Comments on behalf of

The Association of Corporate Treasurers

in response to

An invitation to comment:

The impact of shareholders' pre-emption rights on a public company's ability to raise new capital

(3 November 2004)

I Introduction

The ACT believes that this is a very important topic and welcomes the opportunity to comment.

We would be pleased to further expand any point made herein or to assist the Commission in any other way. Contact details for the ACT are given on the back page of these comments.

The Association

Established in the UK in 1979, The Association of Corporate Treasurers (ACT) is a professional body for those working in corporate finance, treasury, risk, and cash management operating in the international marketplace. It has over 3,300 members, mainly UK based, including representatives from 94 of the FTSE 100 companies (and members are on the boards of 36 of them at summer 2004).

There are 1,500 students in more than 40 countries. ACT examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading global provider of treasury education.

The ACT promotes study and best practice in finance and treasury management. Although a large number of members work in the financial services sector, the ACT represents the interests of non-financial sector corporations in financial markets to regulators, standards setters, trade bodies, etc.

December 2004

II Summary

- The ACT accepts the principle of pre-emption
  - Shareholders should be protected against issue of shares at an undervaluation – or should be the beneficiaries of such an issue
  - Shareholders value levels of fractional ownership and should not be diluted without their consent – not least because companies tend to have a direct relationship with shareholders holding above 0.5%, but shareholders holding less tend to be “below the radar”.
- Informal flexible guidelines are an appropriate mechanism of signalling to companies what institutional shareholders regard as sensitive levels of non-pre-emptive issues
- The willingness of investor bodies to give rapid guidance to companies on their reaction to proposals outside the guidelines is important for companies and helps make real the flexibility implied by “guidelines”. The alternative, discussions with individual shareholders, which can be more difficult to achieve, always remains available.
- The Pre-Emption Group has in the past provided and can still provide a suitable forum for consideration of general changes to the guidelines, bringing together as it does representatives of investor bodies, issuers (among which is the ACT), and of intermediary banks under the chairmanship of the Chairman of the Securities Institute. A note on the background of the Pre-Emption Group is provided in the Appendix, page 13.
- Pre-emption rights go to the heart of the position of shareholders as (fractional) owners of companies. To undermine them would move more towards precedence of a managerial system with full control in the hands of an intendant management. Such a move should not be made lightly.

Note: In this paper we make no comments in relation to pre-emption rights and treasury shares, which we believe are better dealt with elsewhere.

III Comments on the paper

As a general approach we find it hard to distinguish the interests of the company from those (properly defined) of its owners. We see management in place as serving those owners. We do recognise the sectional self-interest of management, as of other stakeholders.

It would be very surprising if company managements, including their treasurers, did not regard *any* required formality in capital raising as an inconvenient restriction on their ability to make some particular issue at some time. The matter is whether that is in the long-run detrimental to the shareholders (and, in this context, to the shareholders immediately prior to the mooted capital raising).

Furthermore, it is important to distinguish urged requirements for speed in transactions as serving the interests on the one hand of potential new investors and intermediary financial advisers etc. and on the other hand as serving the company's interest. Inducing a sense of time-pressure on a company's management can be convenient, getting them to "bite the bullet" and enabling firms to move on to other new revenue earning transactions.

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

Pre-emption has not been an issue raised with the Association's Technical Committee for some years[1]. We are thus not aware of excessive rigidity in relation to pre-emption. Treasurers generally are very aware that legal advisers and some financial advisers may represent the guidelines as rigid and have to be reminded that that is not true. Being human, treasurers, financial and legal advisers and others may remain silent about the flexibility on this as helping to head off a Chairman or CEO from an ill-advised move.

The Association believes that the 3-year cumulative 7½% limit is more inconvenient than the 5% annual limit.

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

The current level of accepted disapplication of pre-emption was arrived at in discussions with investors (see Appendix, page 13) rather than as a result of a theoretical study. It was a compromise. It is convenient in that a company does not normally need independently to justify its availability.

Going beyond that those levels, to ensure agreement, does require specific justification. The criterion by which to judge that justification must be the long-run interests of the shareholders eligible to vote.

