**MICHAEL QUEEN** LOOKS AT THE LESSONS LEARNED FROM THE MYNERS REPORT INTO PRE-EMPTION RIGHTS.

# Pre-emption is still a good idea

In the autumn of last year, Lord Sainsbury, the Minister for Science and Innovation, asked Paul Myners to review the impact of shareholders' pre-emption rights on a public company's ability to raise new capital.

Myners formed an advisory group consisting of people with relevant expertise in assessing the question for pre-emption rights and, in addition, engaged in an extensive consultation process with institutional investors, individual companies and representative bodies. The Myners report was published in February 2005.

One of the more straightforward risks for equity investors is that existing shareholders might face unfair dilution in the value of their investment through the issue by the board of new shares in the company to non-shareholders.

Investors have addressed this risk by demanding a right of pre-emption, which requires that new shares are first offered to existing shareholders pro-rata to their shareholding.

The Myners review process established that there are few in the investment community who can see any case for disturbing the pre-eminence of pre-emption, a view also commonly held by legislators in Europe. There is clear recognition that the fundamental objective of pre-emption rights is to provide company shareholders with protection from wealth transfer and erosion of control.

Despite this, the position in the US is very different. From an original situation where pre-emption rights were valued, today companies have the ability to issue shares on a non pre-emptive basis up to 20% of the voting power or equity share capital. In effect, the approach adopted in the US is that shareholder protection stems from the fiduciary duties that Directors hold to those shareholders to protect their interests. Therefore, shareholders take comfort from knowing that any issues of shares at an undervalue, would potentially expose the Directors to legal action.

The fact that capital markets in both the US and the UK work effectively indicates that shareholders are indifferent to these widely differing pre-emption practices. Indeed, substantial shareholders in the UK market who speak strongly in favour of pre-emption rights are active investors in US companies that regularly disapply pre-emption. Similarly, US institutions are happy to invest in UK companies.

The Myners report considered this apparent anomaly and concluded that the most likely reason for the two systems co-existing was that the potential for legal remedy against Directors was substantially greater in the US than in practice in the UK.

While financial investors in the UK universally held the view that pre-emption rights were valuable, other interested parties had a less clear-cut position. In particular, early stage science-based companies, characterised by low recurrent revenues and significant and unpredictable research expenditure, have argued that pre-emption has inhibited their ability to raise capital for innovation and growth. Indeed one of the main drivers behind the Myners review was arguments made by the Bio-technology Industry Association that the difference between US and UK pre-emption rights was significantly harming the development of a successful biotechnology industry in the UK.

While the conclusion of the Myners review was that there was no compelling reason to change the concept of pre-emption as a cornerstone of company law, there was a strong argument for a flexible approach to the operation of pre-emption guidelines.

The manner in which pre-emption operates currently in the UK is insufficiently sensitive to the needs of both bio-technology and smaller companies. Existing guidelines were developed by a group of institutional investors in 1987 and the most important of these were that non pre-emptive issues should be limited to not more than 5% of the company's capital in any one year or 7.5% in aggregate over three years.

From the perspective of a large company, these guidelines work

## Executive summary

- The Myners report has confirmed that pre-emption rights in the UK should continue to exist to protect shareholders from dilution in the value of their investments. However, in the US companies can issue up to 20% of equity share capital on a non-pre-emptive basis.
- Myners concluded that the two systems can successfully co-exist because in the US there is a greater potential for legal action against Directors if shares are issued at under value.
- The pre-emption guidelines are sometimes seen as too restrictive for smaller or early stage businesses. As a result the DTI and FSA are looking at simplifying the paperwork and shortening the capital raising process.

extremely well, but where a company needs to raise capital on a regular basis, such as early stage technology businesses, then these guidelines could be unduly restrictive.

A limit of 5% may only represent a number of months of negative cashflow.

Many institutional investors would argue that, in these circumstances, companies should turn to their existing shareholders for additional capital. There are, however, a number of problems with this line of argument.

Firstly, the development of these companies normally requires a transition of ownership away from initial capital providers such as executives, friends, family and early stage venture funds, towards a more institutional ownership. The providers of initial capital are unlikely to have sufficient resources to continue financing the development of a company as it moves through several growth phases.

Secondly, institutions have been reluctant to provide companies with cash funding sufficient to cover requirements and contingencies over several years. The preference has been for small but regular funding. While this approach is entirely reasonable, it unfortunately means that the company is exposed to cycles when it becomes unfashionable for institutional investors to finance technology companies. Again, the contrast with the US market is interesting, where although the same cycles apply, because companies are able to raise larger amounts of capital, they're cushioned to a greater extent than in the UK.

None of this would be insurmountable if the current capital raising process did not require a lengthy offering period to existing shareholders to comply with pre-emption, significant fixed cost in terms of professional advice and documentation, and cost in terms of the diversion of senior management time.

One of the side benefits of the Myners review was that it became clear that one of the most important improvements that could be made to the whole fund-raising process, would be through simplifying the documentation requirements and shortening the capital-raising process. Both of which could be achieved without prejudicing the needs of investors. Both of these issues are now being investigated by the DTI and the Financial Services Authority.

So, pre-emption will remain a continuing feature of the UK capital market, but the Myners review identified that there was a clear case for a more enlightened and permissive regime to apply to science-based and smaller companies that have made a convincing argument to their shareholders that they should have greater freedom to issue shares on a non pre-emption basis.

There have been examples over the last few years, where such companies have made a good case to shareholders for their boards to be given greater freedom to issues shares for cash to new investors, and most investors when consulted indicated they were prepared to adopt a flexible approach depending on the circumstances.

It is important to recognise that the existing guidelines are guidelines and not definitive rules. In many cases it appears that the 5% guideline has been viewed as an absolute limit. Awareness of this fact is one of the most important aspects to come out of the Myners review and in many respects the fact that the review took place at all has generated significant benefits by forcing both companies and investors to address this issue and think through their approach to it.

Looking forward, the concept of pre-emption will remain a defining characteristic of UK equity finance and an important source of investor protection. This in turn will ensure an appropriate cost of equity capital for companies looking to expand their activities.

For companies, the lessons of this review are clear – a close and ongoing dialogue with shareholders is absolutely critical if flexibility is required in raising funding to support their development.

Best practice must include a clear discussion of the potential future capital needs of a company and, if non pre-emptive issues are a potential source of capital, this needs to be agreed with shareholders in a timely manner before the capital is required. For investors there is also the responsibility to fully understand the companies in which they are invested – a tick box approach simply asking the question: "Does this meet the guidelines or not?" will be inappropriate for many small and science-based companies.

In respect of pre-emption, no new legislation is required, no new regulation, no new governance processes – clear communication between companies and their shareholders is the main prescription.

The Myners review has, however, identified opportunities for streamlining capital-raising processes and I look forward to the DTI and FSA taking forward this opportunity to make capital raising even more efficient.

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