Guidance on Share Issuing Good Practice For Listed Companies

Prepared by the Bank of England on the basis of consultation with

The Confederation of British Industry
The Association of British Insurers
The National Association of Pension Funds
The Fund Managers Association
CISCO
The Association of Corporate Treasurers
The Hundred Group of Finance Directors

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This document is also available at the Bank of England website:
www.bankofengland.co.uk/shareissuing.htm

INTRODUCTION

1 This booklet is intended to help UK listed companies make informed choices about share issuing methods. It has been prepared at the request of the Monopolies and Mergers Commission (MMC)[1] by the Bank of England and seven organisations closely concerned with share issuance, according to the procedure set out in Appendix 1.

2 The guidance is structured as a list of questions which issuers may wish to consider putting to their advisers, brokers and/or lead underwriters, summarised in the next section. Following the recommendation made by the MMC in its report of February 1999[2], the guidance focuses on the use of tendering for the sub-underwriting and on the circumstances in which deep discounted issues might be advantageous.

3 In the UK, share issues by companies whose shares are already listed are typically underwritten. This involves the appointment of a lead underwriter, who agrees to subscribe, at the issue price, for any shares not taken up by the shareholders or others. The lead underwriter will normally choose to lay off some or all of the associated risk with sub-underwriters, after taking advice from the company's broker on the arrangement of the sub-underwriting. An alternative to this underwriting procedure is a deep discounted issue, where the intention is to offer shares at a sufficiently large discount to the current market price to ensure take-up of the issue without the need for underwriting.

1 Subsequently renamed the Competition Commission.

2 "Underwriting services for share offers", Cm 4168, The Stationery Office; summarised at *www.competition-commission.org.uk/under.*

SUMMARY OF POINTS TO CONSIDER

4 The key points which issuers may wish to consider raising with their advisers are:

(i) whether, in a particular case, putting the sub-underwriting of an issue out to tender is likely to lead to lower costs than if standard fees[3] are used;

(ii) whether sub-underwriting at a negotiated (as opposed to standard) fixed fee might be a substitute for tendering for issues which are relatively small or where the stock is relatively illiquid or volatile;

(iii) whether a "full" tender (i.e. a tender for the whole of the sub-underwriting) might be preferable to a "partial" tender (i.e. a tender for only part of the sub-underwriting), in the light of the MMC recommendation to consider full tenders more positively;

(iv) in cases where a partial rather than full tender is recommended, to ensure sufficient participation by sub-underwriters and to limit risk to the lead underwriter, whether there are other ways of reducing underwriting risks and the associated fees. Examples might include a pre-marketing or bookbuilding process applied to the allocation of the sub-underwriting, a widening of the discount, use of a deep discounted issue, or some combination of these approaches;

(v) the extent to which a tender might be opened to a wider group of potential sub-underwriters, and whether, through the introduction of greater competition into the tendering process, this might lower the costs of the issue. The MMC recommendation that issuers should be encouraged to adopt tenders which are open to as wide a group of potential sub-underwriters as practicable should be borne in mind;

(vi) whether, in the particular circumstances, a deep discounted issue might be a more cost effective way of meeting the objectives of the issue. In arriving at a decision, issuers should bear in mind that in a deep discounted (or, indeed, any) rights issue, the size of the discount and its direct impact on the share price does not of itself impose any loss on existing shareholders or any cost on the issuer (provided the issue does not fail). There is no reason in principle why a deep discounted issue should be associated with a market perception of weakness on the part of the issuer (although, in practice, most recent deep discounted issues have been so regarded)[4].

3 The term "standard fee" refers to the fact that, prior to the introduction of tendering for sub-underwriting, most rights issues were undertaken at a fee of 2% of the gross proceeds of the issue for 30 days and a further 0.125% for each additional seven-day period. Of this total fee, the lead underwriter received 0.5%, the broker arranging the sub-underwriting 0.25%, and the sub-underwriters 1.25%, plus the 0.125% for each additional seven-day period.

4 Historical figures for earnings, assets and dividends per share should always be adjusted to take into account the scrip element of a deep discounted issue. This was not always done in the past, but is now specifically recommended by the Association of British Insurers and National Association of Pension Funds, and is subject to Accounting Standards Board guidance.