In putting forward a case for shareholders to make a judgement on, a biotech company's management, for example, needs to address broadly the company specific factors including the technical development factors, the company's

[1] Except in connection with the introduction of the ability of companies to buy their own shares without cancelling them ("Treasury share's") where a meeting of the Pre-emption Group to discuss issues arising has long been requested.

strategy for product development and for revenue generation or other value realisation, and the costs and time-scales involved, the range of contingences and opportunities, the financing strategy, etc. and the related authorities for non-pre-emptive issue including relative values of issue, levels of dilution and discount and why what authority is sought for is likely to be superior to alternatives (which may not involve non-pre-emptive issues).

How detailed that case has to be, and how far into the future and how wide authorities may be granted, depends entirely on the circumstances.

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?

The Pre-emption Group concluded each year that the 5% guideline was not acting as a block to capital raising. This was on the basis of representations to the meeting from those present that neither they in conducting their own activities had found this to be true, nor had the bodies they represented (which included financial services sector trade associations) had supportable complaints from their memberships that this was true. Furthermore, bodies like the ACT had regular contact with academics in the field of corporate finance and nothing had come up through those contacts.

In each case it was not from active research, but based on the assumption that if anyone had experience to the contrary, they would surely have raised it.

To consider the question now, would probably require the commissioning of a number of academic research projects to look into the points raised by the Biotech industry and related comparative studies.

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?

Frequently parties are indeed objecting to the idea of pre-emption – particularly those parties with origins in the United States, or with US advisors.

Otherwise, guidelines are taken to be rules because it is simpler for advisers to explain them thus (see response to *Question 1*, on page 3). Company managements also frequently find it hard to make cases to shareholders in terms of the shareholders (long-term) interests rather than in terms of the "company's interests", seen as something different. By this we mean that a justification may be "facilitation of growth of the company", rather than "facilitation of growth of shareholder value".

The whole point of the voluntary adoption of the Pre-emption Guidelines and the side participation in the Pre-Emption Group was, of course, to *avoid* rigidity.

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?

One purpose of the Pre-emption Group's regular meetings was to consider if any systematic (as opposed to company specific) issues had arisen among companies' proposals for disapplications going beyond the Guidelines. In general, however, it was expected that company/situation specific matters would have been at issue in each case – the shareholders' long-run interests being the decision criterion.

The circulation of points of wider relevance in the Pre-emption Group's annual letters was seen as of potential importance, especially for advisers.

That the Guidelines are principle based is important. Over-prescription would risk straying into a rules based scheme (which legal advisors like because the game becomes one of finding ways round).

The Guidelines and the Group are essentially pragmatic matters, and we feel it is generally better to allow experience to drive movement rather than deal with hypothetical questions - for which it probably not best equipped.

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?

The approach adopted when the Pre-Emption Group was established was indeed a shareholder-involvement approach. The ACT and others in pressing for the partial liberation of the guidelines originally proposed by the NAPF did not deny that companies should be ready to make their case for specific relaxations in their case where this was merited. We simply felt that a 2½% annual "without specific justification" limit would mean the need to make specific cases on too many occasions, from both companies' and investors' viewpoints.

In any case companies could go directly to shareholders and there is generally a willingness of the principal investor bodies to "pre-clear" proposals which can facilitate this process.

We still support this.

On the other hand, this is not a topic where "comply or explain" is appropriate. Essentially, comply or explain is backward looking – explaining in an annual report why a particular recommended governance approach has not been applied, for example (and the term "apply or explain" is usually more apposite). Future adoption of whatever has not been applied remains a possibility.

Shareholder acceptance of non-pre-emptive issuance, however, is needed in advance because share issuance or the granting of rights to shares is episodic rather than an ongoing state of affairs. The loss of the value of the rights where shares are issued at a discount and the fractional-ownership dilution are irreversible.

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? AND

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

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?

We believe that the differences between US and UK corporate governance, securities laws and market practices are so great that while US comparisons are interesting they are not normally significant or useful for developing UK regulation or practise except in very narrow aspects.

General rights of US shareholders different from those in the UK:

> The parties protected by the core reporting/governance regime in the US are buyers and sellers of shares in the market (not shareholders who did not trade) while in the UK holders of shares are the key parties protected[2].
>
> US listed company shareholders have no say over major transactions while UK shareholders do (Class 1 transactions).
>
> Unlike UK shareholders, US shareholders[3] do not have the right to call EGMs and their votes are not determining in the re-election of directors.

