THE IMPACT OF SHAREHOLDERS' PRE-EMPTION RIGHTS ON A PUBLIC COMPANY'S ABILITY TO RAISE NEW CAPITAL

AN INVITATION TO COMMENT FROM

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3rd NOVEMBER 2004

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Chapter One – context of the study

1. Purpose of study

I have been asked by DTI Science and Innovation Minister, Lord Sainsbury, to examine whether the application of pre-emption rights when new shares are issued may hinder certain public companies from raising finance flexibly for innovation and growth and, as far as there are problems, to recommend possible solutions. I aim to report back to the DTI early in the New Year.

The study follows on from representations, primarily from the biotechnology industry, that current application of pre-emption rights in the UK makes it difficult and expensive for companies to finance research and product development.

The rules for pre-emption rights for public companies are set out in part in the European Second Company Law Directive. This study is particularly timely because the European Commission has just published proposals for some immediate minor technical revisions to the directive (including on pre-emption rights) and is also planning to conduct a more thorough review of the whole area in the next couple of years. More details are set out in Chapter Two.

2. Role of the Advisory Group

I am carrying out the study with the active support of an Advisory Group, comprising members with a wide range of perspectives on the problem, acting as a sounding board for my ideas. While I have drawn on the advice of the Group and contributions from them in producing this paper, it should not be taken to represent the views of the members of the Group. It is I not the group that have determined the approach taken in the paper, and my final report will be produced on the same basis.

Meetings of the Advisory Group (see Annex A for membership) will be focussed on three points in the study process: initial evidence gathering; responses to my invitation to comment; and drawing conclusions.

3. This Paper

This paper sets out the details of the current pre-emption regime, puts them into context, and outlines what I see as the main issues. It asks a series of questions which I believe will help to move the debate forward. And it goes on to invite views on some initial ideas which might help to meet the concerns of companies and their shareholders.

The questions focus on the areas that I believe to be key. But I would welcome comments and views on any aspects of the issue which you feel are relevant.

4. How to respond to this invitation to comment

Comments should be sent, by Thursday 16 December 2004, to:

Natalia Davie
151 Buckingham Palace Road
LONDON
SW1W 9SS

Or email to: mailto:Pre-EmptionStudy@dti.gsi.gov.uk

Phone: 020 7215 1527 *or*
020 7215 6743

Further copies of this report are available from the above address or on the internet at www.dti.gov.uk/cld/current.htm

5. The final report

My report to Ministers will be published.

The report will include a list of those who have contributed to this study and it may refer to particular sources of information, evidence etc. If you do not agree to this, you must clearly ask for your response, or particular parts of it (eg where commercial-in-confidence) to be treated confidentially. Please note that many facsimile and e-mail messages carry, as a matter of course, a statement that the contents are for the eyes only of the intended recipient. In the context of this study such appended statements will not be construed as being requests for non-inclusion unless accompanied by an additional specific request for confidentiality.

Paul Myners

Chapter Two - current pre-emption rights

1. What are pre-emption rights?

The fundamental objective of pre-emption rights is to provide a company's shareholders with protection from wealth transfer and erosion of control. They do this by requiring that, whenever a company is offering new shares for cash, existing shareholders must be offered the chance to buy the shares in proportion to their existing holding before the shares are allotted to anyone else. This is designed to ensure that a company's directors cannot, against the will of its shareholders, issue shares for cash to third parties, especially at a discount to the market price.

Pre-emption rights for public companies can be waived by special resolution of shareholders, requiring a 75 per cent majority[1]. A waiver can be granted generally for all issues for a period of up to five years, or on a case-by-case basis. The statutory position regarding pre-emption is set out in the Companies Act 1985, sections 89 to 96, which in turn are derived from the EU Second Company Law Directive (adopted in 1976). The Directive, and the Act, require that where a public company is intending to issue new shares for cash, it must offer those shares first to existing shareholders unless they have previously agreed otherwise. Listing Rules also require listed companies to comply with these requirements.

i) The Pre-emption Group

The way in which the pre-emption right waiver is exercised by institutional shareholders is subject in practice to guidelines issued by a body called the Pre-Emption Group, established in 1987. The Group comprises institutional investors, listed companies, banks, the London Stock Exchange and corporate finance institutions. The guidelines state that for any new issue of shares for cash:

- the maximum amount to be issued non pre-emptively should not exceed 5 per cent of issued share capital in any one year, or over 7.5 per cent in a rolling three year period

- The discount for a non-pre-emptive issue should not exceed 5 per cent

The Guidelines have no legal force and are not referred to in the Listing Rules. But they do have considerable power because a company knows that if it wishes to have the support of the investor protection committees of the ABI and NAPF, whose members together own (on behalf of their clients)

[1] for private companies, pre-emption rights can also be waived by a provision contained in the memorandum or articles of the company. This option does not exist for public companies *(section 91 of Companies Act 1985)*

almost half of the share capital of UK companies[2], it will need to adhere to the Guidelines, or make a very strong case for a waiver. The role played by the Guidelines is described in more detail below.

Pre-emption rights are only triggered in share issues for cash. They do not apply where companies issue new shares in order to finance acquisitions or raise new capital even though such issues may also dilute the holdings of existing shareholders. Other ways of raising capital such as vendor placings (including "cash-box structures") are described below, and discussed further in Chapter Three.

2. Legal context

Under the current legislative regime, a company must not allot any 'equity securities' on any terms to a person unless it has made an offer to each 'holder' of 'relevant shares' to allot him a pro rata portion of those shares on the same or more favourable terms. These provisions are intended to protect the interests of shareholders, particularly minority shareholders, against dilution by virtue of subscriptions by new shareholders. If there were no statutory pre-emption rights then shareholders would need to look for other ways to protect their interests. One way would be to insert equivalent provisions into the company's constitution – a route that at least some companies may have adopted prior to the legislation.

Otherwise the key relevant area of company law is that of the duties of directors; the directors should not issue more shares if this is in breach of their duties.

i) Directors' duties

Directors' duties are owed to the company rather than to individual shareholders. Shareholder loss is, therefore, generally reflective of the damage suffered by the company and the plaintiff is therefore the company. There are limited circumstances which would allow shareholders to bring derivative actions against the company directly.

The directors of a company have a fiduciary duty to act *bona fide* in the interests of the company[3]. This duty of honesty and good faith is the primary fiduciary duty of a director. Furthermore, there is a duty on the directors to allot shares for a proper purpose, which is owed to shareholders directly[4].
Where a director has breached his fiduciary duties, the company has several remedies available to it. These include, among other things:

[2] National Statistics News Release: *Private individuals' shareholdings worth £204 billion at end-2003* – 10 June 2004
[3] Smith & Fawcett Ltd [1942] Ch 304, CA.
[4] Re a Company [1987] BCLC 82.

1. an injunction or declaration, chiefly to prevent a possible repeated breach;

2. rescission of a contract with the company, subject to the rights of third parties acting *bona fide* without notice and provided that it is still possible to restore the parties to their original positions;

3. removal of the director by the company in general meeting; and

4. personal liability of the directors for the breach.

Although these are enforceable remedies, they do not provide the shareholders with an automatic guarantee protecting their shareholdings.

3. Recent reviews at the European level

In 1999, the SLIM Working Group[5], which was looking at ways of simplifying company law across Europe, put forward a proposal to do away with the need for an expert report, or any specific report of the Board of Directors, when going to the general meeting of a company to seek the suspension of pre-emption rights. The High Level Group of Company Law Experts, chaired by Professor Jaap Winter, endorsed this proposal in their 2002 report as a sensible streamlining measure. The Report said

> "Currently, Article 29 §4 of the Second Directive allows the right of pre-emption to be restricted or withdrawn only if stringent formalities (shareholders resolution adopted with qualified majority, presentation by the board of a specific written report) are observed. As the SLIM Group has suggested, for listed companies it would be appropriate to allow the general meeting to empower the board to restrict or withdraw pre-emption rights without having to comply with these formalities, but only where the issue price is at the market price of the securities immediately before the issue or where a small discount to the market price is applied"[6]

As to the scope for more radical changes, the Winter Group noted (a) that the SLIM Group was not mandated to look at more radical reforms of company law, and that (b) the Winter Group's own soundings had revealed no appetite for a shift to a US style approach to capital maintenance.

Most recently, the European Commission itself, in a Paper responding to the Winter Group Report, has said that "a proposal to amend the Second Directive along these lines [ie as proposed by the SLIM and Winter Groups,

[5] SLIM stands for Simpler Legislation for the Internal Market: it is a programme designed for the simplification of EU law, managed by the Directorate-General for Internal Markets within the European Commission.
[6] Final Report of the Group on a Modern Regulatory Framework for Company Law in Europe - Nov 2002, page 84

including on pre-emption rights] is therefore regarded as a priority for the short term." [7]

The Commission Paper has subsequently been discussed in Working Groups, and a formal proposal to simplify the Second Directive was published at the end of October. As expected, the proposal on pre-emption rights is limited to the withdrawal of the requirement for directors to submit a written report to shareholders, in cases where the shares are offered at or above the market price. But in the longer term, a study into more radical reform of the 2nd Directive is promised, starting in 2005/2006.

4. Recent reviews in the UK

While the issue of pre-emption rights has not itself been the focal point of any recent reviews in the UK, it was considered in some detail as part of both the then Monopolies and Mergers Commission's 1999 Study into the market for underwriting services[8] and the independent Company Law Review comissioned by the DTI, which began in 1999.

The Monopolies and Merger Commission confessed itself divided on the existing pre-emption rights regime. Some members of the group "were sympathetic to several of the points made by critics of the existing arrangements, particularly in relation to smaller companies"; others "did not find their case a strong one".[9] Notwithstanding this division of views, the group concluded that they should not recommend any change to the pre-emption guidelines in their report on the underwriting market. This was for three reasons:

- Although relaxation of pre-emption guidelines might reduce sub-underwriting costs, it was not the case that the wider cost of issuing shares would be any lower on average for non-pre-emptive share issues

- It was by no means certain that relaxing the guidelines would have the effect of making it easier for companies to issue shares non-pre-emptively, since there was every likelihood that shareholders would ignore any new guidelines which suggested they waive these rights in ways that they disagreed with

- The Guidelines, and pre-emption rights generally, are a matter more for corporate governance than for competition policy. The review of company law provides a more appropriate context for considering the treatment of pre-emption rights.

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7 Modernising Company Law and Enhancing Corporate Governance in the EU – A Plan to Move Forward (also know as *The Action Plan*) – European Commission, May 2003

8 Underwriting Services for Share Offers – the Monopolies and Mergers Commission, February 1999

9 *Ibid* paragraph 2.165, page 40.

The Company Law Review examined the legal framework for company law in the Uk in the light of concerns that it had become “a patchwork of regulation that is immensely complex and seriously out of date”. [10]

The Review published a number of consultation documents covering many aspects of the law. The issue of pre-emption rights was dealt with in March 2000 in a document called “Developing the Framework”. It asked four questions specifically about pre-emption rights[11]:

1) Whether the Guidelines unduly restrict companies from raising capital at reasonable cost, and if so whether they should be relaxed or abandoned

2) whether the status of the Guidelines should remain as now or have a more formal status eg. as part of the Combined Code

3) whether the requirements in the Act should be repealed (seeking changes in Community law to make this possible) leaving the matter entirely to Guidelines or Combined Code-type rules

4) whether the minimum period for rights offer acceptances should be reduced from 21 days to 14 days and/or set by regulatory rules

The Review published the answers it received[12] and reached the interim conclusion that:

> “A large majority favoured retaining the present statutory pre-emption requirement. While a significant minority preferred to seek an amendment to the Second Directive which would permit the delegation of any pre-emption requirement to the status of a regulatory rule, this was not apparently seen as a high priority”
>
> “There was strong support for the retention of the pre-emption guidelines with their present content. Even organisations representing business reported that only a minority of their members found the guidelines unduly restrictive. A large majority of respondents felt that the guidelines should remain informal, as an understanding between the participants”

This was reinforced in its final conclusions.

The fourth question, concerning the minimum period for rights offer acceptances, prompted a mixed response and led the Steering Group to conclude that while this period should be maintained, the Secretary of State

[10] Company Law Reform: Modern Company Law for a Competitive Economy – DTI, March 1998
[11] These questions paraphrase the original. See Company Law Reform: Modern Company Law for a Competitive Economy; Developing the Framework (No 5) – DTI, March 2000, page 145
[12] http://www.dti.gov.uk/cld/reviews/urn00656.htm - chapter 4

should be provided with a power to vary the period by secondary legislation. This modest change is expected to be included in the forthcoming company law legislation planned by the DTI to implement the Company Law Review.

