Rights issue rules

Executive summary

- The regulations governing rights issues have been eased to help speed up the process.

Recent months have seen a continued surge in the number of secondary issues as companies embark on fundraisings or attempt to rebuild their balance sheets in response to the depressed market conditions. Of these secondary issues (that is, issues of shares by companies which are already listed), the most common structure used by listed companies has been the rights issue.

DEVELOPMENTS During the course of 2008, in the light of poor take-up of some high-profile equity issues, it became apparent that the rights issue process in the UK was not working as successfully as it should. Many of the problems that emerged in the spate of financial sector capital raisings were caused or exacerbated by the extended duration of the rights issue process. The Rights Issue Review Group (RIRG) was set up to review the much criticised process and, in particular, to look at how it could be made shorter so that the period during which a company and its reputation are at risk and its share price open to potential abuse could be greatly reduced.

RIRG published its report in November 2008. Some of its recommendations have already been implemented, including revised guidelines from the Association of British Insurers (ABI) on the allotment of shares for companies carrying out rights issues and a shorter minimum subscription period for rights issues. The Financial Services Authority (FSA) has also published a discussion paper on short selling, including a discussion of short selling during rights issues (currently the subject of a specific disclosure regime introduced by the FSA last year). The FSA and the Treasury have also made a joint submission to the European Commission advocating short-form prospectuses for rights issues.

The FSA intends to deal with the remaining issues in the RIRG report in a consultative paper later this year. The paper is expected to address the compensatory open offer, accelerated rights issues, possible changes to the FSA's tariffs to ensure that the fees for vetting equity shelf registration are more aligned to those for single prospectuses, and a possible framework for conditional dealings in rights issues (which would allow the rights issue subscription period to run in parallel with the general meeting notice period).

THE WHAT AND THE WHY A rights issue is an offer by a company of new shares or other securities to its shareholders in proportion to their existing shareholdings. Shareholders who wish to take up the offer will subscribe for the shares in cash, typically at a discount to the market price. A key feature which sets rights issues apart from other types of secondary issues is that the right to subscribe for the new shares in itself bears a value, and shareholders can realise this value by selling their rights in the market "nil paid"; that is, selling their rights to take up the shares without first having to pay for them. Such rights are commonly referred to as nil-paid rights.

The main advantage to investors of a rights issue is that even "lazy shareholders" (those who take no action in relation to their subscription) obtain a benefit: they have the right to receive any value over and above the subscription price if the shares which they would have taken up can be sold in the market at the end of the rights issue period. This is in contrast to, for example, an open offer (see next paragraph). The principal advantage to the company of a rights issue is that, unlike other types of secondary issue, there is no limit on its size or pricing.

An open offer, like a rights issue, is a pre-emptive offer to subscribe for shares made by a company to all its shareholders on a pro rata basis. However, unlike in a rights issue, shareholders who do not accept a traditional open offer cannot realise the value of their entitlements by selling them in the market. Under a traditional open offer structure, lazy shareholders are diluted and receive nothing (although it should be noted that Lloyds Banking Group recently undertook the UK's first compensatory open offer which, unlike a traditional open offer, did provide for non-accepting shareholders to receive any premium from a placing of their open offer entitlements following the close of the open offer period).

The listing rules specify that the discount in the case of an open offer should not be more than 10% to the middle market price of the

CHRIS GOWER EXPLAINS THE CHANGING REQUIREMENTS OF THE RIGHTS ISSUE.

shares at the time of announcing the terms of the offer (unless approved by the shareholders or carried out under an existing general disapplication of the statutory pre-emption rights). The ABI has indicated that rights issues are preferred to open offers where the increase of share capital is more than 15% to 18% or the discount is greater than 7.5%.

In contrast to a rights issue or open offer, non pre-emptive fundraising structures, including a straight cash placing, involve an issue of shares for cash to a specific group of investors rather than to shareholders generally. Although this may be the quickest and simplest method of raising additional equity capital, there are restrictions on both the amount of equity that can be raised in this way (generally not be more than 5% of the issued share capital) and on the discount (the listing rules impose a price discount limit of 10%, unless approved by the shareholders or carried out under an existing general pre-emption disapplication, although the ABI limits this further to 5%).

TIMETABLE Under the listing rules, the minimum subscription period for a rights issue is now 10 business days, having been reduced earlier this year from 21 days. The remainder of the timetable will depend primarily on two factors: whether a general meeting has to be called and whether the statutory pre-emption rights are disapplied (see below).

Whether a general meeting is required will in turn depend on whether the directors have sufficient authority for the purposes of section 551 of the Companies Act 2006 to allot the new shares and (in most cases) an appropriate disapplication of statutory pre-emption rights. If a general meeting is required, the timetable will therefore be extended by the notice period of the meeting, which will be 14 clear days unless the company's articles provide for a longer period.