US shareholders may have rights to pursue wrongdoing after the event.

It is a parody, but not that wrong, to suggest that in the US a shareholder's only and best remedy if they dislike aspects of corporate governance of a company is usually to sell the shares. Shares can only be seen as short-term investments in such an atmosphere. In the UK, advocates of concepts such as shareholder responsibility urge shareholders to take a longer-term view.

Allowing companies to choose pre-emption levels (presumably on initial incorporation) could over a very long-term give interesting data, in principle.

However the author of these comments has continuing direct experience of fund-raising at the business-angel stage of company development in the UK, particularly with high-tech and bio-tech spinouts from universities. Non-controlling shareholders or shareholders not closely associated with management simply cannot be attracted without pre-emption rights being closely protected. Compound dilution can be enormous over the years even though arising from seemingly small annual dilution. Start-up and early-stage investors expect a high failure rate among companies they invest in and look to the proportion of successful companies for returns - perhaps many years from their initial investment – to requite the investment in the failed companies too. Dilution of that those returns jeopardises the return from the whole portfolio.

---

[2] *Where economics meets the law*, *The financial reporting system of the USA compared to that of other jurisdictions*, Tim Bush, 2004, available at http://www.hermes.co.uk/pdf/corporate_governance/commentary/Where_Economics_Meets_The_Law_Final.pdf (see page 50 and 17)

[3] These aspects are dealt with at state level. Major registry states, like Delaware follow this practice.

Informed investors would apply similar consideration in investing in the later-stage companies being considered in this consultation – even if the issues then are less starkly obvious. It is difficult to see higher levels of non-pre-emptive issue being other than rarely accepted.

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? AND

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

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

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

The short period for consultation has not permitted suitable review in these areas.

However, we do not believe that anyone needs a "way around" pre-emption. If there is a pre-emption problem, the solution is companies putting a persuasive case to their shareholders.

In a non pre-emptive issue while the bookbuilding goes on the market price commonly falls to a clearing level. Taking this into account the cost to shareholders of issuing in the US can be more than double that of a UK underwritten rights issue. Accordingly we are sceptical of the economy of non-pre-emptive issues unless either (i) the cost considered is limited to that reflected in the company's accounts rather than that suffered by the shareholders prior to the issue or (ii) the issue contemplated is small and the direct cost of communication with shareholders is thus of greater significance. Furthermore, there appears to be embedded in the question inadequate value attribution to the dilution effects on shareholders.

We are sceptical of the "window of opportunity problem". It has not been raised by any of our members, or anyone else, with us.

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

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

The distinction in requirements between cash and non-cash consideration pre-dates the Pre-emption Guidelines, but is designed to enable companies to use shares as acquisition currency for small acquisitions. We presume that institutional shareholders find the dilutive aspects (and any market-price effects from sale by the recipient of the shares, personally or through a cash-box) acceptable. Of course shareholders have a direct say on larger (Class 1) acquisitions.

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?

We do not know of two-stage issues by companies in this position.

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?

There is a value judgement involved in use of the word "constraining". It is not clear that pre-emption rights constrain the actions of companies in any way other that ways which its members desire – and who else should have the right to consider this? Only as a company nears insolvency does any other constituency's interests supplant those of members in the minds of directors, and there is no hypothesis of insolvency under consideration here.

The degree of constraint on non-pre-emptive issue is a matter for shareholders, but companies must explain their particularities and how shareholders' interest may be affected by what ever proposals they may make. Shareholders must balance the relative advantages of more or less rapid growth (or, at least, exploration of its technical space) by a company against dilution of their interest.

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?

The diversification factor is important when looking at institutional overseas investment. Naivety about overseas regulation and practice is important too.

However, while aspects of a jurisdiction's arrangements may be inferior, the overall cocktail brewed from local company law, securities law, laws of property etc. etc. may be considered acceptable, at least for a while. US laws and regulations affecting corporate governance and reporting were considered acceptable by many, but Enron still precipitated wholesale changes. Even in the UK, the relative risk of bonds issued by MyTravel was the subject of litigation at the end of 2004.