5. The role of the Pre-emption Group Guidelines

The Pre-emption Guidelines were introduced in 1987 by a group comprising representatives of listed companies, investment institutions and corporate finance practitioners. The Group was formed under the auspices of the London Stock Exchange and, up until the end of the 1990s, met at least once a year to monitor the operation of the Guidelines and to consider the continued need for such guidance.

In the Introduction to the Guidelines, it is made clear that the Guidelines are not rules:

> "Their purpose is to provide a basis of understanding between companies and investors on the circumstances in which pre-emption rights may be disapplied as allowed by section 95 of the Companies Act 1985 and the Exchange's Listing Rules.
>
> As set out in the Pre-emption Guidelines, a facility exists for consultation with the Secretaries of the Investment Committees of the Association of British Insurers and the National Association of Pension Funds in cases of doubt on the application of the Guidelines. This provides an opportunity for companies to test likely shareholder reaction to the proposed terms of a particular issue prior to a general meeting of all shareholders. The procedure appears to operate well and is particularly important in circumstances where it is proposed to issue shares on a non rights basis at a significant discount to the pre-announcement price."[13]

The Group explained that the Guidelines were being introduced to address a particular harm which they had identified:

> "The internationalisation of markets has greatly broadened the sources of finance available to UK companies. This led earlier this year to a number of non pre-emptive issues. Some of these issues allowed participation in a substantial percentage of the issued capital of the companies involved and the IPCs [the Investment Committees of the ABI and the NAPF] were also concerned at the size both of the discount from current market price and the issue expenses. This situation prompted the IPCs to issue guidelines setting out the circumstances in which they would be prepared to countenance non pre-emptive issues."[14]

The Group produced an annual letter to all listed companies from 1990 to 1999. In this letter, the Group would set out how the Guidelines had been operating in practice in the preceding year. For example, in its 1991 letter the Group said:

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[13] The Pre-Emption Group: Shareholders' Pre-Emptive Rights; Introduction (Institutional Voting Information Service website) – 199?
[14] *Ibid*

> "Since January 1990, the Investment Committees of the ABI and the NAPF have received a considerable number of enquiries involving non pre-emptive issues and approval has been given in all those instances where a reasoned supporting case has been submitted. The Pre-emption Group concluded that the procedures set up under the Pre-emption Guidelines are working satisfactory."[15]

Each letter included a statement that the Group was satisfied that the Guidelines were continuing to operate well and that there was no evidence of any adverse impact on capital-raising. The last Group letter, in 1999, stated:

> "No specific cases have arisen or been identified where the operation of the Guidelines has been found wanting either for companies or their shareholders and, again there is no evidence that the Guidelines have inhibited any company from raising capital when it wished."[16]

In summary, therefore, whilst the Guidelines do not have the force of law, they represent the views of the majority of major UK institutional investors. To avoid going against the collective wishes of the institutional investor base, corporates and advisers attempt to structure issues so that they fully comply with the Guidelines. As explained above, where there are specific circumstances where issuers believe that exceeding the Guidelines is warranted and in the best interests of shareholders as a whole, it is possible to have a specific dialogue with the Investor Protection Committees to discuss whether they would support the approach being adopted. In their 1996 joint paper, the ABI and NAPF explained that:

> "Where there are compelling reasons for disapplying pre-emption, companies can and do seek permission to do so from shareholders. When supported by appropriate justification, such permission is rarely withheld." [17]

However, there appears to be a difference in perception if not in fact around the flexibility of the guidelines. The Pre-Emption Group has not met recently, and in the years since its last review of the Guidelines there have been a number of key developments in corporate gonverance and shareholder engagement. This and the flexibility question is considered further in Chapter Three, and Chapter Four seeks views on this pivotal question.

6. The share-issuing process in practice – available models

This section and the next provide an overview of the most common methods used to raise equity capital in the UK, and compare and contrast practice here with that used in the US and continental Europe. Annex B provides further analysis and detail.

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[15] The Pre-Emption Group: Shareholders' Pre-Emptive Rights; letters
[16] *Ibid*

[17] ABI/NAPF Pre-Emption and Underwriting: Joint Position Paper – July 1996

This section does not address structures used in the IPO market as any pre-emption issues amongst the existing shareholders on an IPO are dealt with privately ahead of the listing and they therefore do not impact the methods used to raise equity on an IPO.

The equity-linked market is also not discussed separately. The same pre-emption issues apply to equity-linked issuance and therefore the structures that have evolved to market equity securities apply equally to the equity-linked market.

i) UK Offering structures

The Companies Act (and the Listing Rules) requires shareholder approval for any waiver of pre-emption rights in public companies. Such a waiver may be general, or specific, but cannot last for more than five years. In practice the issuance process in the UK is structured around the more restrictve provisions on pre-emption contained in the Pre-Emption Group/Investor Protection Committee guidelines[18]. The limiting factors set out in these rules and guidelines for the four current major methods of issuance in the UK market are as follows:

Mechanism (described in Annex B)	Size thresholds	Permissible discount[19]
Cash placing without offering existing shareholders pre-emption	Up to 5% of the issued share capital in any one year Up to a maximum of 7.5% of the issued share capital in a rolling three year period (Pre-Emption Guidelines)	5% including fees and commissions (Pre-Emption Guidelines) 10% discount permitted under the UKLA rules
Vendor placing without offering existing shareholders pre-emption	Up to 10% of the issued share capital (Pre-Emption Guidelines)	5% including fees and commissions (Pre-Emption Guidelines) 10% discount permitted under the UKLA rules[20]

[18] The pre-emption guidelines were originally issued by the Pre-Emption Group, but are now effectively the responsibility of the Investment Committees of the ABI and the NAPF (the "Investor Protection Committees"). For convenience this Paper refers to them as *the Pre-Emption Guidelines* or *the Guidelines* throughout.

[19] The method for calculating the degree of discount from the market price is set out in the Listing Rules

[20] The FSA are currently consulting on the Listing Rules. They propose to relax the 10% rule by allowing waivers.

Mechanism (described in Annex B)	Size thresholds	Permissible discount[19]
Open Offer	No restrictions on size, only limited by market capacity	No Guidelines restriction as fully pre-emptive 10% discount permitted under the UKLA rules (as above)
Rights issue	No restrictions on size, only limited by market capacity	No restriction on discount

The table demonstrates that the limiting factor in most structures in the UK tends to be the restrictions imposed by the Pre-Emption Guidelines on discounts and the sizes of non pre-emptive issuance, and Listing Rules restrictions on discounts. Annex B contains a description of these four major methods of issuance in the UK market.

The Annex also discusses a further alternative method for raising funds: **mandatorily convertible partly paid debt**. Although the issue of convertible stock is still subject to the pre-emption rules by virtue of sections 89 and 94 of the Companies Act 1985, if properly structured, the company should be able to issue shares against pre-determined trigger events as (and only if) it requires the subscription monies.

In Chapter Four, views are sought on whether these various models might offer a way forward on the pre-emption issue.

ii) UK offerings - timetables

Pre-emptive structures (rights issues and open offers) generally have more extensive timetables than non pre-emptive structures as greater time is required to allow existing shareholders to decide whether they wish to subscribe in the offering. As a consequence, from the perspective of the issuing company there is an extended period from the announcement of the funding to completion.

The timetables for non pre-emptive structures (cash placings and vendor placings) are generally significantly shorter than for pre-emptive issues and allow the issuing company to announce, price and allocate the new equity often all within one day with the funds to be received on normal settlement terms on a T+3 basis. This has obvious benefits to the issuing company in terms of speed of execution and if the transaction is underwritten, reduces the period of market risk for the underwriter.

Annex B discusses timing issues in more detail and provides a table of comparative timings.

iii) UK offerings - documentation

Pre-emptive structures (rights issues and open offers) have more extensive documentation requirements than non pre-emptive structures. For SMEs the costs of the documentation for pre-emptive structures, especially if there is a chance that the issue will fail, can be a serious impediment to fund-raising. These costs take the form of both legal and investment banking fees as well as the management effort required to produce the document, which can be significant.

7. International comparisons

i) US legal framework

In the US, there is very little by way of nationwide company law. In general it falls to the individual states to make law relating to companies. Forty-eight of the US States have pre-emptive rights statutes. However, most states allow corporations to pay stockholders to waive their pre-emptive rights, or state in their statutes that the pre-emptive right is valid only if set forth in the corporate charter. As a result, pre-emptive rights are the exception rather than the rule.

Public companies listed in the US must also comply with the rules of the market on which they list.

The New York Stock Exchange (NYSE) requires shareholder approval of:

- any issuance that will result in a change of control; and
- any issuance of ordinary shares equal to 20 per cent or more of the total votes or number of shares outstanding, other than (1) in a public offering for cash or (2) in a private offering for cash if the ordinary shares (or the ordinary shares issues upon conversion or exchange or any convertible or exchangeable securities sold) were sold at not less than the greater of the book or market value of the ordinary shares.

The NYSE also requires non-US companies to allow its US shareholders to participate in rights offerings on the same terms as their non-US shareholders, but the NYSE will grant relief if following the policy would not be feasible due to the time and expense required for US registration.

NASDAQ requires shareholder approval for:

- any issuance that will result in a change of control;
- any issuance of ordinary shares for stock or assets of another company equal to 20 per cent or more of the total votes or number of shares outstanding; or

- any issuance of ordinary shares equal (together with any ordinary shares sold by officers, directors, employees, consultants or major shareholders) to 20 per cent or more of the total votes or number of shares outstanding that is made at a price less than the greater of the book or market value of the stock, other than in a public offering.

ii) US Offering Structures

As set out above, there are no default pre-emption requirements in the US for follow-on offerings and therefore companies are not subject to the same limitations on discounts and the size of issuance compared to the UK market. The key factors that drive the decision on what offering structure to use in the US market are as follows:

- How much time is required to be spent marketing the transaction in order to attract sufficient demand for the offering at the desired price.
- Who will bear the pricing risk, the investment bank or the issuing company; and
- Whether and what type of registration or filings are required with the US Securities and Exchange Commission (SEC).

In the US, equity offerings broadly fall into two general categories: (i) marketed offerings, which include firm-commitment underwriting and best-efforts underwriting; and (ii) bought deals (most often executed through block trades). They are considered in more detail in Annex B, but in summary:

firm-commitment underwriting is the most common marketed offering arrangement in the US. In a firm-commitment underwriting, investment banks agree to purchase, as underwriters, the securities from the issuing company and then resell the securities.

An alternative to a firm-commitment underwriting is a **best-efforts underwriting**. In a best-efforts underwriting the investment bank only agrees to use its best-efforts to find investors and to help the firm sell the issue to the public but it does not actually purchase the securities. In this arrangement, the investment bank acts as an intermediary between the public and the company.

Under both of these marketed offering routes, the company generally announces its intention to issue securities and then undertakes a roadshow, which typically lasts anywhere from one day to two weeks. During the roadshow the underwriters gauge and generate interest and build a book of demand for the issue. The pricing of the securities is set at the end of the process, at the time of, or as near as possible to, the closing price, and depends on the level of demand generated during the marketing process.

In a **bought deal**, often referred to as a block trade in the US, an investment bank purchases a block of stock from the issuer at a pre-negotiated price. The bank may then choose to re-sell the stock to other investors, most often at a premium to the price which it agreed to purchase the stock. Under this structure, because the purchase and price are predetermined, all the pricing risk is passed through to the investment bank. Because there is no roadshow or pre-marketing activities the transaction may be executed in a very short time frame, generally on the same day as announcement, which minimises the bank's exposure to market risk.