In the case of a traded company, the ability to hold general meetings with 14 days' notice is also dependent on two further conditions as a result of the implementation of the Shareholders' Rights Directive. First, the company must have passed a special

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THERE MAY BE GOOD REASONS WHY A COMPANY CANNOT, OR DOES NOT WISH TO, COMPLY WITH THE STATUTORY PRE-EMPTION PROVISIONS.

resolution to enable meetings to be held with 14 days' notice. And second, the company must offer all shareholders the ability to appoint a proxy by means of a website. The notice period of the general meeting and the subscription period for the rights issue cannot run concurrently as the admission of the nil-paid rights cannot be conditional on the shareholder approvals.

A general meeting may also be required for other reasons; for example, because the rights issue will be financing an acquisition that is a class 1 transaction and therefore requires shareholder approval.

Another key event that will need to be factored into the timetable is the preparation of a prospectus. Subject to certain limited exceptions, a prospectus will be required for a rights issue. Preparation of a prospectus and approval by UKLA (the UK Listing Authority) can typically take around eight weeks to complete.

Rights issues are typically underwritten, which means that the issuing company agrees with an investment bank (or syndicate of banks) that, in return for an underwriting commission, the bank will take up any new shares that shareholders do not subscribe for and which cannot be placed at a premium in the market. The underwriting period usually runs from impact day (the day the rights issue is publicly announced) up to and including the day on which the underwriters are informed of the number of shares that remain unplaced. Generally, the longer the rights issue process, the higher the underwriting commissions which are payable because of the greater length of time for which the underwriter is committed.

PRE-EMPTION RIGHTS As a rights issue is an issue wholly for cash, the company will need to consider the statutory pre-emption rules. The rules prevent a company alloting equity securities unless it has made an offer to each holder of ordinary shares in the company of a proportion of those securities pro rata to their existing holdings on the same or more favourable terms (section 561 of the Companies Act 2006).

A rights issue is, by its nature, a pre-emptive offering as the new shares are offered in proportion to shareholders' existing holdings. However, there are two ways in which a rights issue can be carried out. It can be either a complying rights issue, which means that it is made on the basis of the statutory pre-emption rights set out in section 561 of the Companies Act 2006. Or it can be a non-complying issue, which will be the case if this section (or its predecessor, section 89 of the Companies Act 1985) has been disapplied.

Non-complying offer There may be good reasons why a company cannot, or does not wish to, comply with the statutory pre-emption provisions. If so, it would seek to allot securities either under an existing section 571 (or its predecessor, section 95 of the Companies Act 1985) disapplication or, if such a disapplication does not exist or is inappropriate, under a new disapplication to be put in place at a general meeting.

Listed companies usually adopt each year at their annual general meetings a general disapplication which relates to the securities for which authority to allot has been granted. If a company does not need new authority to allot shares, this existing disapplication should be sufficient for the purposes of the rights issue.

It should be noted that as well as a resolution to seek authority to issue up to one-third of the issued share capital, the ABI will now regard as routine an additional request from a company to authorise the allotment of a further one-third of the issued share capital provided that this additional authority is reserved for fully pre-emptive rights issues. It seems that many listed companies are passing this resolution to take advantage of the additional headroom for rights issues.

There are two important advantages of undertaking a non-complying offer. The first relates to overseas shareholders. Overseas securities legislation may lead to difficulties in making the offer in certain jurisdictions such as the US, Canada, Australia and Japan. However, where statutory pre-emption rights are disapplied, overseas shareholders can generally be excluded from the offer (provided that this is permitted by the disapplication resolution) and alternative arrangements can be made for their entitlements to be sold in the market and the cash proceeds from the sale remitted to them.

The second advantage concerns fractional entitlements. Under the statutory pre-emption provisions, the entitlements of shareholders have to be rounded down to the nearest whole number of shares and fractions of new shares disregarded. But where the pre-emption provisions have been disapplied, fractional entitlements are usually aggregated and sold in the market for the benefit of the company.

The listing rules also contain pre-emption rights similar to the statutory pre-emption rights, although these do not apply where the shareholders have authorised a general disapplication of the statutory pre-emption rights. In any event, unlike the statutory pre-emption rights, the listing rules allow for overseas shareholders and fractional entitlements to be dealt with in the manner described above.

Complying offer If the statutory pre-emption rights are not disapplied, section 562 of the Companies Act 2006 sets out how a pre-emptive offer must be made. In particular, if a shareholder either does not have, or has not provided the company with, a registered address in the European Economic Area (Iceland, Liechtenstein, Norway and the 27 members of the EU), then the offer may be made by publishing the offer, or a notice stating where a copy of the offer can be obtained, in the London Gazette (sometimes referred to as the Gazette route). The offer must be open for 14 days from the date on which the offer is sent or, in the case of an offer made by the Gazette route, the date of publication (reduced from 21 days on 1 October 2009).

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