It must be doubtful if investors are in a position accurately to price these differences, individually or as a whole.

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?

Not for primary listings which is what applies here.

Smaller UK companies are generally very reluctant to expose themselves to the rigours of US reporting and compliance. Major European companies have recently been lobbying against the impact of US reporting requirements and ITV is undertaking a scheme of arrangement to avoid them.

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

We regard the opportunity for competition between different regimes for listing of companies as a good thing. Just as companies are free move their operations and tax base within the EU for example. Companies and investors will seek out regulations which provide a balance of rigour and cost. A

dynamic balance will be established changing as circumstances cause people to focus on the lack of rigour or the excessive costs (of all kinds).

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

No.

Overseas participation should not be used as a pretext for lowering the standards of UK markets.

If overseas shareholders have made arrangements for voting of their shares, that is right and proper. If they have not, that is their choice – i.e. they are abdicating corporate governance issues to other shareholders. Shareholders from jurisdictions (such as the US) where shareholders have little say on corporate governance matters will often not make arrangements to exercise their votes. As disapplication of pre-emption provisions requires a qualified majority of those voting, abstention does not represent any kind of a vote against.

Modern methods of communication should enable companies to have effective communication with shareholders wherever they are located. It is important that all aspects of company law are kept up to date in permitting the use of modern methods of communication – and indeed requiring them where significant reductions in the time needed to complete corporate actions can be achieved.

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

Generally, larger, deeper markets can support more specialists. Influences, particularly taxation and the structure of their liabilities, on investors can make them more or less willing to undertake the kinds of risk involved in particular stages of development of particular industries.

These are factors to be taken into account when a company decides where to list. However, if attractive investment opportunities exist in a market and are not being taken up by local investors, that will tend to attract in other investors (if they find all other factors influencing investment decisions acceptable).

In the UK, specialist investors in early stage companies (in whatever sector) tend to regard trade-sale or listing as an opportunity to exit. In principle, investors specialising in investing in companies at a later stage (post-listing) can develop. If they do not, it may be because the volume of such opportunities in a particular market may not be enough to sustain that investment style.

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?

We realise that the use of the words "wrong type of ..." is humorous and may be intended to suggest that it is up to companies seeking to raise capital to

shape their offer to appeal to those potential investors to which they do have access.

However, it is quite conceivable that UK based investors do not have the kind of liability structures or tax arrangements etc. which encourage investment in early listed biotechs. Such companies potentially have large future funding requirements which will involve future share issues. Even if such a company is successful, positive earnings and cash flows may well be long deferred.

If non-UK investors are better placed to manage such long, risky exposures, that would be an incentive for biotechs to attract non-UK based investors.

Early stage companies are usually driven by technologists and entrepreneurs who are motivated respectively by the technology and the potential market. Neither of these types is renowned for wanting to understand the markets for the financial resources they will need access to to realise their visions – or even acknowledging that adapting to those markets is as much part of their "business" as adapting to technological constraints or (product) market conditions.. Such an acknowledgement is an essential part of the ingredients for success in any business.

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?

We are unable to comment on this.

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

We suspect that the concerns expressed are being overstated. See also Question 1, on page 3.

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

Shareholders can take size into account when responding to proposals for disapplication of pre-emption restrictions. However, the dilutive effect of a 5% non-pre-emptive issue is proportionately as large to an investor irrespective of the size of the company.

Supplementary comments

The ACT and pre-emption rights

The ACT has been a long-standing supporter of shareholder pre-emption rights, but has sought to ensure that companies have access to sufficient flexibility from shareholders when this is needed while acknowledging that it is, of course, the right of shareholders, as owners, to deny that right if they collectively so choose.

The Association is involved in the Pre-emption Group, and a note on the origins of the group is appended. It has been a matter of regret to the ACT that the Pre-emption Group has not met since 1999.

Experience shows that since the start of the current arrangements, investment banks and firms of lawyers have used the Pre-Emption Guidelines as a way of discouraging companies from making unreasonable proposals for non-pre-emptive issues. Such firms were reluctant to be seen supporting unreasonable proposals made to the investment committees of the main investor bodies. In those few cases where individual companies attended Pre-Emption Group meetings to suggest that the guidelines bore too heavily on them, the company executive present was always surprised to find that the guidelines were not rules.