Issue size is an important factor when considering which offering structure to pursue. The market capacity for a marketed offering is greater than for a bought deal, and often the larger offerings are more commonly executed through an underwriting arrangement, either by firm-commitment or best-efforts. By its nature, the marketed offering generally provides a greater opportunity to actively sell the investment proposition to the market and it is therefore more appealing when the issuance is large.

iii) European Offering Structures

All EU countries are governed by the provisions on pre-emption rights in the 2nd Company Law Directive. But those provisions are relatively permissive and hence there is some variation between the regimes in different Member States. The five biggest markets for equity issuance in the rest of Europe are France, Germany, Italy, the Netherlands and Spain. The issuance regime in each of these markets is set out in Annex B.

iv) Pre-emption rights elsewhere

In **Australia**, there are pre-emption rights but the law allows non-pre-emptive issues of up to 15 per cent every year. In **Canada** there are also pre-emption rights but the stock exchange rules permit non-pre-emptive issues of up to 25 per cent every six months. In **Japan**, there are no pre-emption rights and the board of directors of a listed company can decide to issue new shares without any shareholder action as long as the issue price of the shares is fair. But if a company contemplates the issue of new shares below the fair value of shares, shareholders' resolutions will be required in general and a two-thirds' votes is required. The purpose of this procedure is to give the shareholder an opportunity to reject the new share issue at such lower price since it has a negative impact on the economic aspects of the shareholding. This does not however guarantee the right to purchase shares in proportion to shareholding. In this sense, this shareholder approval requirement is not the same as a pre-emption right.

Moreover, if the new share issue is made at a lower price, but the new shares are allocated proportionately to all shareholders, then such shareholder approval procedure will not be required since the shareholders are given the opportunity to cover the downside of new share issue at a lower price.

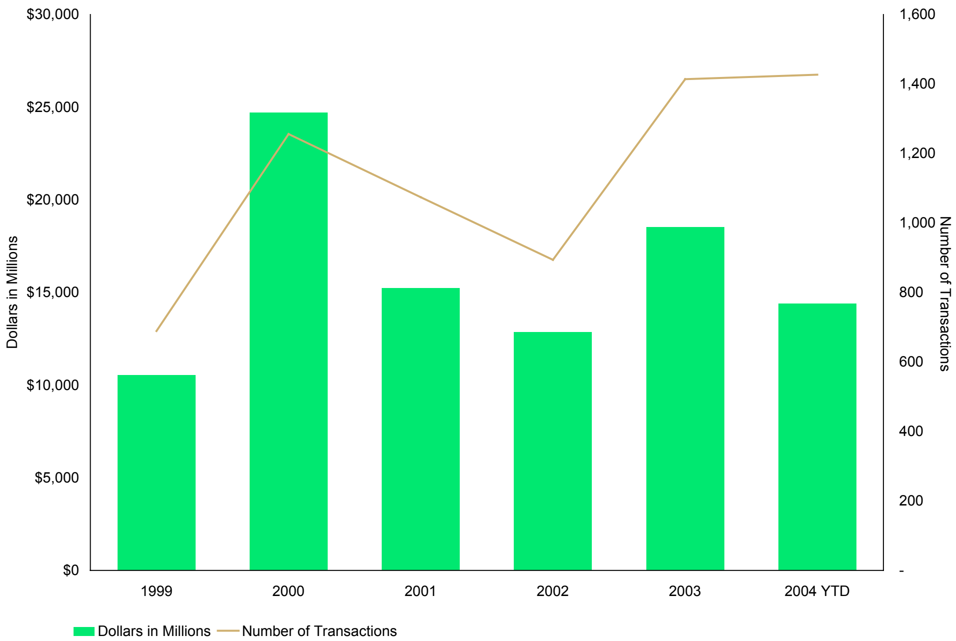
v) PIPE structures

PIPE's are Private Issues of Public Equities and are effectively placements of equity amongst a private group of shareholders. As such they fall very much into the category of non pre-emptive issuances, as there tends to be a very limited ability for existing shareholders to participate in any PIPE issuance. The structure is generally used by companies when they believe that there will be insufficient demand for their securities amongst the public markets and therefore they wish to access less mainstream investors in the private markets such as hedge funds or private equity investors.

PIPE issuance in the US

Partly due to the limited nature of pre-emption restrictions in the US, PIPE structures are prevalent in the US capital markets. In 2003 over $18bn was raised via PIPE structures in the US capital markets in a total of 1,414 transactions. Figure 4 below details the growth in PIPE transaction in the US capital markets since 1998. Annex C lists all PIPEs of over $10m completed between April and October this year in the biotechnology sector around the world.

Figure 4 – PIPE transactions in the US capital markets



Note: 2004 year to date data covers up to 30 September 2004

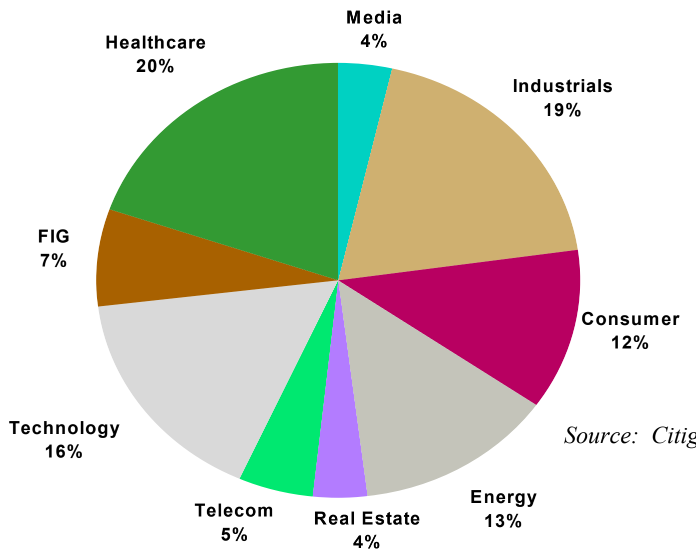
Source: Citigroup

The PIPE structure in the US capital markets is particularly attractive to issuers as it allows a placement of securities to occur without waiting for registration by the SEC. The securities are placed with investors at the outset in unregistered form with registration typically occuring after a further 90 days, at which point the securities become fungible with the existing quoted stock. Due to the absence of requirement for prior SEC registration the PIPE issuance structure is extremely flexible in terms of timing and US corporates can therefore take advantage of windows of opportunity for issuance that would not necessarily be open to them under a standard equity offering structure.

Securities issued via the PIPE structure are aimed at the more risk tolerant investors as they involve a period when securities are unlisted and therefore less liquid. As the structure has developed in the US the investor universe has broadened to include traditional institutional investors, venture capital firms, financial sponsors and hedge funds although it is understood that hedge funds remain the dominant investor in these structures, reflecting their risk appetite.

The split of PIPE issuance by sector in the US is illustrated in Figure 5 below.

Figure 5 – PIPE issuance in the US capital markets by sector 1 January 2003 – 30



Source: Citigroup

September 2004 ($ Raised)

The Healthcare and Technology sectors have seen significant equity issuance using PIPE structures. This is primarily due to the repeated funding rounds undergone by early stage technology and biotech companies and the ability through PIPEs to take advantage of windows of demand without the need to have completed the Securities and Exchange Commission (SEC) registration process prior to issuance.

The need to raise equity in this manner is often a feature of companies in the early stages of their development. The PIPE issuance market therefore tends to be dominated by smaller companies; in the US capital markets in 2003 and 2004 year to date over 90 per cent of PIPE transactions by number occurred for companies with market capitalisations of below $250 million. Figure 6 below illustrates this data.

Figure 6 – PIPE issuance in the US market 1 January 2003 – 31 December 2003 (number of transactions)

Market Capitalisation	2003		2004 YTD	
$500m +	67	5%	48	3%
$250m - $500m	70	5%	58	4%
$100m - $250m	224	16%	200	14%
$25m - $50m	551	39%	539	38%
< $25m	502	36%	582	41%
Total	**1,414**		**1,427**	

Source: Citigroup – YTD data up to 30 September 2004

UK and European PIPE issuance

PIPE structures might be expected to have particular appeal to smaller companies that seek a high degree of flexibility and speed of issuance coupled with the ability to target new investors. However, as PIPE structures for public companies involve the issue of equity, or equity-linked securities, they are subject to pre-emption rights in the same way as a straight issue of equity would be. Reasons why PIPEs have not been widely used in Europe appear to include:

- The perception of a rigid approach by existing investors to pre-emption rights restricting the ability to offer large amounts of equity to new investors
- Lack of clarity on disclosure requirements and the extent that information can be provided to potential new investors without breaching selective disclosure regulations
- A less well developed, and limited, universe of potential European PIPE investors. The lack of experienced European PIPE investors is not however believed to be a limiting factor as it is anticipated that the larger participants in the US PIPE market would be prepared to invest into European PIPE structures alongside specialist European smaller capitalisation investors.
- Lack of a concept of registration (and hence pre-registration) in the UK/European model

To date, the limited PIPE issuance in Europe has been driven by founder shareholders selling stock to drive liquidity (secondary share sales) or by companies seeking to raise funds in a period of financial distress.

Chapter Three – current concerns

1. The Biotech industry and its concerns

While pre-emption rights apply to all sectors, certain circumstances make this a particular issue for high-technology, capital-hungry companies operating in volatile markets; including the biotechnology, IT, electronics and telecommunication sectors. Loss-making, research-based companies requiring repeated injections of capital to achieve maturity are the most affected. The UK trade association for the bioscience industry, the Bioindustry Association (BIA), has raised the issue of pre-emption rights with Government on various occasions. Technology-based loss-making companies in other sectors have also raised concerns about the issue from time to time.

The UK Government has made clear its desire for a strong UK bioscience sector. In his Foreword to the Report of the Bioscience Innovation and Growth Team (BIGT), the Prime Minister states that

> "our measures to encourage the commercial start-ups and licensing of ideas from our universities and public sector research establishments has borne real fruit. We must ensure that the flow of new companies continues, but also work on improving the long-term viability and strength of these companies so they can grow into global, profitable businesses. " [21]

The US Government also sees the value of its biotech sector. According to the Milken Institute 2004 report:

> "there is a good reason why governments are fighting hard for biopharmaceutical dollars: These companies have the potential to add thousands of jobs and millions of dollars to their economies. A new study from the Milken Institute, *Biopharmaceutical Industry Contributions to State and U.S. Economies*, shows just how strong the impact is - more than 2.7 million jobs and $172 billion in real output in 2003 [in the US] when one includes the full impact the industry has on all sectors of the economy."

i) Recommendations of the Bioscience Innovation and Growth Team (BIGT)

The BIGT was set up in January 2003 with a mandate to formulate a strategic approach to the future of the bioscience industry. Its final report was produced in November of that year. It recommended that shareholders waive pre-emption rights to allow biotechnology companies to issues up to 20 per cent of new shares in any three year period [22]. In its detailed examination of the issue, this recommendation was refined to apply only to loss-making companies with a market capitalisation of less than £1 billion[23].

[21] "Bioscience 2015" Bioscience Innovation and Growth Team report, Foreword by Tony Blair - Nov 2003 (available at http://www.dti.gov.uk/bio-igt/bio-igt-index.html)
[22] *Ibid*, page 66
[23] *Ibid*, page 76

The BIA believes that the current limits imposed by the Pre-emption Guidelines are too restrictive and are a major, but not the only, factor in biotechnology companies in the EU, including the UK, raising significantly less capital than those in the US, unless they elect to list in the US. According to a recent article in “Start-Up” magazine, in 2003 Europe’s biotech companies raised $1.1bn compared with the $14bn raised by US companies[24]. This disparity leaves UK public biotechnology companies at a disadvantage in the global market compared with US companies. As noted above, there are a number of differences between the UK and US frameworks of company law and capital raising, and these go much wider than the matter of pre-emption rights. But in a 2003 BIA survey of senior UK bioindustry executives, over half indicated that they had experienced difficulties in raising funds due to UK pre-emption limits.

ii) Particular features of biotechnology sector

Bioscience companies are characterised by very high demands for capital that can increase by an order of magnitude as companies proceed through the various stages of drug development. For example, the costs of a later stage (Phase III) clinical trial can be ten times the cost of an earlier stage (Phase I or II) trial. As a consequence, bioscience companies are more likely to need funding support from outside their existing shareholder base to meet their capital demands as they progress and the sector has argued that pre-emption rights effectively act as an impediment to introducing outside investors.

This can be seen by an illustrative example. Annex D sets out a brief life history of a newly public US biotechnology start-up company.

Markets in bioscience stocks tend to be volatile relative to other sectors, and funding windows can open and close very quickly. The sector argues that the long offer period which pre-emption necessitates can prejudice the success of an issue because funding windows can open and close within that period, and this is exacerbated by the fact that, in a sector where company stories are relatively complex and require detailed and time-consuming analysis which is often not primarily financially based, sub-underwriting in the usual manner practiced in the London market is much less feasible because of the narrow window of time that is typically available to sub-underwriters.

