

16 December 2004

Natalie Davie
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Dear Ms Davie

The Impact of Shareholders' Pre-emption Rights on a Public Company's Ability to Raise New Capital

The IMA represents the UK-based investment management industry. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

As managers of investors' assets, our members have a direct interest in protecting the beneficial owners of companies from potential wealth transfer and erosion of control, which may occur without a pre-emption regime. As such our members strongly support the statutory pre-emption requirement. In addition the current ABI/NAPF Guidelines are viewed as working well.

In a broader context the concept of pre-emption and preservation of economic entitlement is completely aligned with the Government's policy of encouraging shareholder engagement with companies and the exercising of ownership rights. Any loosening of the pre-emption regime would be contrary to this policy.

With respect to the ABI/NAPF Guidelines, our members are in favour of retaining the current limits on disapplication and on discounts. To increase the annual 5% limit to say 20% would loosen the whole regime by giving too much leeway to companies to make a significant issue to third parties and thereby dilute existing shareholders' holdings. Nor would it help a company which needed to raise a significant amount of capital.

Our members regularly engage with the companies in which they invest and capital needs is one of the topics which would frequently be discussed. It is, however, clear that investors are reluctant to give companies carte blanche when it comes to capital

raising for cash, while some flexibility is desirable with respect to issuance for acquisitions. There is no evidence that the City has not been able to provide financing for a company when needed.

The IMA would support the reformation of the Pre-emption Group in order to conduct a review of the current guidelines and would be willing to nominate candidates from our membership in order to widen the representation of market practitioners. Some of our members have commented that perhaps some more flexibility could be introduced into the Guidelines, although this is not a universal view.

Some members have also commented that the six week period from announcement to completion of a rights issue could be shortened which would reduce the period companies are at risk and thereby reduce costs. Clearly the interests of the private investor would have to be taken into account should this proposal be taken forward.

With regard to the biotech industry IMA members do not believe that that sector should be made a special case, thereby setting an undesirable precedent. If the investment case is sound then those companies will be able to raise finance. It may be the case that some biotech companies come to the public market too early and that they should remain private further into their development phase. Venture capital investors tend to have more resources than conventional investors to analyse smaller companies more thoroughly. The fact is that the biotech industry comprises some 0.2% of the FT All Share Index and therefore is not an area of focus for many managers. Specialist managers who run healthcare funds do not believe that the pre-emption regime is a handicap to raising capital for biotech, but more that the UK biotech industry is less attractive on fundamentals than the US industry.

Please find our responses to the questions in the Consultation Paper in the appendix to this letter. If you have any points which you would like to discuss, please do not hesitate to contact me.

Yours sincerely

Liz Rae
Senior Adviser – Investment Operations

QUESTION 1: Are the guidelines being applied too rigidly, resulting in automatic refusals to disapply pre-emption rights regardless of individual circumstances?

There is no evidence to show that the guidelines are being applied too rigidly, and no evidence of automatic refusals to disapply pre-emption rights. Our members are of the opinion that the current guidelines work well. It is certainly the case that shareholder engagement is more developed today than when the guidelines were introduced, but our members believe that a rigorous set of guidelines is essential. There is little room for discretion in the application of pre-emption rights given their fundamental safeguard for share ownership and for the prevention of the transfer of value away from existing shareholders. The guidelines do allow, however, for a waiver of pre-emption rights should the shareholders agree.

QUESTION 2: What criteria should be used in determining whether or not to disapply pre-emption rights?

A company may have many reasons for wishing to disapply pre-emption rights. Each individual case should be assessed on its individual merits. If the disapplication might lead to serious dilution of existing shareholders, then those shareholders can refuse the waiver. If the company ignores the guidelines and dilutes existing shareholders with an issue to a third party, then that company's future cost of capital will rise.

Many of our members believe that individual shareholders should not be approached for a waiver but that the existing arrangements are the most suitable process for deciding. The reasoning behind this is that if too many companies approach their individual shareholders for disapplication, the result could be a gradual breakdown in the application of the pre-emption rights regime.

QUESTION 3: On what basis did the Pre-emption Group assert that there was no evidence of the 5 per cent limit acting as a block to capital-raising? And would it reach the same conclusions if it looked at the matter now?

Despite occasional assertions to the contrary, we are aware of no evidence of the City's failure to finance any large capital raising exercise under the pre-emption regime.

QUESTION 4: Is there a problem of perception rather than fact: that the guidelines are taken to be rules because questioning the guidance is viewed as questioning the principle of pre-emption itself?