5 In evaluating the choice between a sub-underwritten and deep discounted issue, companies may wish to consider the range of alternatives between these two approaches. Other things being equal, these will involve different combinations of the discount and the sub-underwriting fee, with the fee narrowing as the discount increases.

PURPOSE

6 This guidance has been produced following the report of February 1999 by the Monopolies and Mergers Commission on underwriting services for share offers. One of the report's recommendations was that the Bank of England should bring together and publish guidance on share issuing good practice for companies whose shares are already listed. The MMC recommended that the guidance should, in particular, encourage a more widespread use of tendering for sub-underwriting and explain when deep discounted issues were likely to be advantageous. Matters that were not the subject of public interest findings by the MMC are excluded. Further details of the MMC report and the recommendation relating to the Bank of England are provided in Appendix 1.

7 The ultimate purpose of the guidance is to assist companies to make informed choices, particularly in the context of pre-emptive share issuing. The issuance of equity is an important event for most companies and one whose efficient execution and success can be vital for the company's well-being. The market for equity issues, however, is dynamic and changing. It is therefore very important that companies ensure that they receive good advice, and that they are aware that the lead underwriting of any equity does not have to be undertaken by their general advisers. Advisers will need to be alert to the full range of issuing techniques and companies should be prepared to consider which of these best meets their own circumstances.

8 This suggests that there is no single right way to go about issuing equity. The approach should vary depending on the circumstances, including:

- the nature and size of the company
- the size and purpose of the issue
- the shares to be issued
- the extent to which certainty of proceeds is needed
- the liquidity and volatility of the existing stock and
- the more general economic and market environment.

This guidance is not, therefore, a universal blueprint but rather a checklist of points for companies to consider and questions for them to put to their financial advisers and/or lead underwriters, and their brokers, if they think it appropriate. It encourages companies to give thorough consideration to tendering and deep discounting, while recognising that these will not necessarily be the most appropriate methods in all circumstances.

9 The guidance is part of a wider initiative. In line with a separate recommendation by the MMC, the Financial Services Authority[5] has reminded[6] corporate finance advisers of their obligations to provide information to their clients as indicated by FSA Principle 5 (information for customers). This states that: "A firm should take reasonable steps to give a customer it advises, in a comprehensible and timely way, any information needed to enable him to make a balanced and informed decision. A firm should similarly be ready to provide a customer with a full and fair account of the fulfilment of its responsibilities to him". Specifically in the context of this Principle, the FSA has also reminded corporate finance advisers that their advice to customers considering share issues should include an evaluation of the alternatives to sub-underwriting at standard fees, such as tendering for sub-underwriting and non-underwritten deep discounted issues. The FSA will, in the course of monitoring its member firms' corporate finance activities, continue to look for compliance with this particular aspect of FSA Principle 5. The MMC report found no evidence that companies were dissatisfied with the advice they received, but the FSA has said that it will investigate any complaints made to it.

10 In discussing alternatives to the "standard" approach, issuers will appreciate that the sub-underwriting fee should compensate for the risk faced by the sub-underwriter. This depends on various factors, including:

- current market conditions
- the size and purpose of the issue
- the duration of the underwriting period
- the volatility of the share price and
- the issue price discount.

For a given discount, the sub-underwriter will seek a fee which matches the perceived riskiness of the issue, whether through bids in a tender or in direct negotiation with the issuer. The issuer may also seek to limit the sub-underwriter's fee (and risk) by widening the discount.

11 In that event, however, issuers will need to weigh up carefully both the benefit and cost of a wider discount. The cost of a wider discount will be the reduced value of the short-term underpinning insurance provided to the shareholders should the issue fail (in the sense of the share price falling below the issue price during the underwriting period). The wider the discount, the greater the loss suffered by the shareholders of the company relative to the sub-underwriters in the event that the issue should fail. The benefit of a wider discount includes the reduced fee payable to the sub-underwriter and the lower probability that the issue will fail because, other things being equal, the share price is less likely to fall below the issue price. A reduction in the probability of a failed issue, with all the longer-term reputational damage from such a failure, is an important objective for the company.

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5 Strictly, the Securities and Futures Authority Limited currently, until the Financial Services and Markets Bill is enacted.