The sector contends that one of the problems it faces is that the companies still in the research and development phase are not only complex and hard to analyse, but also relatively "small cap" deterring many institutional investors from developing specialisation in this sector. By contrast, specialised investors, who are often overseas-based and private, may see opportunities and be willing to commit to perceived winning stocks. It is argued therefore that often both supply and demand for non-pre-emptive finance co-exist, but with hesitation on the part of existing shareholders to commit more funding.

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[24] *“Working around pre-emption rights”*; Hazel Dawson, Start-Up – September 2003

The long-lead times before products can be brought to market, typically of 10-12 years, due to regulatory and other factors, means that companies in the bioscience sector may have no source of income for many years. Significant funding is required to perform the necessary clinical trials on a new product to achieve appropriate regulatory approvals prior to going to market. However, the pre-emption process that makes this need for additional funding public can put downward pressure on the share price. This is because the process in the UK requires extensive confidential pre-marketing to ensure shareholder support for the disapplication as well as the issue. There is a risk that the share price falls during this process, even though the process is supposed to be confidential. The sector points out that in the US the process for PIPEs is different with usually just one or two days spent on marketing the issue so only potential investors are contacted with less risk of a leak about the issue.

iii) Other sectors with similar features

Small, fast-growing public companies are likely to want to raise large amounts of new equity finance, regardless of the sector in which they operate. It is clear that at the present time, in the UK, many of the small fast-growing public companies operate in the Biotech sector. While in principle the problem ought to be a generic one, little has been heard about pre-emption rights difficulties thus far from other sectors. The question of other affected sectors is posed in Chapter Four.

2. The shareholders and their concerns

UK investment institutions see the principle of pre-emption rights as a vital safeguard for their ownership rights, arguing that adherence to the pre-emption principle prevents transfer of value to third parties, and safeguards their rights as owners to hold management to account. They also argue that it helps keep the cost of capital low, promotes the ability of companies to deliver long-term value, and enables them to raise capital in a cost-efficient way.

i) Dilution of existing shareholding

The investment community's case is that the right of shareholders to subscribe to new capital issues in proportion to the shares they already own is a fundamental protection. It means the stake of shareholders cannot be diluted by the sale of shares to third parties against their will. Were companies freely able to sell new shares to third parties, the ownership rights of existing holders would be weakened and they would suffer dilution of their economic interest as regards their future entitlement to earnings streams. To the extent that shares were issued at a discount, shareholders would suffer immediate loss of value. In extremis, in the event of disagreement with existing shareholders, management would in essence be free to sell the company to others. At the heart of this argument is the belief that investors cannot be expected to take responsible decisions in the long term interests of all stakeholders if they run the risk of being diluted. The institutional investors stress that pre-emption rights seen in this context are part of the wider debate about shareholder engagement – and support Government concerns about emphasising the role of genuine long-term investors over short-term speculators.

The pre-emption principle is thus strongly supported by investors such as insurance companies and pension funds. Such institutional investors argue that they have a long-term time horizon, and argue that this has engendered a tradition of shareholder responsibility. These groups see particular benefits in pre-emption rights because the rights process helps cement their long-term relationship with companies in which they have invested.

As explained in Chapter Two, the existence of pre-emption rights does not prevent a company from issuing further equity shares. However, institutional investors argue that by structuring an issue such that it is the existing shareholders who are approached first, it is the investors who already have the greatest familiarity with the company and its prospects who will judge the merits of the issue and this may help to deter companies from launching inappropriate capital issues, the proceeds of which may fail to generate value.

It is important to note that the purpose of capital issues is to raise additional cash. It should not be confused with the objective of introducing new investors to the share register. The investment community have pointed out that a listing on a liquid market will provide opportunities for new investors to buy shares, and moreover that they will have greater incentive to do so if their subsequent rights are protected through, among other things, the pre-emption principle.

The investors case is that pre-emption provides an important benefit to existing shareholders: it gives them the choice of whether to invest on a particular basis. They are enabled to take this decision on its merits and in a considered fashion.

As explained in Chapter Two, the legal framework enables shareholders collectively to choose to vary or disapply their rights. The institutional investors say that in practice these rights are used by shareholders flexibly. Where companies make a specific case for issue of shares to an outside party, shareholders can address such a proposal on its merits and vote to grant a specific waiver of pre-emption if they consider this justified. The flexibility of the Guidelines and the way they are applied in practice is a key issue for the Paper and is discussed further in Chapter Four.

ii) Cost of capital

The investment community also argue that pre-emption ensures that, where shares are issued at a discount to prevailing market value, this is not a cost to shareholders. This is because they are given the ability to subscribe for their full *pro rata* share of discounted equity securities being issued. The pre-emption framework also provides the basis for the rights issue, a transparent market mechanism that allows shareholders not wishing to exercise their pre-emptive right, in whole or in part, to realise the economic value of these. For the company there is also the choice of whether or not to underwrite the rights issue. While such underwriting incurs a cost, the institutional investment community points out that this is modest compared to costs typically incurred in a non pre-emptive issue, and relative to the potential economic cost to shareholders.

Their argument is that transparent market mechanisms are more likely to allocate investment capital in an efficient way. Non pre-emptive issues will typically be more costly either through fees that have to be paid to market intermediaries or through shares being placed at a discount. Such fees or discount are a real cost to shareholders and the company.

Company law currently mandates a period of 21 days between launch and closure of a rights issue unless the shareholders have agreed a shorter period.[25] This is designed to enable private holders to consider the issue and make arrangements to subscribe if they wish. Institutions point out that while they could use technology to accommodate a shorter timetable, it is hard to see how this could be done while fully maintaining pre-emption rights for private shareholders.

iii) Shares for assets

As explained in Chapter Two, the pre-emption framework allows companies to issue shares in exchange for assets which are being acquired. Sometimes these issues are accompanied by a simultaneous sale by the vendor of the assets of the shares so received (see “vendor placing” in Chapter 2). While companies sometimes argue that the distinction between an issue of shares to finance the acquisition of assets and a direct sale of shares for cash to finance expansion is artificial, the institutions counter this by explaining that the precise and defined nature of the assets being purchased makes this a different type of transaction than a sale of shares for cash. Institutional investors argue that as the company’s balance sheet is being expanded through the purchase of assets, which have a value, the investor’s stake in the enterprise is maintained. In addition the decision to acquire specific business assets, for an attractive price, is, within appropriate limits, a matter of management and board judgment. By contrast, claim the investors, there is no such skill in deciding whether to issue shares for cash.

This question is looked at further in Chapter Four.

[25] But see Chapter Two for recommendations of Company Law Review

iv) UK versus US

A specific issue raised by the biotech industry is that it competes with companies in the US where pre-emption rights do not normally apply. The institutional investors argue that the precise impact on the cost of capital of this is impossible to quantify because a range of factors are at stake. Similarly they say that it is difficult to state with certainty why US investors show less interest in pre-emption rights than their UK counterparts.

v) Summary

Institutional investment bodies such as the ABI and NAPF claim that the UK market has developed over the years a strong consensual support for the pre-emption right principle, and the flexibility with which it is applied by institutions has reinforced that consensus. They argue that creating additional flexibility for one particular sector would lead inevitably to pressure for it to be applied to all. And the impossibility of ring fencing means that the principle – and the consensus on which it rests – would be eroded.

Chapter Four – key issues, questions and possible remedies

This is a discussion paper, the purpose of which is to seek views and invite comments on specific questions. In chapters two and three, the paper set out the current position regarding capital-raising and pre-emption rights in the UK and elsewhere, and described the various concerns that have been raised in this regard. In this chapter, the key issues are summarised and a series of questions posed. Following on from these questions are some potential remedies and the further questions which these raise.

1. Flexibility of the Pre-emption Guidelines

As explained in Chapter Two, the ABI and the NAPF are clear that the Guidelines are not inflexible rules, and can be waived under certain circumstances. They explain that

> "Where there are compelling reasons for disapplying pre-emption, companies can and do seek permission to do so from shareholders. When supported by appropriate justification, such permission is rarely withheld." [26]

There are some examples of such disapplications being granted. There are a number of cases where permission has been given for up to 10 per cent of share capital to be raised – most recently in the case of Antisoma which has been given the go-ahead by the ABI to seek a 10 per cent non pre-emptive issue authority, to be voted on at its AGM in November. It is much harder to find examples where more than 10 per cent has been permitted for companies with a listing on the fully regulated market. In the 5 – 10 per cent cases, it appears that the waiver has sometimes been granted by the shareholders of a particular company, by-passing the institutional investors as a group. At least one company listed on the AIM market has raised around 25 per cent non-pre-emptively. But this was a very small company and again it is not clear that dispensation was granted by the ABI/NAPF Investor Protection Committees; rather, the shareholders were notified directly.

It has been alleged that this is symptomatic of a wider phenomenon: that the existence of the guidelines encourages the committees (as opposed to individual fund managers) to automatically vote to reject any request for disapplication of pre-emption rights over 5 per cent, without having regard to the particular circumstances of the individual company. For this reason, it has been suggested that those handling new issues for biotech companies often go direct to the company's shareholders, including ABI/NAPF members, rather than to the ABI/NAPF investor protection committees.

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[26] ABI/NAPF Pre-Emption and Underwriting: Joint Position Paper – July 1996

This paper reveals some differences of opinion as to whether the 5 per cent pre-emption limit harms companies' ability to raise capital. In a series of letters up to 1999, the Pre-emption Group stated that it had found no evidence of this being the case. But the biotech industry in particular states that it is a significant hindrance to companies in that sector.

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

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

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?

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?

Possible remedy

The Guidelines are the creation of the Pre-Emption Group and applied by the investor protection committees of the institutional investor bodies. They are not part of company law or the UKLA's listing rules. It follows that the content of such Guidelines and the way in which they are applied is entirely a matter for those bodies, their members and the shareholders. Any remedy that involves changes in this regard will therefore need the full support of the investment community, and to be implemented by those bodies.

Relatively modest changes to the Guidelines could be made by simply making more explicit their status as guidance, and by setting out within them, clearly and unambiguously, the specific criteria which institutional investors will apply in determining whether or not to approve a request for disapplication.

More radically, it might be argued that the Guidelines date from a time when corporate disclosure and shareholder engagement was much less developed than is the case today. This does not preclude the value of guidelines with clearly defined criteria but the basis on which they are applied should reflect current best practice. Corporate strategy and plans for funding growth and innovation should be key areas for active dialogue between companies and engaged shareholders. In the spirit of 'comply and explain' and better information flows between management and shareholders, companies should be ready to make their case for exceptional treatment where there is a need to do so, and shareholders should be ready to consider proposals on their merits.

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?

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?

2. Directors' duties to shareholders, and the necessity for pre-emption rights

In Chapter Two the legal context for pre-emption rights was set out briefly. Ultimately, there are safeguards for shareholders against dilution of control and value by the actions of directors which do not rely on the existence of pre-emption rights. In jurisdictions such as the US, where pre-emption rights are limited or non-existent, one would expect such safeguards to play a more significant role. In a litigious culture such as the US there might be expected to be evidence of class actions brought against directors who are felt to have acted improperly in issuing new shares at the expense of existing shareholders.

The difference between the UK and US in this regard has been characterised as the difference between a "liability rule" in the US and a "property rule" in the UK.[27] While the liability approach allows the aggrieved parties to seek redress through court action, the property rule confers an absolute right on minorities to avoid dilution.

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?

Possible remedy

The law on pre-emption rights is derived from a European Directive, the 2nd Company Law Directive. In order to change the UK law it would therefore be necessary to persuade the European Commission to propose, and a qualified majority of EU Member States to support, a change to the Directive. Nonetheless, as explained in Chapter Two, there is an intention in the longer term to radically review this directive with a view to simplifying it and it is therefore worth considering the situation where there were no statutory pre-emption rights in the UK, as in the US.

It seems unlikely, however, that there will be an appetite in the EU for a wholseale shift in the approach to capital maintenance from the current

[27] Goshen, Z (1998) "liability or property rule: voting in conflicts of interests in corporate law and minority's protection", mimeo

property-based regime to a US style one relying on litigation through class action to obtain compensation. It may therefore be more fruitful to consider the extent to which a property rule system could be made more flexible while retaining the pre-emption principle. For example, it has been suggested that companies could be given more leeway to choose from alternative pre-emption regimes that allow 5 per cent, 10 per cent, 20 per cent or other limits to non-rights issues. The market would price the shares accordingly.

