakening of ownership rights.

6.446. Commenting on the hypothetical remedies set out in the issues letter (see Appendix 2.1), Norwich Union said that tendering of sub-underwriting should not be mandatory, and the setting of limits on sub-underwriting fees was not appropriate.

6.447. Norwich Union said that there should be no enforced relaxation of pre-emption rights. It was not appropriate for the MMC inquiry to determine whether or not shareholders should lose their rights. The MMC proposals amounted to a legal prescription of the extent of permissible waivers that would replace the existing freedom investors had to reach their own agreement. At the moment the 5 per cent limit could be expanded if wished, but if the MMC's proposal came into force, the limit could not be lowered from 15 per cent. Flexibility on pre-emption limits existed and it was up to companies and their shareholders to decide the appropriate levels.

Perpetual Portfolio Management Limited

6.448. Perpetual Portfolio Management Limited (Perpetual) said that any sub-underwriting activities entered into on behalf of its relevant funds were done primarily for investment management reasons on behalf of the investors in the funds. If sub-underwriting returns benefited the investors in

the funds, the returns would not be considered excessive. Seen from the share issuer's point of view, returns could be seen as excessive. The problem for issuers would be to attract fund managers to sub-underwrite an issue. If an issue were unattractive to fund managers, no sub-underwriting would be taken up.

6.449. Commenting on the hypothetical remedies set out in the issues letter (see Appendix 2.1), Perpetual said that tendering should not be made mandatory, nor should a cap be set on sub-underwriting fees. Perpetual thought the whole of the sub-underwriting should be tendered and the tender be open to as wide a group of potential sub-underwriters as possible. Financial advisers should be required to advise clients of the alternatives to underwriting at standard fees; and companies which did not tender sub-underwriting should be required to explain to their shareholders why they have chosen this route. Information for companies about share-issuing best practice should be made available and the pre-emption guidelines should be relaxed. Brokers should inform companies in advance of the identity of proposed sub-underwriters.

Prudential Portfolio Managers Limited

6.450. PPM said that market forces were likely to establish the correct price for underwriting risk. Standard fees provided a benchmark for negotiation. Commenting on our provisional conclusions on complex monopoly situations, it questioned the appropriateness of including IPOs among the issues used to define share of supply. With regard to Professor Marsh's findings, PPM said that option pricing theory was designed to price marginal transactions in a perfectly informed market. It was highly suspect to apply this theory to substantial changes in a company's equity capital when significant new information might invalidate historic share price volatility assumptions.

6.451. On the question of whether underwriting fees were sufficiently transparent, PPM said that it was incumbent upon companies to obtain information about what services they were paying for in order to safeguard the interests of their shareholders. Tendering had certainly reduced costs and pressure from companies, supported by their shareholders, would ensure that costs were minimized. Structures with tendering would continue to develop. Standard fees did result in an element of cross-subsidy to smaller, developing companies; and capital-raising costs might well have to increase for such companies. In the past, PPM had on the occasion of the [88] issue in mid-1996 offered with MAM both a reduction in the sub-underwriting fee and a reduction in the discount of the issue price, but this had not been accepted by the broker. PPM had also sought to reduce issue costs when Jarvis had a rights issue in 1996.

6.452. The pre-emption guidelines protected shareholder value, thereby significantly contributing to efficient capital-raising. The UK was very competitive internationally in this regard. When there was a good case for waiving pre-emption rights, shareholders could be expected to support it. Weaker protection of shareholders' rights of pre-emption had resulted in capital-raising costs being higher in many other countries.

6.453. On the question of why sub-underwriting was so rarely undertaken by persons other than fund managers, PPM said that sub-underwriting decisions had to be made quickly and existing shareholders were likely to have the best understanding of the company concerned. Fund management groups were now very significant shareholders and furthermore had the capital resource necessary to support sub-underwriting risk.

6.454. Intense competition prevailed within the industry generally, but established relationships based on trust and supported by a history of sound advice should not be lightly disregarded. An issue which needed careful consideration was the potential risk of price-sensitive information leaking while the company was 'shopping around' for advisers.