No. The guidelines are followed because they work, and because the consequences of loosening pre-emption rights would go contrary to the Government's policy of encouraging shareholders to exercise ownership rights in their engagement with companies. The consequences of loosening the pre-emption guidelines would undermine that policy as well as the concept of long-term share ownership.

QUESTION 5: Should the criteria for determining whether or not to disapply pre-emption rights be set out in the Guidelines? What, in your view, might these criteria be?

Criteria for determining whether or not to disapply pre-emption rights vary in different circumstances and so each case should be assessed on its merits. To set out criteria whereby disapplication may be allowed would be too prescriptive and would be open to manipulation by companies' advisers.

QUESTION 6: Should the "comply or explain" or shareholder engagement models be applied to the application of pre-emption rights? And if so, how might this work in practice?

No. If explanation were sufficient, then shareholder protections could be easily disregarded which would be unacceptable. Such a model could quickly become subject to abuse by companies and their advisers. In the same way, the shareholder engagement model would not offer sufficient protection, although engagement is to be encouraged between companies and shareholders with respect to any capital raising exercise.

QUESTION 7: Is there any evidence of actions concerning alleged shareholder value abuses through non-pre-emptive issues in the US? If not, why not?

It is possible that there have been cases of shareholder value abuses in the US although none of our members has identified a specific case. Companies in the US, however, typically make less use of secondary issues than UK companies, and so the problem does not frequently arise. It is relatively rare for shareholders to sue, although they do have legal recourse against egregious behaviour, and can participate in class action suits to seek redress.

QUESTION 8: If it were possible, would it be desirable to move to a US style liability approach rather than a property approach?

No. The UK approach helps prevent serious dilution from occurring while the US approach only allows for recompense once the value destruction has taken place.

QUESTION 9: If it were not possible or desirable, would there be scope to develop the current property approach into something more flexible that allows a company to choose from various pre-emption right options?

There may be room to allow for flexibility under the current guidelines. There is, however, already a choice of fund raising mechanisms in the existing market structure, which companies can employ, as outlined in Appendix 4 in the Consultation Paper.

QUESTION 10: Do any of the existing alternative models offer a practical way around the "pre-emption" problem, in terms of both size of issue and speed?

The issue is less to do with "a practical way around the pre-emption problem", but to do with protecting existing shareholders' economic ownership. Alternative models

for share issuance, e.g. vendor placings, have developed to provide flexibility to companies making an acquisition which is logical as the acquired assets then belong to existing shareholders. The guidelines with respect to vendor placings put a limit on the discount at the time the placing is underwritten or executed which helps to protect existing shareholders.

QUESTION 11: What are the relative costs, direct and indirect, of the various models? Particularly between a placing and a rights issue?

The IMA has no hard figures but believes that the costs of a placing are higher than those of a rights issue, particularly with respect to investment banking fees.

QUESTION 12: Which sets of interested parties stand to gain from which models?

Pre-emptive underwritten rights issue: the issuer benefits from the certainty that he will obtain his funding. The investment bank benefits from underwriting and arranging fees. The shareholder is not disadvantaged as, if he declines to take up his rights, he has a tradable entitlement which he can sell in the market place.

Placings (cash, vendor, bookbuilt etc): the main beneficiary from these models is the issuer's investment bank, which typically charges higher fees for placings and will also charge a fee for arranging any hedging exercise undertaken in order to protect the issuer or vendor from price risk. Existing shareholders risk dilution, while the company may or may not have certainty of proceeds. We are not sure that there is any evidence that it is easier to raise cash in this way.

QUESTION 13: Does the window of opportunity problem occur in other industry sectors? If so, how is it addressed?

While understanding that the biotech sector suffers from considerable price volatility, our members believe that the concept of a "window of opportunity" can be exploited under the pre-emption rules. When an underwritten rights issue is launched, the company has certainty that it has raised a defined amount of cash. The window of opportunity problem does occur in other sectors, depending on market conditions, type of company etc.

QUESTION 14: Is there a good case for the different limits applicable to raising cash for acquisitions as against natural growth of the company?

While the case could be made for having the same limit on the issuance of shares for cash as for acquisitions (i.e. the 5% limit), it is probably not practical to reduce the flexibility of management in this way. With an acquisition the assets of the acquired company go on to the balance sheet of the acquirer and may produce an immediate investment return, and shareholders maintain their economic interest. Vendor placings are currently an exemption to the guidelines and should remain so rather than be a separate set of rules.

A tighter limit on cash raising should remain as the future returns on that cash will be delayed depending on the time horizon of the investment programme undertaken by the company.