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

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?

3. The feasibility of other capital-raising models

Chapter Two set out a number of models that are used in the UK by public companies to raise additional capital. Annex B explores these models and sets out a number of differences between them. In some cases it is relatively evident why such models would be less appropriate for the types of circumstances described in Chapter Three in regard to the biotechnology sector. And it has been argued that some of them involve higher fees to be paid by the company, and therefore a higher cost of acquiring capital. But there may be scope in exploring the models further. In particular, there is a question of the practicalities, costs and timing of the different methods. The biotech sector in particular has mentioned the difficulties presented by windows of opportunity for obtaining new investment, which can open and close very quickly. An ideal model would therefore seem to be one which preserves the principle of pre-emption while allowing a company to move very quickly to secure new funding when a potential investor is identified.

Costs, timing and price risk

Costs both internal and external to the company will be affected by the time duration from beginning to end of the various models, demonstrated in Annex B. The strain and opportunity cost of local management, particularly of a small company, may also vary (see also Question 26 below). Additionally there will probably be differences in costs from professional advisers such as lawyers and accountants, and formal documentation associated with the different models. There may be different commissions payable. Discount on share price may in some circumstances be the equivalent of an extra cost.

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?

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

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

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

<u>Possible remedies</u>

Shares versus cash, and cashbox structures: As explained in Annex B, there are different rules in place for shares issued for equity (or other non-cash considerations) rather than for cash. And certain structures have developed that allow an issuer to raise cash by an issue of equity without breaching the rules or guidelines on pre-emption. When used in conjunction with an acquisition, this avoids the need for the vendor to be a party to any of the arrangements and technically would allow a vendor placing to take place without the existence of an acquisition. However, it is not clear whether the use of a cashbox structure without an associated acquisition (either current or historic) would breach the Investor Protection Committee guidelines. If it is the case that cash box structures could be used to raise capital above the 5 per cent limit for cash offers in the Guidelines, then there is an apparent inconsistency between guidelines which apply to the volumes of new shares that can be issued, given that either route would seem to offer a threat of dilution to existing shareholders.

An explanation and possible justification for the current distinction between an issue of shares to finance the acquisition of assets and a direct sale of shares for cash to finance expansion is set out in Chapter Three. It is argued that whereas the decision to acquire specific business assets is an appropriate matter for directors' judgment, the question of whether or not to issue shares for cash does not require management judgment but is properly a matter for the owners to determine. Others have countered that the difference in approaches by institutional investors to the two types of financing tends to encourage companies to grow by acquisition rather than by investing in, for example, research and development and achieving natural expansion.

Another argument is that evidence of dilution should be clearer in a cash issue because of transparency of pricing. A non-cash issue is less transparent and more dependent on subjective judgements of value - making it if anything more rather than less susceptible to being used to dilute shareholder value.

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

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

Mandatorily convertible partly paid debt: as explained in Chapter Two, this potentially offers a number of advantages for companies seeking to achieve a "drip-feed" of new capital. However, the process would require a substantial commitment on the part of investors as they will not only be required to take a decision with regard to a current investment but also commit to a future contribution. As a result, companies would need to take a commercial decision as to whether their activities are sufficiently attractive to investors to merit that level of commitment. The companies would also need to consider whether they are in the position, in terms of the advancement of the research, to ensure that they will meet the condition so as not to forfeit much needed funding.

An advantage of this structuring is that only the first instalment of the stock is underwritten, reducing the underwriting fees that would otherwise be payable. As the second and subsequent instalments are not underwritten, the company is at risk of not receiving payment. However, the sanction for non payment is forfeiture of earlier instalments (in addition to the company's remedy to sue for payment of the instalment) and this is generally taken to be a sufficient incentive to pay the instalment.

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?

4. Capital-raising in the US

The statistics show that, at least in regard to the biotechnology sector, the smaller start-up public companies are much more successful in raising additional capital under the US system than under European, including UK, systems. It is argued that this is in part down to a different and more flexible framework of company law and less restrictive rules on capital maintenance.

It should follow that the downside to this success is more vulnerability for US shareholders to dilution and loss of control, and possibly a higher cost of capital. Economic models would predict that in the absence of pre-emptive safeguards for investors, overall investment is riskier in the US and the cost of capital should be higher. Indeed it has been argued that if pre-emption rights are removed, then the price at which new equity is issued becomes extremely significant and economically sensitive. This places directors, and their advisors, in a very difficult position; if they raise new equity too cheaply then they would be open to complaint (and possibly legal action) from existing shareholders. .

While it is recognised that the differences between the two regimes are more fundamental than simply a different legal approach to pre-emption rights, it is nonetheless worth exploring the cost/benefit calculations that have implicitly been taken in the two jurisdictions, and the reasons for such different answers being obtained. Academic studies have found evidence that the trade-off involved in employing or foregoing pre-emption rights can be closely balanced. In the US it has been found that in some cases announcements by companies that they are eliminating pre-emption rights are associated with share price increases.[28]

It is also interesting to note that many of the same institutions which see pre-emption rights as a crucial safeguard against dilution in a UK/European context invest considerable amounts in the US market and other jurisdictions where pre-emption rights are weaker or non-existent.

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?

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?

Possible remedy

One obvious remedy would be for UK biotechnology companies, and any other companies that felt they were disadvantaged by the UK pre-emption regime, to list on NASDAQ or the NYSE or instead of in London, to take advantage of the more flexible regime there. There is very limited anecdotal evidence of this happening. It may be that UK companies are deterred by the costs of having a US listing (especially since the Sarbanes-Oxley Act 2002 came into force), or by the perception that once listed in the US they would need to move headquarters to the US to take full advantage of that market. Given that one of the stated objectives of the UK Government in respect of the biotechnology sector is to "work on improving the long-term viability and strength of these [UK] companies so they can grow into global profitable businesses"[29], the wholesale movement of UK companies to the US is unlikely to be an attractive response from the perspective of the Government.

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[28] see for example Bhagat S (1983) "the effect of pre-emptive right amendments on shareholder wealth"; journal of Financial Economics, 12, 289-310, *and* Smith C (1977) "alternative methods for raising capital: rights versus underwritten offerings"; Journal of Financial Economics, 6, 273-307

[29] Bioscience 2015 Report by the BIGT, Prime Minister's Foreword – November 2003

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?

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

5. International ownership of UK equities

The Pre-Emption Group guidelines are applied by UK institutional investors to companies listed in the UK market. UK institutional investors hold just under half of the total equities in UK listed companies. But a third of equities in UK listed companies are held by non UK investors[30]. It is therefore worth querying whether the views of international investors are sufficently taken into consideration in the application of pre-emption rights.

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

6. The need for specialist investors

One observation that is sometimes made is that there is a category of investor in the US which simply does not exist in the UK: the sector-specialist investor who understand the unique challenges of bioscience development and is prepared to take risks in this distinct sector. Most investors in the UK have large and diverse portfolios and can spend little time on the particular challenges of this one sector and in particular the smaller start-up companies in it, despite holding shares in these companies. This in turn leads to the likelihood of requests for disapplication of pre-emption rights above 5 per cent to be dismissed out of hand rather than considered on their merits.

There is a circularity to this issue. It has been suggested that the reason that no specialist sector of institutional investors has developed in the UK to exploit this gap in the market is that it does not deliver any returns. But equally, a reason for the poor track record of the sector in delivering returns may be precisely because the institutional know-how for investing in the sector does not exist here and hence the companies are starved of cash. A more fundamental issue may be whether the publicly listed company is the most suitable vehicle for a small company in a sector like biotechnology with such high cash demands, extensive regulatory hurdles and long lead times to market. Many analysts believe that some consolidation is required in the sector, but that is beyond the scope of this Paper.

Differentiation by size

[30] National Statistics News Release: *Private individuals' shareholdings worth £204 billion at end-2003* – 10 June 2004

As noted in Chapter Two, the 2003 BIGT Report into the Bioscience sector recommended that shareholders waive pre-emption rights to allow biotechnology companies to issue up to 20 per cent of new shares in any three year period, and then went on to refine this to apply only to loss-making companies with a market capitalisation of less than £1 billion[31]. Others have suggested that there might be scope for the Pre-Emption Group guidelines to apply only to companies above a certain threshold - perhaps £500m capitalisation – and below this for the company directors to be invited to go direct to their individual shareholders. It has been pointed out that for companies with smaller levels of capitalisation, the 5 per cent limit is more onerous as the amounts permitted to be raised without applying for a waiver to pre-emption rights will be extremely small in absolute terms.

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

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?

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?

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

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

[31] *Ibid*, page 76

How to respond to this invitation to comment

Answers to these questions and any other comments should be sent, by Thursday 16 December 2004, to:

Natalia Davie
151 Buckingham Palace Road
LONDON
SW1W 9SS

Or email to: Pre-EmptionStudy@dti.gsi.gov.uk

Phone: 020 7215 1527 *or*
020 7215 6743

Further copies of this report are available from the above address or on the internet at www.dti.gov.uk/cld/current.htm

Annex A

MEMBERSHIP OF ADVISORY GROUP

The Advisory Group members are:

- John Aston – Chief Financial Officer, Cambridge Antibody Technology
- Kate Bingham - General Partner, Schroder Ventures Life Sciences
- Peter Blythe – Director of Finance, GUS plc
- Nigel Boardman - Corporate Partner, Slaughter and May
- Giles Craven – Managing Director, Shell Pensions Management Services Ltd
- Colin Mayer - Professor of Management Studies (Finance), Said Business School, University of Oxford
- Michael McLintock - Chief Executive, M&G Investments
- Calum Paterson – Chief Executive, Scottish Equity Partners
- Charles Plowden – Partner, Baillie Gifford & Co
- David Porter - Head of Private Equity, Nomura International plc
- Norman Price – Chairman, Bede plc
- Michael Queen – Finance Director, 3i
- Alex Snow - Chief Executive, Evolution Securities
- Robert Swannell – Co-Chairman, European Investment Bank, Citigroup
- Tim Wise – Managing Director, Corporate Finance, Cazenove

<u>Notes:</u>
The membership of the Advisory Group was announced on 8 October in a DTI Information Note.

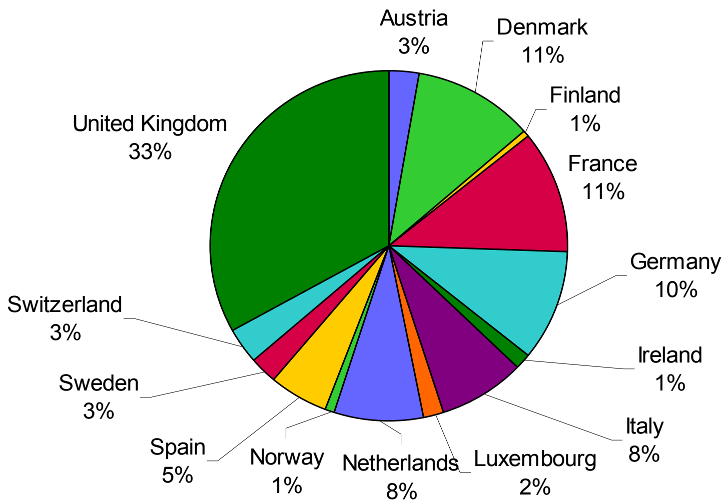
Members were invited to participate in an individual capacity by Paul Myners and with a view to achieving a balance of different interests and expertise.

Annex B

EQUITY ISSUANCE IN UK, EUROPE AND THE US

Figure 1 illustrates the relative sizes of the European equity markets in issuance terms for 2004 to date. The UK is the most active equity market across Europe, accounting for 33 per cent of equity issuance (excluding IPOs) in 2004 to date.