6.455. PPM did not believe there was a conflict of interest between funds as shareholders and as sub-underwriters. Sub-underwriters sought to price risk, while shareholders sought efficient capital-raising.

6.456. PPM commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It submitted that each underwriting and sub-underwriting had its own separate risk. While all sub-underwritings could certainly be tendered, a subsequent reduction in costs could not be guaranteed in every case. Setting a limit on sub-underwriting fees might impair the most efficient access to equity capital.

6.457. On the proposal that the OFT should continue to monitor the use of tendering for sub-underwriting for a further two years, PPM said it believed that since November 1996 more than 70 per cent of capital raised by rights issues had arisen in the context of tendered sub-underwriting. On the proposal that the whole of the sub-underwriting should be tendered and the tender should be open to as wide a group of potential sub-underwriters as possible, PPM said that the time-critical nature of sub-underwriting and the creditworthiness of potential sub-underwriters must be taken into account. More risky issues might benefit from increased confidence of outcome when less than 100 per cent was open to tender.

6.458. PPM said that continuing encouragement to companies to observe best practice was unlikely to be harmful. On pre-marketing, it had actively participated in the recent rights issue by Monument where a very concentrated shareholder register permitted such an approach.

6.459. On the proposal to relax the pre-emption guidelines, PPM said that the current level of flexibility at 5 per cent appeared to have worked well in practice, and shareholders would support different arrangements in particular instances if compelling arguments were presented. Raising the level above 5 per cent would probably inhibit the current developments of innovations with rights issue structures, and would probably result in an increased cost of capital for UK companies.

6.460. As for the proposal that brokers should be required to inform companies whose share issues were being sub-underwritten who the proposed sub-underwriters were and how much sub-underwriting they would be offered, PPM commented that it was unclear that any useful purpose would be served by this proposal.

Railways Pension Trustee Company Limited

6.461. The Railways Pension Trustee Company Limited said that, as a major institutional investor, it naturally wished to see mechanisms that reduced the cost of capital. It also considered pre-emption to be a basic shareholder right that should not be eroded. It strongly believed that the pre-emptive rights issue was an equitable and cheap method of raising capital. Book building by contrast did not guarantee shareholders the right to subscribe for their pro rata entitlement and could lead to an involuntary dilution in wealth.

6.462. The Railways Pension Trustee Company Limited was not convinced that the pre-emptive rights issue was expensive and anti-competitive. It noted the OFT's concern that there was insufficient flexibility and competition in the supply of services in relation to underwriting but did not believe that there was a monopoly, given that companies were often approached by many advisers who were in intense competition with each other to offer services for the issue. The deep-discounted rights issue was probably the cheapest form of raising capital. Evidence from the USA suggested that book building was expensive.

Schroder Investment Management (UK) Limited

6.463. SIM submitted evidence and attended a hearing. It said that it did not earn any revenue from sub-underwriting and that, for its clients, this was a *de minimis* source of revenue. It emphasized the importance it attached to the value of pre-emption rights and its opposition to any proposals which significantly weakened those rights. It was concerned that, in the interest of considering to what extent underwriting and sub-underwriting costs might have led to a cross-subsidy by strong companies of weaker companies and, possibly, to unnecessary high total fees in some cases, the cure might be substantially less satisfactory than the situation it had been designed to remedy. If issuing costs to companies were to rise as a result of MMC recommendations and shareholders' rights were under-

mined at the same time, a great disservice would have been done to the corporate sector and to the shareholders of UK quoted companies.

6.464. Historically, sub-underwriters had been encouraged to 'take the rough with the smooth' in accepting individual commitments and to take the longer view on the profitability of this activity. Prior to tendering, and looking over a period of time, this had probably resulted in sub-underwriting fees being too high for some sound companies and too low during adverse market conditions and for weaker companies.