While pre-emption may seem an inconvenience to individual company managements at particular times, the ACT takes the view that the long-term interest of issuers is in capital raising at the lowest cost to members of the company – the shareholders.

The cost of capital raising is in part recorded in the books of the company, and in part borne by shareholders by way of share price changes and changes in their fractional ownership.

Costs of issues

It is important not overlook that the effect of a share issue or potential or expected issue on share prices. While the discount to market price may be a cost for a non-pre-emptive issue, some mechanisms cause some or all of that discount (proportionately adjusted in relation to the volume of shares already issued) to be reflected in the share price at the time of fixing of the actual price of the new issue. The discount to market price may thus understate the actual cost to shareholders.

Claw-back

The possibility of issuing shares non-pre-emptively with a claw-back agreement to satisfy any demand from existing shareholders who choose, after the placement of the shares is agreed, to exercise pre-emption rights should not be over-looked.

Disapplication for a period or for a specific purpose

We believe that companies and their advisers do not make optimum use of the flexibility provided by current arrangements.

For example, because power resides with existing shareholders, companies can seek disapplication of pre-emption to permit a specific issue or class of issue, with certain minimum conditions, during a period of time – for example where existing shareholders have indicated reluctance to take further shares and a PIPE type issue may be more appropriate. While a potential PIPE issue may weigh on the share-price during such a period, knowledge, which would be widespread, that the company will

need extra funds in any case would weigh on the share price, and knowledge of an active PIPE intention should opportunity arise may serve to relieve some of that pressure. A good case could in principle be made for the limited disapplication needed to allow this.

Appendix
The Pre-emption Group - background

The origin of the Pre-emption Group is as follows:

- The National Association of Pension Funds (NAPF) announced that it would recommend that its members oppose companies' non-pre-emptive issue of shares at a level greater than 2.5% per annum.
- The ACT considered that this level of restriction did not give companies sufficient flexibility.
- On the initiative of the Association of British Insurers (ABI) and the ACT, meetings to consider the matter were held under the auspices of the Bank of England, involving investors (the ABI and NAPF), issuers (the ACT) and representatives of several of the then trade associations of intermediary banks.
- From this process the current structure emerged:
  - Guidelines that the investor associations would generally not oppose non-pre-emptive issues within guidelines of up to 5% per annum with a rolling three-year maximum of 7.5%
  - The investment committees of the investor associations would consider particular company proposals which went beyond the guideline levels on a case by case basis, indicating what recommendations they would expect to make to shareholders about the proposals if they were made by the company to shareholders – and companies can propose what they wish to their shareholders directly, of course.
  - The Pre-emption Group would be created
    - to review the workings of the guidelines annually, and as necessary to consider whether the guidelines themselves needed review/change in light of market circumstances or representations from affected bodies and
    - comprising representatives of the investor associations, representatives of issuers (one from the ACT and one from the company representatives on the Stock Exchange's Listed Companies Committee) and of intermediary banks, under the chairmanship of the Securities Institute.
    - The Stock Exchange agreed to provide limited secretariat services and to host the meetings and also introduced a requirement for filing of a return, Form PE, on listing of new shares in order to facilitate monitoring of pre-emptive and non-pre-emptive issues. The ABI agreed to undertake an annual analysis of these returns for consideration by the Pre-Emption Group.
  - It was emphasised that the "guidelines" were just that, and not rules.

The ACT believes that the current mechanisms, including the Pre-emption Group, are appropriate ways of handling these matters. It is a matter of regret for the ACT that, while the Pre-Emption Group continues to exist, it has not met in recent years.

Contacts:

Richard Raeburn, Chief Executive
(020 7213 0734; rraeburn@treasurers.co.uk)

John Grout, Technical Director
(020 7213 0712; jgrout@treasurers.co.uk)

Martin O'Donovan, Technical Officer
(020 7213 0715; modonovan@treasurers.co.uk)

The Association of Corporate Treasurers
Ocean House
10/12 Little Trinity Lane
London EC4V 2DJ

Telephone: 020 7213 0728
Fax: 020 7248 2591
Website: http://www.treasurers.org

The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at the above address