QUESTION 15: *Is there any evidence of adverse consequences where non-cash assets have been issued for shares?*

We are not aware of any instances either way.

QUESTION 16: *Have any companies in this situation tried using partly-paid debt to raise cash? Is there any reason why this could not work?*

There have been instances when companies have tried this method of capital raising. Our members, however, do not find this form of issuance to be particularly attractive and believe that a company should come back to shareholders for funding as and when required in the future. This is particularly true when a company is in the early stages of development when it should not be incurring large interest costs on debt.

QUESTION 17: *Where do you believe the balance of advantage lies between the constraining effects of pre-emption rights and their safeguarding of shareholder value and owners' rights?*

IMA members believe that the pre-emption rights regime is vital to the safeguarding of ownership rights and to the prevention of the transfer of value to outsiders. There is no question of a balance of advantage, as ownership rights are so fundamental. The constraining effects of pre-emption rights are overstated.

QUESTION 18: *Why does the lack of pre-emption rights in other jurisdictions apparently not deter UK investors from investing in companies in those jurisdictions? What price, if any, do they place on the additional risk?*

Investment managers assess many factors when investing in foreign markets. The standard of corporate governance and the judicial regime with respect to shareholder and ownership rights are two of those factors, which are looked at when a foreign market is valued for its investment attractiveness.

QUESTION 19: *Are you aware of companies in the biotech or other sectors that have considered listing in the US? Has pre-emption been the deciding factor in the decision?*

Anecdotal evidence suggests that some UK companies have considered a US listing. We are not aware that pre-emption rights have been a major factor in this consideration.

QUESTION 20: *What would be the consequences of this happening – including for existing UK investors?*

In a global market place, companies are free to raise capital wherever they wish and where the cost of capital is lowest. It is the prerogative of management to do so within the existing judicial and regulatory regime. If a significant number of UK companies begin listing overseas, however, then one would question the economic and political background which was leading to an exit of capital from the UK.

A company with a UK listing, considering whether to move it to the US, would have to have the agreement of existing shareholders.

QUESTION 21: Does the growth in overseas share ownership of UK companies have implications for the universal application of UK Pre-emption Guidelines?

No. Overseas investors are free to express their views with respect to the suitability and effectiveness of the UK Pre-emption Guidelines. It has been pointed out that US investors cannot subscribe to UK rights issues due to their securities laws which require that shares are registered with the SEC before being subscribed to. The delay that this process involves means that US investors cannot subscribe to UK rights issues, but they are entitled to the nil paid rights which have a value which overseas investors appreciate.

QUESTION 22: Does the absence of specialist “boutique” investors in the UK contribute to the problem (or perceived problem) of additional capital-raising?

If the investment case is a good one, then investors, whether specialist or not, will be willing to invest. It is not clear that there is an absence of specialist investors in the UK market place. There are a number of fund management houses which have specialist healthcare funds, as well as a significant number of UK smaller company funds. Several members have pointed out however that the UK biotech sector is so small (0.2% of the FT All Share Index) that it is not an area of focus for them.

QUESTION 23: Does the lifecycle of a typical biotech company inevitably lead to it being owned by the “wrong” type of investors in the UK, but by the “right” type of investors in the US? What are “wrong” and “right” in this regard?

There is no basis to suggest that there is any difference in the type of individual investors who own biotech shares in the US and those who own those shares in the UK. Investors understand the nature of the biotech industry and that it has a lengthy development cycle.

In the US, given its more entrepreneurial culture, it is likely that scientists are more willing to join a riskier commercial venture from academia, than those in the UK. In this case the “right” investor could be the founder of the company who has the idea, who is committed to its commercial success and who understands the time period required before the company reaches profitability. UK academics are sometimes considered to be more conservative, less willing to take such a risk and to put up their own capital, although some commentators believe that this is now changing.

QUESTION 24: What consideration has been given by those unhappy with the pre-emption guidelines to either (i) staying private and raising funding through that route; or (ii) making explicit in their initial offering that investors will be afforded less pre-emption protection than is the norm?

This is outside the IMA's remit.

QUESTION 25: Are the concerns about pre-emption rights that the biotech sector has identified unique to that sector? If not, which other sectors have come across similar problems?

No. There is no case for the biotech sector to use special pleading with respect to pre-emption rights. For many reasons, there will be cases when it is inconvenient for a company to follow the pre-emption guidelines but to make an exception for one sector sets an undesirable precedent.

QUESTION 26: Is there scope to apply the guidelines differently in respect of larger and smaller companies?

No. Any case to waive the guidelines or to apply them differently should be made on a company by company basis.