Figure 1 – Equity issuance by proceeds (excluding IPOs) (1 January 2004 to 12 October 2004)



Source: Citigroup

1. Types of UK equity issuance

<u>1) Cash Placings</u>

Cash placings in the UK are a common form of equity issuance used by companies to raise relatively small amounts of new equity. The benefits to the company include:

- Speed of execution with the transaction usually being capable of being executed within one to three days
- Low level of documentation
- The ability to broaden the shareholder base outside of existing investors. This ability to attract new investors is often important to corporates given the declining ownership of the UK market by UK institutions

The major drawbacks of the cash placing structure are as follows:

- Only a relatively small amount of equity can be issued (maximum of 5 per cent of the issued share capital in any one year and a maximum of 7.5 per cent in any rolling three year period)
- The discount at which the new stock can be placed is restricted to no more than 5 per cent at the time the placing is underwritten or executed
- Existing shareholders suffer dilution if they do not participate on a pro-rata basis in the cash placing

ii) Vendor Placings

Vendor placings are a common method of raising new equity and are often used in merger and acquisition situations where the vendor wishes to receive cash but the issuing company has insufficient cash resources or debt capacity. Under these circumstances the issuing company executes a vendor placing whereby new equity is placed to third party investors and the vendor receives the cash proceeds of the new issue.

Pre-emption rights do not apply under the Companies Act where the consideration received by the company is non-cash. A vendor placing falls into this category as it involves the marketing of shares that have been theoretically allotted to a vendor as consideration for an acquisition. Under Investor Protection Committee guidelines up to 10 per cent of the issued share capital can be issued under a vendor placing on a non pre-emptive basis and therefore this mechanism allows more equity to be issued than under a cash placing.

Vendors often want cash and wish to bear no execution or pricing risk on the sale of new equity under the vendor placing structure. Mechanisms have therefore evolved to ensure that on a vendor placing the vendor bears no pricing risk, does not need to be a party to any legal agreements in relation to the placing and avoids the risk of being charged stamp duty on the transaction. Under these mechanisms the vendor receives the certainty of cash but with all the risk of execution being borne by the company.

Historically there needed to be very clear links between the vendor placing and an acquisition in order to satisfy the Investor Protection Committee guidelines that the transaction was a vendor placing. In recent years these links appear to have become slightly less restrictive with the Investor Protection Committees being prepared to enter into discussions on a case-by-case basis with companies regarding whether placings can be considered to be vendor placings for already executed acquisitions, for example refinancing past acquisitions temporarily funded by debt.

Cashbox structures: A vendor placing implies the need for a vendor. Structures have however developed that allow an issuer to raise cash by an issue of equity without breaching the rules or guidelines on pre-emption, and importantly without involving a third party vendor in the contractual documentation. These structures are known as cashbox structures.

Under a cashbox the consideration for the issue of securities by the company, instead of being cash, is the transfer of shares in a company whose only material assets are cash or near-cash – the “cashbox company” – which is normally a newly incorporated subsidiary of the issuer. When used in conjunction with an acquisition, this avoids the need for the vendor to be a party to any of the arrangements and technically would allow a vendor placing to take place without the existence of an acquisition.

The use of a cashbox structure without an associated acquisition (either current or historic) would however breach the Investor Protection Committee guidelines and is likely to lead to an adverse reaction from both the Investor Protection Committee and existing shareholders wishing to protect their pre-emption rights. Cashbox structures in the UK therefore tend to be utilised in conjunction with an acquisition.

Restrictions on discounts on cash placings and vendor placings: As cash placings and vendor placings are non pre-emptive methods of issuance, in order to protect the interests of existing shareholders there is a significant element of attention placed on the discounts at which they are executed. The Investor Protection Committee guidelines on discounts are more onerous than the UKLA Listing Rules. Whilst the UKLA permits a discount of up to 10 per cent, the Guidelines limit the discount to no more than 5 per cent, including fees and expenses, at the time the placing is underwritten or executed. This limitation is often a material concern for issuers, especially where the issue is associated with an acquisition where the market reaction is uncertain.

Historically cash and vendor placings would involve the issuers pre-marketing the transactions to investors in the one or two days prior to announcement with a view to arriving at a price level, within the Investor Protection Committee guidelines, at which the issuer, and the underwriters, were confident the issue could be successfully sold to investors.

Investors spoken to in this pre-marketing exercise would be made insiders as to the forthcoming issue and would be unable to deal in the underlying securities until the transaction had been announced. After a successful pre-marketing the placing would be underwritten and announced as occurring at a fixed price and investors would be invited to subscribe at that price. The institutions pre-marketed to would provide a level of comfort to the underwriters that the transaction would succeed at that fixed price and would usually provide the cornerstone of demand for the issue.

The fixed price and the limited pre-marketing undertaken in these circumstances is a potential inefficiency in the price setting mechanism as it does not allow a wide range of institutions to make their views on pricing known to the issuer. Accelerated equity offering (“AEO”) structures have therefore evolved where the price discovery exercise is opened up to the market at large after the announcement of the transaction. The price on the transaction is set via a bookbuild where institutions indicate the number of shares they are prepared to subscribe for at different price points. This auction mechanism should theoretically allow a higher price to be achieved in the placing as it allows a wide range of market participants to participate in the price discovery process.

Bookbuilt non-underwritten placings have emerged where certainty of execution is not a pre-requisite for the transaction. If certainty is not a pre-requisite there is no need for underwriting and it is possible to execute the placing on a best endeavours basis. Under this structure the transaction is announced and the placing agents, usually the company's corporate brokers or investment bankers, use their best endeavours to build a book of demand at various prices during the course of the placing, usually over the course of one day. The impact of this is that the market price adjusts to the likely level at which the book of demand is building and therefore when the book comes to be priced it will usually be at a level within 5 per cent of the prevailing market price at that point in time, and therefore complies with the Investor Protection Committee guidelines. The significant disadvantage of this structure is that the issuer has no certainty of pricing, or of execution, as the offering is not by definition underwritten at the outset.

Bookbuilt, backstop underwritten placings have emerged where certainty of execution is a requirement. If there is sufficient confidence in the investment case the transaction can be underwritten at the outset (the backstop underwriting) at a discount within the Investor Protection Committee 5 per cent guideline. A bookbuild would be executed on the day of the placing to attempt to place the new securities at a price exceeding the backstop underwritten price.

If there is less confidence at the outset in the ability to attract investors within the 5 per cent Investor Protection Committee pricing limit, it is possible to enter into discussions with the Investor Protection Committee on a case-by-case basis as to whether it is possible to underwrite, and potentially price, at a wider discount than the 5 per cent permitted by their guidelines but still within the 10per cent permitted by the UKLA. The logic of this course of action is that a wide range of investors would be aproached in the bookbuilding exercise and the eventual pricing should be an accurate reflection of market appetite.

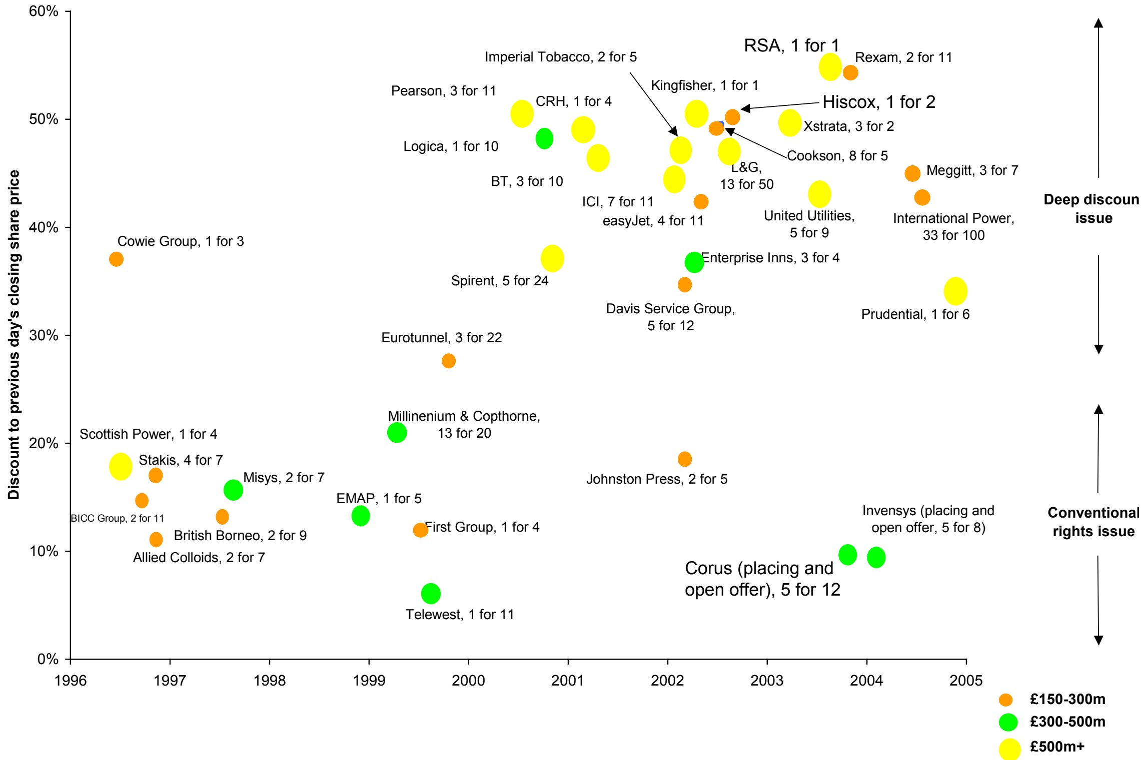
If the discussions with the Investor Protection Committee are positive then it may be possible to proceed with the issuance at an underwritten discount of more than 5 per cent. In these circumstances the placing is announced as backstop underwritten but with a bookbuilding being executed to set the final issue price. The backstop underwritten price has to be within the UKLA 10 per cent limit, and the underwriters undertake a bookbuild exercise in order to ascertain the price the market is prepared to pay for the issue of securities. If demand is sufficient the securities will be placed at a higher price than the backstop price, and within the 5 per cent Investor Protection Committee guidelines limits. Should demand not be sufficient the securities would be priced at the backstop underwritten price.

iii) Rights issues

Rights issues are fully pre-emptive issuing structures and are the most popular mechanism in the UK and Europe to raise significant quantities of equity (greater than 10 per cent of issued share capital). Under a rights issue, existing shareholders have a tradable entitlement that they can sell in the market should they choose not to subscribe. The value of this tradable entitlement compensates those shareholders not subscribing in the rights issue for the dilutive effects of the rights issue. Due to the compensation provided by this tradable entitlement there are no restrictions placed upon the discount at which the new shares can be offered in a rights issue.

The major trend in recent years in the UK rights issue market has been towards deep discounted rights issues (a subjective classification but defined for the purpose of this paper as those issues where the discount is > 30%). Figure 2 below details the discounts for rights issues over £150m since 1996 and illustrates the trend towards deeply discounted rights issues amongst issuers.

Figure 2 – The evolution of rights issue discounts since 1996



Source: Citigroup

A benefit of a deep discount rights issue is that the significant discount at which the new securities are being offered reduces the risk that the underwriters will be unable to sell the new stock to existing shareholders or new investors. This reduced risk improves the ability to execute an underwritten deep discount rights issue and reduces the associated underwriting fees to the benefit of the issuer and its investors.

Historically issuers used to avoid executing deep discount rights issue due to concerns that it was a sign of weakness on behalf of the companies concerned. These concerns have dissipated in recent years as commentators have recognised that deep discounted rights issues are generally more cost effective for the issuers given the reduced underwriting risk.

iv) Open offers

Like rights issues, open offers are fully pre-emptive issuing structures and therefore are capable of being used in the UK market where the issuer wishes to issue more than 10 per cent of its existing issued share capital (in the case of vendor placings with associated acquisition). The important difference between an open offer and a rights issue is that there is no tradable entitlement for existing shareholders in an open offer and therefore if an existing shareholder chooses not to subscribe there is no compensation for the dilution that the shareholder will suffer. For this reason the UKLA limits the level of discount at which an open offer can be priced to no more than 10 per cent. to the mid market price at the time the terms are announced. This restriction protects existing shareholders from significant dilution.

Open offers are inherently harder to underwrite than a deep discounted rights issue as the structure involves getting investors to subscribe for new shares at a level closer to the prevailing market price. As such they are not as prevalent as rights issues in the UK market.

v) Mandatorily convertible loan stock

An alternative method for raising funds for an industry which needs to continuously and expediently raise finance for the purposes of research and development may be for the companies to issue mandatorily convertible partly paid debt. Although the issue of convertible stock is still subject to the pre-emption rules by virtue of sections 89 and 94 of the Companies Act, if properly structured, the company should be able to issue shares against pre-determined trigger events as (and only if) it requires the subscription monies.