6.465. It was too early to tell whether tendering for sub-underwriting had removed previous distortions of competition. While open competition had been evident, the period had been exceptional. Not only had most companies been so profitable and cash generative as not to need to raise new equity, but also many larger groups had been returning capital to shareholders at a time when institutional liquidity had been high. The perception of sub-underwriters had been that market risk had been low and this had spurred them to compete. In different market conditions and at higher levels of issuance the competitive spirit could quickly ebb. If the alleged distortions to competition had been removed then on similar pricing policies sub-underwriting commissions ought to be infinitely variable. In practice there was probably a level of market risk beyond which fund managers would not sub-underwrite and for which issuers would not pay the price. Whether that ceiling had been raised or lowered by tendering, now that sub-underwriters' attitudes had been re-orientated away from taking the rough with the smooth, remained to be seen.

6.466. The publicity surrounding recent tendering innovations and the very fact of the MMC inquiry had ensured that those companies which could would have their sub-underwriting tendered. The tendering process had reduced issue costs mainly at the expense of the sub-underwriter for larger and more financially sound companies. In that there was an element of fixed cost associated with an issue, there was proportionately less scope for smaller companies to benefit. If smaller companies were regarded as fundamentally more risky at any state of the market, underwriting and sub-underwriting charges could become higher in percentage terms for them as a group. A more likely development in respect of sub-underwriting commission was that if any more than the benchmark 1.25 per cent commission rate had to be offered or the commission was not subject to tender, this would be regarded as an admission of failure by the market. Consequently the issue price would be adjusted accordingly or the issue might not even take place.

6.467. SIM commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It did not consider that tendering of sub-underwriting should be mandatory. The company should be free to choose according to circumstances and its assessment of its advisers' recommendations. A cap on sub-underwriting fees might, in some market conditions, prove insufficient to attract any sub-underwriters.

6.468. Sub-underwriting which was open to all comers could increase the commercial risk of default for underwriters and ultimately raise issuing costs. Some pre-qualification was necessary. Eligibility to sub-underwrite should remain within the province of the underwriter and the broker who would know the strengths of their business associates. No evidence suggested that a wide pool of potential sub-underwriters existed. Furthermore, in many cases companies were anxious to ensure that sub-underwriters would not automatically seek to sell shares after an unsuccessful issue, but would potentially be able to hold them on an investment view. Companies might also wish to exclude certain categories of investors. It should also be borne in mind that very few sub-underwriters were likely to be available on a one-off basis. Seeking such sub-underwriters might appear to be the best way to ensure that risk was properly priced, with potential sub-underwriters pouncing on especially attractive issues and helping to drive down the costs of those issues. However, a concerted attempt to draw in a range of other sub-underwriters might attract some initial interest, but this would rapidly evaporate in the event of a failure on the scale of the 1987 BP issue. The nature of sub-underwriting, even where correctly priced, was that profits per issue were by definition small in scale and predetermined, while losses could amount to the value of the entire commitment. Those interested in a one-off involvement might well require a higher, not a lower, fee.

6.469. SIM agreed that it was in the interest of shareholders that company officials should be aware of all the possibilities and be in a position to select the most efficient option. However, it doubted that mandatory pre-marketing would be practical in all cases. It could not agree with the

suggestion that whenever possible the roles of financial adviser and underwriter should be separated. The financial adviser was in the best position to judge the risks associated with a particular client. Forcing companies to go elsewhere could raise rather than reduce costs. It had no objections, however, to companies choosing to separate the roles if they believed it was advantageous in a particular case.

6.470. SIM opposed the proposal to relax the pre-emption guidelines. It did not see that it was necessary to increase the vulnerability of shareholders for the profit of others. It might be that the UK had stronger pre-emption rights than in most other markets, but these were rights which could be seen to have provided a safeguard for good corporate governance and provided no valid grounds for their relaxation. The option always existed for shareholders to waive their rights in a good cause.

6.471. On the proposal that brokers should be required to disclose to companies the identity of proposed underwriters and amount of sub-underwriting, SIM had no objections to this suggestion and believed it might well happen already in practice.