6 In the July 1999 edition of the "SFA Update".

12 In their discussions, issuers may also wish to take into account recommendations made by The Association of Corporate Treasurers (ACT) to its members in The Treasurer's Handbook 2000, which is available from the ACT, and reproduced on the ACT's website at *www.corporate-treasurers.co.uk*. These highlight information which issuers might request from advisers if they are contemplating a tender for the sub-underwriting or a deep discounted issue. It should be emphasised, however, that the recommendations are neither prescriptive nor exhaustive, and the actual information that it is useful to seek will depend on the circumstances of the issue. For small companies, it may not be appropriate or feasible (on cost grounds) to obtain all the information listed by the ACT; in other instances, the scope for additional information might be considered. This information should provide greater transparency in determining how sub-underwriting has been allocated, although account will need to be taken of any legal or regulatory restrictions on such information being made available, or on its use.

USE OF TENDERING IN SUB-UNDERWRITING

13 The MMC concluded that the use of standard fees could mean that the cost of sub-underwriting is higher than would otherwise be the case, and that greater use of tendering for the sub-underwriting should on average reduce the cost.

14 In practice, whether the use of tendering achieves a reduction in the cost of sub-underwriting a particular issue, and the extent to which it does so, will depend on various factors specific to that issue, notably the size of the company, the size of the issue, its purpose, its complexity, the degree of liquidity of the underlying stock and prevailing market conditions at the time. In some circumstances, particularly for smaller companies, it is possible that tendering may actually increase sub-underwriting costs, compared with the present standard fees. In relation to an issue for which it has been decided to consider underwriting, issuers might aim to cover the following points in their discussions with their advisers and brokers:

(i) whether, for the particular issue under consideration, tendered fees are likely to lead to a lower or higher overall underwriting cost;

(ii) in view of the MMC conclusion summarised in paragraph 13 above, the reasons for any recommendation not to use a tender, bearing in mind that the cost associated with sub-underwriting should be counted as a cost to the company irrespective of whether sub-underwriters are in fact existing shareholders. In this context, the argument that the cost associated with sub-underwriting is not a true cost to the company because it is largely paid to existing institutional shareholders is incorrect. Only in the case where sub-underwriting is offered only to all existing shareholders in proportion to their shareholdings could the cost of that sub-underwriting be disregarded by the company;

(iii) if a tender is considered inappropriate, whether it might still be possible to reduce cost to the company by negotiating a sub-underwriting fee below the standard rate;

(iv) in cases where the sub-underwriting risk is relatively high, so that tendering could result in a sub-underwriting fee above the standard rate, whether there are ways of reducing the underwriting risk, e.g. by increasing the discount and thereby reducing the fee.

TENDERING FOR THE WHOLE OF THE SUB-UNDERWRITING

15 The MMC report noted that the majority of the rights issues which had employed tenders had applied those tenders to significantly less than 100% of the sub-underwriting ("partial tenders"). It encouraged issuers to consider positively the use of tenders for the whole of the sub-underwriting ("full tenders") in appropriate circumstances, or at least to invite tenders for as high a proportion of the sub-underwriting as possible.

16 In determining the proportion of the sub-underwriting opened to tender, issuers might cover the following points in discussions with their advisers and brokers:

(i) the reasons for any recommendation that less than 100% of the sub-underwriting be tendered;

(ii) the fact that, under the London Stock Exchange's proposed changes to the listing rules[7], companies would be required to explain their reasoning to shareholders, in both the offer document and the annual report, when less than two-thirds of the sub-underwriting is offered for tender;

(iii) whether a partial rather than full tender may be necessary to ensure that enough sub-underwriters participate, through initial allocations of stock to them at standard fees, and thereby to limit risk to the lead underwriter and ensure that the issue is supported. This might occur in cases where the issue is relatively small, or involves relatively illiquid and/or volatile stock. Once again, however, it would be sensible to consider other ways in which the risks, and associated fees, might be reduced. Possibilities might include some form of pre-marketing or bookbuilding process applied specifically to the sub-underwriting, a widening of the discount, or employment of a non-underwritten deep discounted issue;

(iv) whether, even in other circumstances, a partial tender may still be required, for example to reduce the cost and risk which arise if sub-underwriters are reluctant to bid in a full tender. This might be because they are unwilling to commit resources to a full tender if they could end up with no allocation at all. In such circumstances, the non-tendered allocation may be necessary to encourage bidders to participate in the tender;

(v) whether it is possible to increase the benefits of a partial tender by pricing the non-tendered allocations at a rate related to the strike rate (i.e. the lowest rate in the tender at which acceptable offers of sub-underwriting are sufficient to meet the amount tendered) rather than at the standard rate.