Commonly referred to as “trombone rights issues”, these offer shareholders convertible securities payable in instalments (normally two) instead of shares. The first instalment would be paid up when the rights issue offer closes and the second (and any other instalment), if and when a pre-agreed condition is satisfied. This is usually the condition to an acquisition but could be a condition upon, for example, a drug in the initial stages of development passing certain clinical tests or receiving approvals.

If the condition is not satisfied, the holders do not have to pay the second or later instalment. Their loan stock would, however, still be convertible into shares up to the value of the previously paid instalments. The company will, in the event of such a failure, only receive the amount of the first instalment. If the condition is satisfied, the second or further instalments becomes payable. Once the issue become fully paid up, the loan stock becomes mandatorily convertible into ordinary shares, the company discharges the debt and receives the additional funds it needs and the shareholder receives equity.

Finally, **Treasury Shares** is a recent development in the UK market. Previously when a company repurchased its shares it had to immediately cancel them. Under the Treasury Shares legislation a company is allowed to repurchase its shares and hold them pending a re-issue. Any subsequent issue of shares for cash met by the use of Treasury Shares is subject to the pre-emption provisions of the Companies Act, unless disapplied, and is subject to the Investor Protection Committee guidelines.

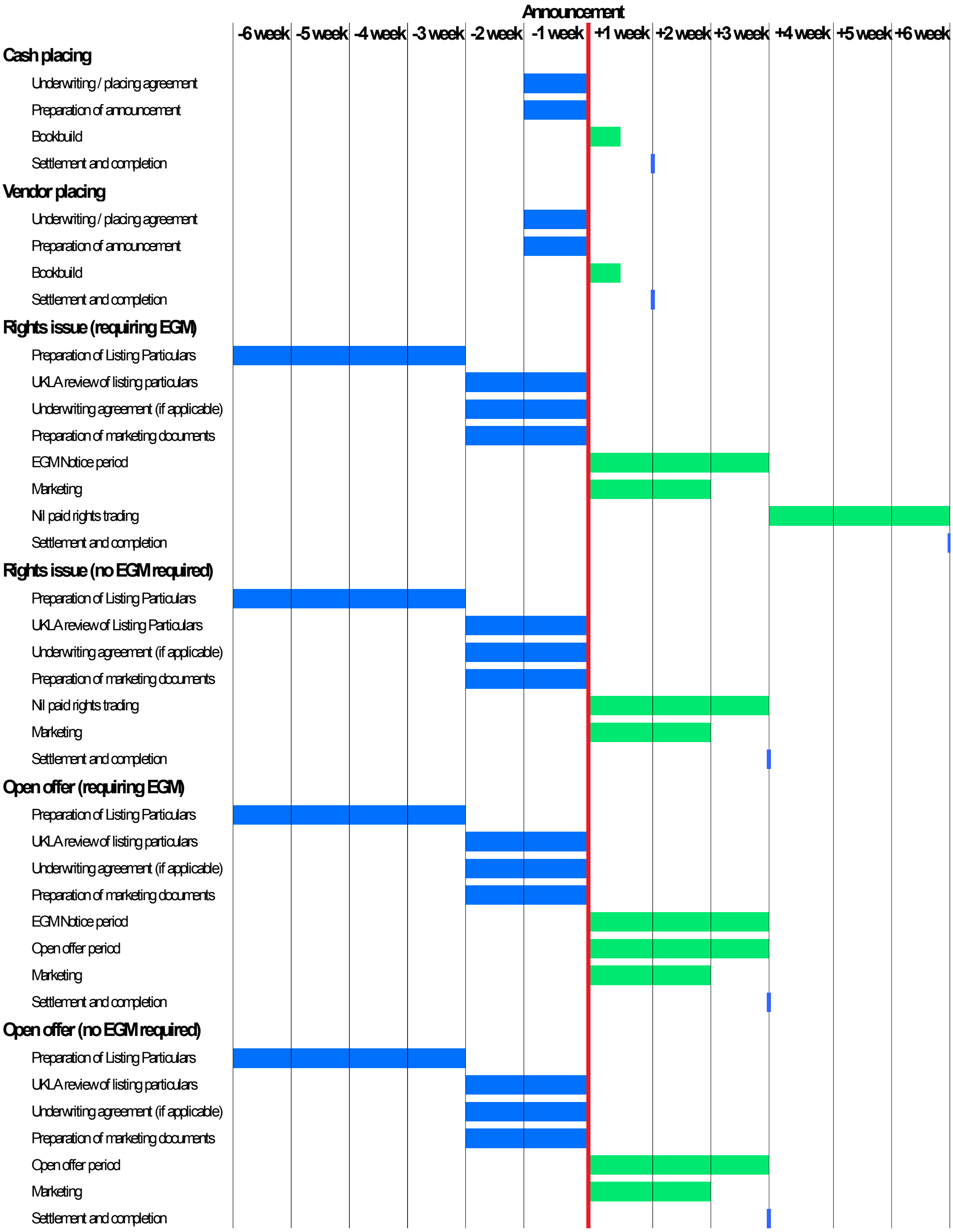
Any issue out of Treasury Shares can therefore be considered as analogous to a fresh issue of equity and therefore subject to the same structural considerations as detailed above. This places a significant practical restriction on the company's abilities to sell Treasury Shares to raise new funds for the company.

2. Timelines of types of equity issuance

Pre-emptive structures (rights issues and open offers) generally have more extensive timetables than non pre-emptive structures as greater time is required to allow existing shareholders to decide whether they wish to subscribe in the offering. As a consequence, from the perspective of the issuing company, there is an extended period from the announcement of the funding to completion.

Figure 3 below illustrates the various timelines for the different UK issuance structures, assuming a three-week EGM notice period.

Figure 3 – UK issuance timelines



Source: Citigroup

Section 90 of The Companies Act 1985 stipulates that a rights issue must remain open for a period of not less than 21 days for acceptance. This requirement is mirrored in the UKLA Listing Rules (Listing Rule 4.21). In addition, if an EGM is required to approve the rights issue this further extends the period from announcement of a rights issue to completion. An EGM notice period to approve the issue cannot be run in parallel with the rights issue offer period as the London Stock Exchange will not allow the nil paid rights to trade on a conditional basis (conditional on the EGM approval) and therefore the offer period cannot commence until after the EGM has approved the issue. Assuming 21 days is also required as the notice period for the EGM this can lead to the rights issue timetable stretching to approximately 42 days from announcement to completion.

An open offer generally has to be open for 15 business days (approximately 21 calendar days). Unlike in a rights issue there is no tradable entitlement and therefore the offer period can be run in parallel with an EGM required to approve the open offer. This means that an open offer can generally be executed from announcement to completion in approximately 21 days, irrespective of whether an EGM is required to approve the issue.

The timetables for non pre-emptive structures (cash placings and vendor placings) are generally significantly shorter than for pre-emptive issues and allow the issuing company to announce, price and allocate the new equity often all within one day with the funds to be received on normal settlement terms on a T+3 basis. This has obvious benefits to the issuing company in terms of speed of execution and, if the transaction is underwritten, reduces the period of market risk for the underwriter.

3. Types of US Equity Issuance

<u>i) Marketed offerings</u>

The **firm-commitment underwriting** is the most common marketed offering arrangement in the US. In a firm-commitment underwriting, investment banks agree to purchase, as underwriters, the securities from the issuing company and then resell the securities to the public, brokerage firms, private investors or a combination thereof. Typically, a group of underwriters, known as the underwriting syndicate, act together under the guidance of the managing underwriter, who negotiates deal terms with the issuer and arranges the issuance, among other responsibilities. The underwriters in the syndicate commit to purchase the issuer's shares and receive the shares at a price which is less than the public offering price as compensation for the underwriting services and risk.

Importantly, under a firm-commitment underwriting the risk is not fully assumed by the underwriter until the end of the marketing period when a book of demand has been built, a price is established for the issue and the underwriting agreement is executed. At this point, under a firm-commitment underwriting the underwriters assume the risk if the shares cannot be sold to the public at the stipulated offering price. Up to this point in time the issuer bears this risk.

An alternative to a firm-commitment underwriting is a **best-efforts underwriting**. In a best-efforts underwriting the investment bank only agrees to use its best-efforts to find investors and to help the company sell the issue to the public but it does not actually purchase the securities. In this arrangement, the investment bank acts as an intermediary between the public and the company, and thus even once the price for the issuance of the new securities has been established the investment bank avoids assuming the risk that the shares cannot be sold to the public at the stipulated offering price. Typically a fee is a paid to the investment bank for its efforts in helping place the issue that has been pre-negotiated and the fee size reflects the fact that the risk of placing the securities remains with the company.

Under both of the marketed offering arrangements described above, the company generally announces its intention to issue securities and then undertakes a roadshow, which typically lasts anywhere from one day to two weeks. During the roadshow the underwriters gauge and generate interest and build a book of demand for the issue. The pricing of the securities is set at the end of the process, at the time of, or as near as possible to, the closing, and depends on the level of demand generated during the marketing process.

In either type of marketed offering, pricing and execution risk remain with the issuer until the end of the process described above, at which point the investment bank underwriting the transaction assumes the placing risk in a firm-commitment underwriting arrangement. In a best-efforts underwriting the investment bank is generally acting as an agent for the issuer and does not assume the risk of buying and reselling the offered securities.

A marketed offering structure is generally used where the size of the offering is significant relative to the existing free float of the company and therefore an extensive investor education process is required in order to maximize demand for the securities. As there are no pre-emption limitations, the issuer is able to consider new as well as existing investors as the potential market for the securities and has no restrictions on the ultimate price of the securities.

ii) bought deals

A bought deal is often referred to as a block trade in the US. In a bought deal, an investment bank purchases a block of stock from the issuer at a pre-negotiated price. The bank may then choose to re-sell the stock to other investors, most often at a premium to the price at which it agreed to purchase the stock. Under this structure, because the purchase and price are predetermined, all the pricing risk is passed through to the investment bank in the event that it cannot resell the securities at a higher price. Because there is no roadshow or pre-marketing activities the transaction will be executed in a very short time frame, generally on the same day as announcement, which minimises the bank's exposure to market risk.

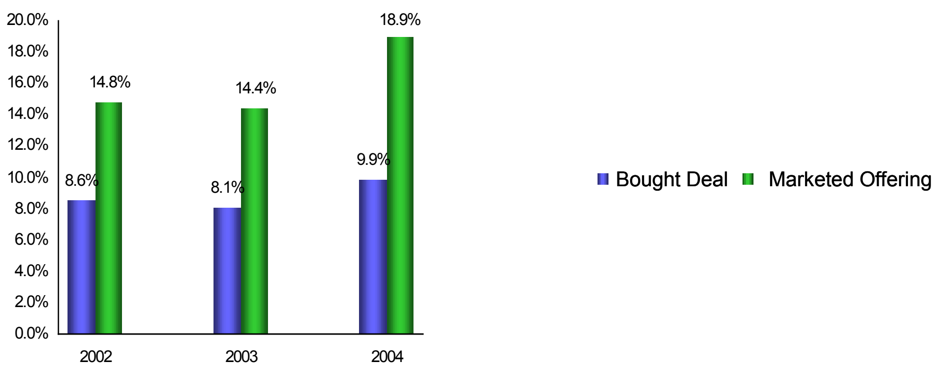
The benefit of the bought deal or block trade structure to the issuer is that this type of deal has a certainty of funding and pricing at the outset and the transaction can be quick to execute, requiring limited investment in time and money in investigating the issuer's business, disclosure and SEC filings and marketing activities.

In order to maximise the price at which new securities are being issued, the issuer will often invite bids from different investment banks for the bought deal to establish an element of competition. This competition helps to ensure that as tight a discount as possible is achieved relative to the prevailing market price of the issuer's shares.

Issue size is an important factor when considering which offering structure to pursue. The market capacity for a marketed offering is greater than for a bought deal, and often the larger offerings are more commonly executed through an underwriting arrangement, either by firm-commitment or best-efforts. By its nature, the marketed offering generally provides a greater opportunity to actively sell the investment proposition to the market and it is therefore more appealing when the issuance is large.

Figure 3 below illustrates the fact that marketed offerings are more prevalent the larger the issue size.