Scottish Equitable Asset Management

6.472. Scottish Equitable Asset Management (Scottish Equitable) said that sub-underwriting was an inexpensive and efficient mechanism for both companies and shareholders. Its policy-holders had never made a significant profit from the activity. It saw the activity as vital to the functioning of a primary market and almost as a public service. It saw no conflict of interests between those of shareholders and companies in the current system. If the costs of underwriting were to be reduced, this could well impact first on more risky share issues which in many cases came from the smaller-growth companies most in need of finance.

6.473. Scottish Equitable would not agree with the proposed relaxation of the pre-emption guidelines. Institutions had a duty not only to their policy-holders but to the shareholding public in general to avoid the dilution of interest.

6.474. The use of tendering for sub-underwriting did offer choice on price. Scottish Equitable tendered for underwriting only when it already held shares in the company or had considerable knowledge of it. It was a waste of scarce and expensive analyst time to look at new, small or unknown companies for at best a marginal underwriting profit. This meant that the new tender system might disadvantage small or unglamorous companies.

6.475. Scottish Equitable suggested a further discussion period of two years, at the end of which the prevailing situation at the time should be reviewed. It should not be assumed that it would be right to make tendering of sub-underwriting mandatory at the end of that period.

6.476. The rights system offered very good value. Scottish Equitable certainly did not want the expensive US system where the very substantial fees were kept by the issuing house to the detriment of companies and shareholders.

Scottish Widows Investment Management Limited

6.477. SWIM said that it disagreed with the statement in the issues letter that, in a competitive market, one would expect lead underwriters to pay different fees to sub-underwriters in different cases (Appendix 2.1, paragraph 11). The existence of a fixed price for a particular product or service from a number of different vendors was evidence of a monopoly only if both the product or service and the price were the same. £10-worth of groceries would always cost £10, but because retailing was competitive, the quantity or quality of the groceries would vary from store to store. Similarly, no two share issues were identical. The fixed fee was therefore of no significance when other aspects of the offering varied from issue to issue.

6.478. SWIM was offered sub-underwriting at prices and on terms which had been set by others, based on their judgment of what was needed for sufficient underwriters to accept. SWIM had the option either to accept or decline on these terms. The fact that it had chosen to restrict its underwriting activity in recent years was clear evidence that it was not being over-compensated.

6.479. It was not the case that the use of standard fees resulted in the cost of underwriting for share issues of listed companies being higher than it otherwise would be. If this were the case, sub-underwriters would be asked, and be prepared to accept, sub-underwritings on finer terms, with correspondingly higher risk.

6.480. With regard to Professor Marsh's findings, SWIM doubted the validity of using an option pricing model in the circumstances of an issue which would often be accompanied by new information and changes in the company's circumstances. The impact of this on the share price would not be confined to the morning of the initial announcement.

6.481. Although underwriting and selling puts were similar mathematically, the psychology behind the two was totally different. Puts were normally sold by individuals or institutions acting on their own in a market which had many factors determining the future direction of stock price movements. Further, the other side of the trade was effectively another individual or institution. With underwriting, the other side was the company issuing the stock. There were substantially different risk characteristics involved when comparing underwriting to selling puts.

6.482. Any measurement of *ex-post* returns would be influenced by the strongly rising trend in equity markets in recent years. Sub-underwriters made rational assumptions consistent with their internal projections of market movements, but the measured outcomes during strongly rising markets would show a lower than expected proportion of failed underwritings and higher than expected profits. The opposite would of course apply in periods when market returns were below expected levels.

6.483. The measured *ex-post* returns might also not allow for the fact that the quoted price would be very 'fragile' after a failed underwriting, and it would be unable to withstand significant selling pressure. Underwriters would therefore have to release unwanted stock slowly, and the stock price was likely to under-perform during this period.

6.484. Tendering had pushed down sub-underwriting fees, but SWIM did not consider that there were or had been restrictions or distortions of competition. Tendering appeared to have worked well for issuers, and as a result it was likely to be used in an increasing proportion of issues. The increasing use of tendering had lowered average fees, and this process was likely to continue as issuers and underwriters became more familiar and comfortable with the process. Although the average fee was declining, fees would be higher for some issues which were seen as being riskier. Also, discounts might widen or the exposure period reduce to compensate for lower average fees and increased complexity.