7 "Proposed changes to the listing rules", consultative document issued by the London Stock Exchange, September 1999 at page 35 (proposed new rules 9.41 and 9.42); also available at *www.londonstockex.co.uk/new/new.asp*.

TENDERING TO AS WIDE A GROUP OF POTENTIAL SUB-UNDERWRITERS AS PRACTICABLE

17 The MMC report encouraged issuers to adopt tenders for sub-underwriting which are open to as wide a group of potential sub-underwriters as practicable, having regard to their status and willingness to stand by the issue. Again, the extent to which this can be done will depend on various specific factors, including the size of the issue, the degree of liquidity of the underlying stock and the existing and potential shareholder base of the company.

18 In considering whether to widen the allocation of the sub-underwriting, issuers might cover the following points in their discussions with their advisers and brokers:

(i) the pros and cons of achieving as close an overlap between existing shareholders and sub-underwriters as practicable, bearing in mind that the existing shareholder base may be too small or too constrained to tender for the entire issue. In making this assessment, issuers may wish to consider the desirability of widening the shareholder base and the group of potential sub-underwriters, for example by targeting additional potential buyers of the unsubscribed nil-paid rights;

(ii) the extent to which the broker has the capability to open the tender to a wider group of potential sub-underwriters and, by introducing greater competition into the tendering process, lower the cost of the issue. Discussions will need to bear in mind the practicability of inviting sub-underwriters with no existing connection with the company to tender, given the very short time in which a response can be required (for reasons of risk and confidentiality). The likelihood of any wider group not only taking, but also retaining, any underwriting "stick" will also need to be borne in mind, as will the method of disposal of any stick not retained;

(iii) whether the appointment of a different broker, or more than one broker, might allow access to a wider circle of sub-underwriters, particularly where international interest is sought.

DEEP DISCOUNTED ISSUES

19 As noted in paragraph 9 of this guidance, the FSA states that advisers must ensure that their clients are made aware of alternatives to underwriting at standard fees, and are provided with sufficient information and time to enable issuers to make a balanced and informed decision on these alternatives. One such alternative is a non-underwritten deep discounted issue.

20 In recent years, non-underwritten deep discounted issues have been little used in the UK as a means of raising equity. It has been argued that this reflects a number of drawbacks, including:

- lack of certainty of proceeds
- adverse impact on share price
- unwillingness of the company to adjust dividend per share
- a signal to the market that the company is weak
- potential problems for shareholders, including tax issues
- imperfections in the nil-paid rights market

21 The MMC report suggested that, while there could be disadvantages in certain market conditions or in relation to particular issues, issuers should nevertheless consider the option of a non-underwritten deep discounted issue. In evaluating the possible advantages and disadvantages, issuers should bear in mind that:

(i) other things being equal, uncertainty about the proceeds may be reduced, though not eliminated, by increasing the discount;

(ii) the direct effect of a deep discounted (or, indeed, any) rights issue on the share price, as measured by the theoretical ex-rights price on the first day of trading, does not of itself impose any loss on existing shareholders or any cost on the issuer (see the Technical Annex). The impact on executive share option schemes can normally be limited by appropriate adjustments to such schemes;

(iii) similar points apply also to concerns over the effects on earnings, assets and dividends per share. In this context, any rights issue can be seen as a combination of an issue of shares at the market price and a scrip issue. The Accounting Standards Board has issued guidance on the adjustment of dividends per share to take account of the scrip element in any rights issue (Financial Reporting Standard 14, 1 October 1998). Other things being equal, all historical figures for earnings, assets and dividends per share should therefore be adjusted

accordingly. If the company wishes to change its dividend payout policy by maintaining future dividends per share on the enlarged share capital, this should be made explicit (see Technical Annex). The need to make these adjustments is now widely understood by institutional investors, as recognised in the Joint Position Paper published by the ABI and NAPF in July 1996[8]. However, this wider understanding would be reinforced if the scrip element in all deep discounted issues was always made explicit, as recommended by the MMC;