Figure 3 – US Bought Deals vs. Marketed offerings – average percentage of market capitalisation raised



Source: Citigroup

4. Pre-emption rights in the rest of Europe

<u>i) France</u>

Full pre-emption rights are enshrined under French law. However, historically a non pre-emptive offer has been permitted whereby the pricing of the offer complied with the 10/20 rule. The 10/20 rule allowed stock to be placed non pre-emptively where the offering price was no lower than the average price of the securities for ten consecutive days in the last twenty trading days. This meant that a non pre-emptive placing could generally be executed for a small issue size in a rising market but was difficult to execute for a larger issue size or in a flat or falling market because of the pricing restriction imposed.

Since June 2004 the 10/20 rule has been cancelled. France has now adopted a new mechanism that permits non pre-emptive issues in certain circumstances. The new mechanism will take effect upon the adoption of an implementation Decree, the timing of which is still uncertain. However, pursuant to the last draft of the implementation Decree, it is anticipated that the new mechanism will allow up to 10 per cent of the issued share capital to be issued non pre-emptively as long as it is within a 5 per cent discount of the volume weighted average price over the last three business days.

There is a requirement to involve retail when issuing stock on a non pre-emptive basis and the requirement is that, where retail is involved, the retail offer must be left open for three business days thereby influencing the timetable for non pre-emptive offerings.

Rights issues on a fully pre-emptive basis are used for larger issues and there are recent moves to attempt to shorten the period from announcement to completion from around fice weeks to around four weeks (reduction of the subscription period from ten to fifteen business days).

ii) Germany

Full pre-emption rights are enshrined under German law. In order to issue shares non pre-emptively in Germany (i) the shareholders in general meeting must resolve upon the exclusion of the pre-emptive rights or (ii) the board needs to have valid and sufficient authority to exclude the pre-emptive rights of existing shareholders and such authority can be granted by the shareholders in general meeting. In each such case the exclusion of shareholder's pre-emptive rights must be reasonably justified. If the authorised capital has expired or has been exercised by the board, this authority is normally renewed by the shareholders in the next ordinary general meeting. Under this authority the board, with approval of the supervisory board, has the ability to exclude pre-emption rights in certain cases generally where less than 10 per cent of the issued share capital is issued and where the discount is not significant relative to the prevailing share price (generally interpreted to be less than 5 per cent). Only one non pre-emptive issue of less than 10 per cent of the issued share capital can be executed by each company per year, otherwise an extraordinary general meeting must be convened to grant a new authority to the board.

Theoretically a shareholders' resolution could be used to exclude pre-emption rights for a larger issue than 10 per cent or at a greater discount than the 5 per cent range. This approach is extremely rare due to the risk of a challenge by a minority shareholder.

Therefore, issues greater than 10 per cent of the issued share capital tend to be executed on a pre-emptive basis via a rights issue structure.

iii) Italy

Under Italian law there is a general presumption that in the case of an issue of new shares the existing shareholders have the right of pre-emption. This right may be excluded, upon shareholder approval, in the following cases: (i) when the new shares are being issued in consideration for contributions in kind (ii) and when it is in the company's interest to do so. The exclusion of the right of pre-emption requires approval by the shareholders in general meeting and is only granted in specific instances where the reasons for the non pre-emptive issuance together with the criteria adopted for the setting of the issue price, must be explained to shareholders in a report from the directors. The statutory auditors, by means of their own report, are also required to express their view on the adequacy of the issue price.

In addition, the by-laws of companies listed on regulated markets may also exclude shareholders' pre-emption rights where the amount of stock issued does not exceed the 10 per cent of the issued share capital, provided that (i) the issue price is equal to the market value of the shares and (ii) this is confirmed by a report issued by the statutory auditors.

Finally, the shareholders meeting may rule out the right of pre-emption for up to a quarter of the new shares to be issued where the shares are offered in subscription to the employees of the company (or to the employees of the controlling company or of the companies controlled by the company issuing the new shares). Any exclusion of the right of pre-emption exceeding the above-mentioned amount needs to be approved by a general resolution of shareholders.

Where Italian companies need to raise capital on a pre-emptive basis the most common structure used is a rights issue.

iv) The Netherlands

The Netherlands has a general right of pre-emption on any issue of new shares. However the general meeting of the company may limit or exclude pre-emption rights and may delegate the power to issue shares on a non pre-emptive basis to the managing board for a set period that may not exceed 5 years. It is common practice for listed companies that such authority is delegated to the managing board for prolonged periods, subject to approval of the supervisory board (if applicable). Usually such authority is capped at 10 to 15 per cent of the then-issued share capital. The 10 per cent threshold corresponds to the same threshold in the Euronext Rules that triggers the prospectus requirement.

Except for the prohibition on the issuance of shares at below nominal value, there are no limitations on the discount at which new shares can be issued or upon the size of any non pre-emptive issuance, unless the shareholders resolution on the delegation of the authority to issue shares includes a cap on the discount.

Where shares are offered on a pre-emptive basis a rights issue is the most common structure adopted. It is common practice for Dutch issuers to exclude certain groups of foreign shareholders (commonly US shareholders) in order to avoid compliance with cumbersome applicable foreign securities laws.

v) Spain

Pre-emption is enshrined in the legal regime applicable to Spanish corporations (Sociedades Anónimas) and there are no general carve-outs to allow non pre-emptive issues to occur. If a corporation wishes to issue new shares on a non pre-emptive basis it needs to get approval at a general shareholders' meeting to expressly exclude pre-emption rights. In addition, the company must do the following:

- At the time the general shareholders meeting is called, make available to the shareholders a report from the company's directors justifying the proposal to issue shares on a non pre-emptive basis and the issuance price;
- Provide a report from an independent auditor, appointed by the Commercial Registry, reviewing the reasonable value of the shares, the theoretical value of the preferential subscription rights that are being excluded and the reasonableness of the data reflected in the report issued by the directors.

  For a listed company, reasonable value is deemed to be market value, which in turn is based on the trading price. This notwithstanding, the general shareholders' meeting, upon receiving the directors' and the independent auditors' reports, may approve the issue at a different price, provided that it exceeds the net asset value, as determined in the auditors' report. The net asset value shall be established by the auditors on the basis of the latest audited annual accounts of the company, or if available, any later audited financial statements drawn-up by the company's directors. The relevant annual accounts or financial statements shall in any event be dated no earlier than 6 months prior to the date on which the share capital increase is resolved.

  However, in the event of the general shareholders' meeting of a listed company delegating to the directors the ability to increase the share capital, the price of any shares issued by subsequent resolution of the directors shall be the reasonable price determined by the independent auditors in their report.

If the generic approval has been obtained and the company is able to execute the non pre-emptive issue within the applicable pricing restrictions, then the company can issue the shares on a non pre-emptive basis.

Larger issues tend to be executed on a pre-emptive basis via a rights issue structure.

Annex C

BIOTECH PIPES COMPLETED BETWEEN APRIL AND OCTOBER 2004 WITH GROSS PROCEEDS IN EXCESS OF $10 MILLION

Funds raised ($m)	**Company**	**Type**	**Country**
$500.0	Imclone Systems Inc.	Senior convertible notes	USA
$500.0	Sepracor	senior sub. convertible notes	USA
$350.0	Chiron Corp.	convertible debentures and warrants	USA
$250.0	Human Genome Sciences Inc.	subordinated notes	USA
$175.0	Amylin Pharmaceuticals Inc.	Senior convertible notes	USA
$150.0	Qiagen NV	Senior convertible notes	NETH.
$150.0	Medarex Inc.	Senior convertible notes	USA
$125.0	CV Therapeutics	Senior convertible notes	USA
$125.0	Oscient Pharmaceuticals	Senior convertible notes	USA
$125.0	deCode genetics Inc.	Senior convertible notes	ICELAND
$110.0	Cell Genesys	Senior convertible notes	USA
$100.0	Epix Medical Inc.	Senior convertible notes	USA
$90.0	Transkaryotic Therapies Inc.	Senior convertible notes	USA
$75.6	Idenix Pharmaceuticals Inc.	common stock	USA
$62.5	ViroPharma Inc.	notes and warrants	USA
$60.0	Myogen	common stock and warrants	USA
$40.0	Novavax Inc.	common stock and convertible notes	USA
$35.5	SkyePharma Plc	convertible notes	UK
$31.8	NicOx SA	common stock	FRANCE
$30.4	Illumina Inc.	common stock	USA
$25.0	ViroPharma Inc.	Senior convertible notes	USA
$25.0	Spectrum Pharmaceuticals Inc.	common stock and warrants	USA
$24.0	Cytogen	common stock	USA
$23.4	Northfield Laboratories Inc.	common stock	USA
$20.6	Active Biotech	convertible debentures and warrants	USA
$20.0	StemCells Inc.	common stock and warrants	USA
$20.0	Viragen Inc.	convertible notes and warrants	USA
$20.0	Axonyx Inc.	common stock and warrants	USA
$20.0	Prana Biotechnology Ltd.	common stock	AUSTRALIA
$18.7	Sirna Therapeutics, Inc.	common stock	USA
$17.9	Acusphere Inc.	common stock and warrants	USA
$17.7	BioSante Pharmaceuticals Inc.	common stock and warrants	USA
$16.8	Pharmos Corp	common stock	USA
$15.2	Sonus Pharmaceuticals, Inc.	common stock	USA
$15.1	Immunomedics Inc.	common stock and warrants	USA
$15.0	Adventrx Pharmaceuticals Inc.	common stock and warrants	USA
$13.9	Halozyme Therapeutics Inc.	common stock and warrants	USA
$13.3	Ista Pharmaceuticals	common stock	USA
$13.2	Karo Bio AB	common stock	SWEDEN

$12.8	Amarin Corp. plc	common stock	UK
$12.6	AP Pharma Inc.	common stock	USA
$12.6	GenVec Inc.	common stock	USA
$12.0	The Immune Response Corp.	common stock and warrants	USA
$11.9	Valentis Inc.	common stock and warrants	USA
$11.8	Hybridon Inc.	common stock and warrants	USA
$11.4	Procyon BioPharma Inc.	common stock	CANADA
$11.0	Alliance Pharmaceutical Corp.	common stock and warrants	USA
$10.9	Genetronics Biomedical Corp.	convertible preferred stock and warrants	USA
$10.3	Cellegy Pharmaceuticals Inc.	common stock and warrants	USA
$10.3	Miravant Medical Technologies Inc.	common stock	USA
$10.3	Incara Pharmaceuticals Corp.	common stock and warrants	USA

Annex D

CASE STUDY OF A NEWLY PUBLIC US BIOTECHNOLOGY COMPANY

LeukoSite was a US immunology/oncology discovery and development company based in Cambridge, MA, founded in the late 1980s. Early pipeline developments focussed on interfering with specific tissue recruitment of T cells that causes abnormal pathologies eg ulcerative colitis, irritable bowel, etc, as well as oncology drugs that eliminate specific cancerous cells. Leukosite had experienced management from big pharmaceutical companies (SmithKline, etc) and the biotech sector. Funded in part by traditional venture capital financing rounds from leading international venture capitalists, it also had significant corporate partnerships with big pharmaceuticals including Parke Davis, Roche Bioscience, Kywo Hakko, Genentech, etc that contributed to around 50 per cent of costs.

Step 1: IPO in August 1997 (second try with H&Q) raising $17m with a post money valuation of $57m ($6/share). Very weak market conditions with little analyst coverage. Net cash raised funded the company for ~18 months (including corporate funding) so additional cash would be needed again soon.

Step 2: Around $10m PIPE in 1998 at $6/share (post money $67m) to fund company/product acquisitions (Campath – P3 cancer drug, Cytomed – immunology company acquisition); equity acquired at market price with short lock-up before stock was freely tradable. Net burn of company at this point ~$10-15m, so PIPE offered approximately 9-12 months of funding

Step 3: $10m PIPE in 1999 at $9/share (approximately market price with short lock up as before) to build cancer capability for Campath and to fund additional acquisition (Proscript). Existing VCs contributed to this PIPE to ensure the maximum up to 20% was raised

Step 4: October 1999, Millennium announce acquisition of LeukoSite at $660m market cap ($25+/share) rising to >$1bn/$40/share at closing

Note: As the ownership of the company evolved through the progressive finance-raising steps, some venture capitalists stayed in and others disposed of their holdings**.** Public shareholders were not included in the PIPE offerings as they had made clear they had no appetite for expanding their shareholdings.

Conclusion: PIPE fundraising was a critical part of LeukoSite's growth and its successful exit could not have been achieved without the 20% PIPE financings