6.485. SWIM strongly defended pre-emption rights, which were the right of the owners of a business to maintain their level of ownership in the company unless they voted otherwise. Issue costs appeared to be higher in countries where pre-emption rights had been lost, and a book-building approach was normal. The pre-emption guidelines waived pre-emption rights for small issues, when the rights mechanism might not be practical. The provision of additional flexibility could never be described as an inhibition. With regard to waiving pre-emption rights, SWIM would be very sympathetic to reasoned arguments. The issue had not arisen in very many years, suggesting that the existing framework operated very well in practice.

6.486. Sub-underwriting was a natural activity for fund managers with substantial equity holdings. So long as the sub-underwriting exposure was kept to a reasonable level, they would generally have sufficient working cash balances or anticipated cash flows to take up any unexpected commitments (within reason), and could if necessary retain any securities taken up without unduly distorting existing portfolios. Other kinds of organization acting as sub-underwriters would be required to tie up highly variable amounts of capital, and, not being natural equity investors, would be much less willing holders of any stock they had to take up. If most sub-underwriters were not fund managers, the impact on the share price when the underwriters were called on to take up stock would be much

greater, and the underwriters' losses therefore much larger. This was because the market would see that a lot of stock was in the hands of loose holders, leaving an uncertain overhang which gradually, over an indeterminate period, would filter back into the market.

6.487. There was an obvious conflict between the interests of the company (and therefore of its shareholders) to raise money on the best terms, with the greatest possible certainty and at the lowest possible cost, and the interests of sub-underwriters in maximizing their returns from this activity. If sub-underwriters also held the stock these conflicts would to some extent be neutralized. However, for most fund managers, sub-underwriting was a marginal activity so that their predominant interest was in having an efficient, orderly and cost-effective issue process for the companies they invested in, with a minimal risk of market instability when issues failed.

6.488. SWIM commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). It did not agree with the assumption underlying most of these proposals, namely that tendering always provided a more cost-effective solution. On mandatory tendering, it could not see any merit or justification in compulsion. It asked if there was any precedent for compelling companies to buy goods or services in a particular way. The suggestion of a cap on underwriting fees would merely result in larger discounts for issues perceived to be risky. Continued monitoring by the OFT would be a sensible strategy if it was considered that tendering was, in most cases, a preferable approach. As to the extent of tendering, SWIM looked at all underwritings on their merits, whether or not tendering was involved. While SWIM expected the finance director of the companies it invested in to have a very clear understanding of financial markets and an awareness of current developments, it should be 'best practice' for advisers to explain fully all the available alternatives.

6.489. As regards the suggestion that companies be required to explain to their shareholders why they had not chosen to tender sub-underwriting, SWIM said that the company's decision would have been a judgment made after weighing the advantages and disadvantages of alternative approaches. It was difficult to see how the company could say much more than this without going into commercially sensitive matters.

6.490. As regards the proposal that information for companies about share-issuing best practice should be made available, SWIM said that it did not believe tendering was necessarily always the best approach. On the suggestion that pre-marketing of rights issues be encouraged, SWIM commented that surely a 'firm commitment' was what underwriting provided; and shareholders would not make such commitments without recompense. Once pre-marketing began, the issue would become public knowledge, but would not have been sub-underwritten. The objective of the current approach was to minimize risk for the issuer by having the sub-underwriting in place as soon as possible after the issue was announced. This meant that the information given to the sub-underwriters was necessarily limited, and they would have no opportunity to question the company. Pre-marketing implied meetings with institutions which would inevitably take several days and considerably extend the risk period.

6.491. On the proposal to relax the pre-emption guidelines, SWIM considered that this would effectively remove pre-emption in most circumstances, and it was completely opposed to any change in this area.

6.492. On the proposal that the broker disclose to the company the proposed sub-underwriters, SWIM said that the only reservation it had was that its decision to decline a sub-underwriting might adversely affect its ongoing relationship with the company if the company knew that it had done so.

The Equitable Life Assurance Society

6.493. The Equitable Life Assurance Society (Equitable Life) said that it was not possible to say with any certainty whether underwriting costs would always be higher if fee rates were fixed rather than if they were not. That would depend on the circumstances of the issue (company situation, size of discount, general market environment). In some cases, one would expect a fixed rate to be lower. In any event, if the underwriting cost were higher, it did not follow that the true cost of capital was higher than if another basis of capital-raising had been adopted.

6.494. Equitable Life did not fully accept Professor Marsh's methodology, and certainly not its application to all cases of capital-raising, regardless of size and market environment. As for the

proposal of a cap on underwriting fees, there could be a benefit in knowing the cost of the underwriting aspect of capital-raising in advance so that there was no dependence on a sudden deterioration in market conditions.

6.495. Sub-underwriting fees and the service they secured were fully transparent. It was less clear that that was true in respect of lead underwriting fees. The introduction of tendering for sub-underwriting had obviously been beneficial for the modest number of companies that had adopted such a procedure in the last 18 months. It should be borne in mind, however, that the market environment had been broadly supportive over that period. There was no reason why the tendering process should be abandoned, even if the competition authorities did not press for further changes. However, if further changes were insisted upon, it was quite possible that many UK savings institutions would not continue to sub-underwrite. Such institutions had, as shareholders, not rejected a book-build alternative provided it was accompanied by the tradeability of nil-paid rights. They would, by implication, be opposed to the abandonment of pre-emption rights.

6.496. The proportion of an issue which was subject to tendering could probably increase further, but with no guarantee that the result would always be beneficial to the company. Market conditions would influence the pace of further change, if any. Smaller companies might well end up paying more, particularly given recent developments in the secondary market (ie the substantial divergence in performance of large and small company share prices and the poor liquidity of small company equity).

6.497. There were no specific barriers to entry for lead underwriters and brokers other than corporate finance expertise, though size might be a factor on occasion in respect of the lead underwriter. For sub-underwriters, the obvious barrier to entry was the availability of sufficient sterling to accept the contingent liability. Equitable Life's small percentage of amount underwritten relative to its proportion of the net secondary market would suggest that there was no current shortage of sub-underwriting capacity or any significant exclusions. A few very wealthy individuals might have the capital to sub-underwrite on an occasional basis but it was unclear who else other than savings institutions had the resource to honour the sub-underwriting obligation regularly.

6.498. Equitable Life commented on the hypothetical remedies set out in the issues letter (see Appendix 2.1). On the proposal that tendering of sub-underwriting be mandatory, it said that it really should be for companies to decide, on appropriate advice, whether or not to offer the sub-underwriting of an issue to a tendering process. If, however, there was a long-stop position of a low fixed rate, that was something of an option against sub-underwriters, who might react accordingly; so a mandatory position might be preferable, without a size hurdle. If there was no tendering, and bearing in mind that the circumstances of each issue would be different (with regard both to the company and the market), a maximum rate as low as 0.5 per cent might well persuade a lot of institutions to withdraw from sub-underwriting, since that rate would not be considered, over a variety of circumstances, to be sufficient compensation for the risk, particularly if the rate did not vary according to the length of time on risk.

6.499. Bearing in mind the small number of issues being made currently, Equitable Life believed that the OFT should continue to monitor the use of tendering for, say, two years before requiring it to be mandatory, or some other change. It would regard the tendering of 100 per cent of the sub-underwriting of an issue as undesirable, as smaller institutions would be steadily squeezed out and ultimately greater volatility and uncertainty of fees would result.

6.500. Companies should be ready to explain to shareholders why a particular route had been adopted in connection with a share issue. Compulsion might concentrate the mind, but there might on occasion be good reasons why a company might not wish to disclose publicly the reasons for a decision on underwriting.

6.501. On the suggestion that information on share-issuing best practice be made available, the availability of a document clearly setting out the matters to be considered when making a share issue might be helpful in raising the level of understanding in certain quarters. However, Equitable Life was very dubious about the concept of best practice in each aspect of the issuing process, though there were certain key principles which should govern the way in which decisions were made by

companies. In particular, it did not believe that pre-marketing, with all the associated costs, was necessary. Additionally, not all shareholders might have the capital to make such a commitment, while others might wish to reserve their position until market conditions around the subscription date were known.

6.502. The pre-emption guidelines should not be relaxed without shareholder approval in specific cases. A higher limit than 5 per cent would be acceptable only if there was an opportunity for existing shareholders to claw back their pro rata entitlement. There was no reason why size of company should be a factor in this respect.

6.503. On the proposal that brokers should be required to inform companies of the identity of proposed sub-underwriters, Equitable Life said it suspected that lists of sub-underwriting allocations were already supplied to companies. While this information was of some interest to companies, Equitable Life could not see how the information would improve the efficiency of the capital market.

The Standard Life Assurance Company

6.504. The Standard Life Assurance Company (Standard Life) attended a hearing. It said that its main concern, as a manager of funds and as a shareholder, was that the cost of capital-raising should be as low as possible. The process of capital-raising meant that the senior executives of companies needed good, confidential advice from trusted advisers, and it was sometimes not practical to change these advisers frequently. That limited the ability of issuers to seek the most competitive price for each capital-raising. Lead underwriting had to be confidential to avoid depressing the share price ahead of the issue (because if the market were forewarned of an issue, there would be no buyers of the stock, on the assumption that the new stock would come at a discount). It was difficult to achieve true competition in the relationship between companies' finance directors and their financial advisers; companies might well feel that advice from their trusted financial adviser was not a commodity on which the 'right price' could be put.

6.505. Broker services also had to be confidential but did not necessarily have to be long-standing. Competition could be achieved by inviting lead underwriters to procure binding quotations from brokers on what they would charge to procure sub-underwriting for an issue of a certain size.

6.506. Sub-underwriting was the easiest area in which to achieve competition, because sub-underwriters could refuse an offer of sub-underwriting if they wished. Competition had already been introduced to some extent by the tendering process. Currently, tenders were advertised but it was not the practice among fund managers to respond by requesting sub-underwriting; they were still offered appropriate sub-underwriting by brokers.

6.507. In 1987 Standard Life had made a loss on sub-underwriting which was about eight times its annual average profit. Inevitably the 1987 experience coloured subsequent judgment of the right price for taking sub-underwriting risk. This was not covered by Black-Scholes calculations.

6.508. Standard Life regarded sub-underwriting as marginal, and did not tender, as it felt this involved it in too much work. It was not against other people tendering, because as a shareholder it benefited from a reduction in company sub-underwriting fees. If tendering became mandatory, Standard Life would probably withdraw from sub-underwriting.

6.509. The use of standard fees had resulted in higher sub-underwriting costs than if there had been an auction. Up to about 18 months ago, there had been a wide range of discounts in rights issues, to take account of the varying risk. Discounts were now fairly standard and small companies were getting a 'free ride' to some extent by using standard fees. If more competition and more transparency were introduced, the result would probably be a greater discrepancy between easy and difficult issues. At the moment, 50 per cent maximum of the issue tended to be tendered; it was likely that this figure would be exceeded in the short term, as many sub-underwriters would simply tender at 1.25 per cent.

6.510. It was vital that pre-emption rights remained a feature of the UK equity market. These rights prevented existing owners of capital from having their ownership diluted or devalued involuntarily through the issue of shares to third parties. Some commentators claimed that the US system allowed equity capital to be raised more cheaply because the issue price was closer to the market price. What they had failed to understand was that, with pre-emption rights, the issue discount was not a cost to shareholders no matter how wide it was and under the US system fees were much higher and were a true cost to the issuing company. It was important that any solution found maintained pre-emption rights in the UK. If it proved impossible to maintain pre-emption rights and have full competition on fees, it would be far better for UK companies and shareholders to accept some limitation on competition rather than weaken these rights. It was true that pre-emption rights did not exist in the USA, but litigation was more common and if a company tried to sell on terms over which most shareholders had no control, it might well run the risk of being sued for a large sum of money. As for Europe, underwriting tended to take place at about the same kind of price as in the UK, but cross-holdings were more common and the banks had a much bigger proportion of the equity, with the result that the conflicts of interest were different. Probably the big shareholders had more power over the actions of companies than in the UK.

6.511. As regards the hypothetical remedy that the broker should disclose to the company the identity of proposed sub-underwriters and the amount of sub-underwriting offered, Standard Life said that in principle it did not have a problem with this proposal. In practice it doubted if companies would wish or be able to make constructive suggestions about sub-underwriting.

6.512. Standard Life was in favour of companies being given the option to vary the period between the announcement of a rights issue and the final acceptance, provided that this was with shareholders' permission and did not lead to disadvantages for small shareholders.

6.513. With regard to the suggestion that information for companies about share-issuing best practice should be made available, Standard Life said that good company finance directors should already be exploring with their financial advisers what options were right in particular cases. It was nervous about issuing an official version of 'best practice' for all situations.

United Friendly Asset Management Ltd

6.514. United Friendly Asset Management Ltd (United Friendly), on behalf of a number of client companies within the United Assurance Group, supported the existing arrangements for underwriting rights issues. United Friendly said that it was not at all clear that popular alternatives to sub-underwriting, such as book buildings and placings, were cheaper to operate overall, since lower price discounts were often counterbalanced by higher investment banking fees. United Friendly had reservations about the merits of book building as it inevitably involved institutions disclosing their demand and price sensitivity to the issuing company's broker, to the possible advantage of that broker.

6.515. All stock issuance came at a price to the existing shareholders; the debate should centre around how these costs were borne. The current UK system had the merit of allowing the major shareholders the opportunity, in effect, to claw back some of this expense by participating in the sub-underwriting process. Consequently, the recent trend to offer competitive tendering for sub-underwriting at reduced commission rates produced some saving in fees by the company, but at the expense of existing shareholders. All other possible alternatives allowed non-shareholders to gain at the expense of the existing shareholders.

6.516. United Friendly would be content for companies to issue stock at a deep discount, thus obviating the need for any underwriting. Revision of the tax rules would permit greater use of this method and not disadvantage personal shareholders.

Universities Superannuation Scheme Limited

6.517. The Universities Superannuation Scheme Limited said that generally companies chose to make rights issues when stock markets were rising. Only a few rights issues took place during falling markets and so, to some extent, the excess return observed by Professor Marsh was an illusion. Intuitively it was the case that most rights issues took place after the company share price had risen. The risk to the sub-underwriter was that the market would turn down. The variance used in the Black-Scholes model should be calculated at turning points in share price movements.

6.518. Pre-emption rights should be retained. In this way deep-discount rights issues would remain a viable option for companies. In addition, pre-emption was vital in ensuring equality across all constituents of the investment world. It allowed shareholders to retain their exposure to companies without the excessive costs of reinvestment. For small shareholders, stockbrokers' commission costs could be in excess of 2 per cent in addition to the spread between buying and selling prices of shares. Pre-emption maintained each shareholder's share, in percentage terms, of the company.

6.519. The Black-Scholes methodology used short-term treasury interest rates as the risk-free rate of return which was inappropriate for many of the sub-underwriters. Many were pension funds or insurance companies with large pension fund assets. For these sub-underwriters, the true risk-free cost was likely either to be the actuarial hurdle rate which was required, or the expected rise in the stock markets over the period of the sub-underwriting as money was put to one side to cover the cost of purchasing shares in the event of a sub-underwriting allocation.

6.520. The degree of charging, either through fees or price discount, levied by investment banks when taking and placing stock in the market should be examined. This should give a truer indication of charges that these firms might be expected to impose if the current system were to be replaced. It would be counterproductive to end up with a more perfect yet more expensive market.

6.521. Variable commission fees for sub-underwriting had recently been introduced. In some rights issues, institutions had been offered the opportunity to tender for further tranches of sub-underwriting. This had increased the competition for sub-underwriting allocation although to date the process had lacked a consistent approach, but nevertheless it had reduced the overall cost of the sub-underwriting service.