(iv) there is no reason in principle to associate a deep discounted issue with weakness on the part of the issuer. In practice, a number of deep discounted issues have formed part of corporate rescues in the past, leading to a market perception that non-underwritten deep discounted issues are a sign of weakness. But there have also been occasions in the past when such issues have been made by sound companies in normal market conditions. Indeed, a strong company with a good track record and a supportive shareholder base - looking to raise finance for future investment, as distinct, say, from guaranteed finance for a specific acquisition - may be well-placed to consider a deep discounted issue;

(v) the capital gains tax treatment of a deep discounted issue is no different from that of other rights issues, except that there is a greater chance that the exemption threshold will be exceeded. This risk has been reduced, but not eliminated, by the Inland Revenue's clarification that, if the taxpayer's receipt from the sale of nil-paid rights is less than the greater of 5% of the value of the underlying shareholding or £3000, the sale will normally not be treated as a disposal for CGT purposes. Taking into account also the annual exempt amount, the benefits of indexation for pre-6 April 1998 holdings and the new taper relief for disposals after 5 April 1998, the incidence of a tax charge may be reduced for some shareholders (and, of course, does not exist for tax-exempt shareholders, such as pension funds and charities). The MMC also recommended that the CGT rules be amended so that "tail-swallowing"[9] is not treated as a disposal and HM Treasury invited representations on this issue. The Technical Annex provides more details on these points, and considers how much additional capital a company might be able to raise for various levels of discount, without giving rise to a CGT charge;

(vi) there is no necessary reason why imperfections in the nil-paid rights market should be any greater in a deep discounted issue, although the risk evidently increases with the size of the discount. In some cases, especially in relation to smaller company stocks, there is evidence from spreads and fees that such imperfections are significant. Much will depend on the market's perception of the company, and the size of the issue, but such imperfections might be reduced if there is more than one market maker in the nil-paid rights.

8 Reproduced as Appendix 6.1 of the MMC report.

9 See the Technical Annex, paragraph A13(iii) below.

22 Deep discounted issues may be an attractive option more often than is generally appreciated. A strong company with a good track record, which needs to finance future investment rather than a specific acquisition and has a supportive and stable base of shareholders who are likely to subscribe to the shares, may well find a deep discounted issue is to its advantage. In cases where complete certainty of proceeds is required, however, a non-underwritten deep discounted issue would be less appropriate. This might apply particularly where the issuer has irrecoverably committed to pay away the proceeds, for example to fund an acquisition, and has no alternative finance available.

23 In some circumstances, it may be appropriate to consider an underwritten deep discounted issue. This reflects the fact that, ultimately, sub-underwritten and deep discounted issues are not always mutually exclusive, and companies would be well advised to consider whether an increase in the discount might reduce or largely eliminate the fees associated with underwriting, without adversely affecting the objectives of the issue.

TECHNICAL ANNEX

A1 In this section some key technical aspects of rights issues are explained. The aim is to help companies estimate the true cost of their chosen equity raising method.

A2 The easiest way to illustrate these technical aspects is by way of an example[10]. Shares in Company X are currently trading at £5. The company has 100 million shares outstanding, so its market capitalisation is £5 x 100 million = £500 million.

A3 The company wants to raise £125 million of new capital via a rights issue. Together with its advisers, the company has decided that a 20% discount to market price would be appropriate. This means the new shares will be issued at a price of £5 x (1–0.2) = £4. The number of new shares to be issued equals £125 million ÷ £4 = 31.25 million shares.

The level of the discount is not a cost to the issuer

A4 After the rights issue, the company should have a market capitalisation of £500 million + £125 million = £625 million. There will be 100 million shares + 31.25 million shares = 131.25 million shares outstanding. The theoretical price of shares ("Theoretical Ex-Rights Price" or TERP) will therefore be £625 million ÷ 131.25 million shares = £4.762 per share[11] on the first day on which the shares trade ex-rights. A decrease of the share price from £5 to £4.762 therefore reflects the fact that the increased capital and reserves have been distributed over a larger number of shares. It does not represent a loss to shareholders, nor a cost to the issuer (although, if the TERP falls too near the par value of the share, the company's freedom of manoeuvre may be affected, since shares cannot be issued at a discount to par value). The discount determines the number of shares to be issued. At a larger discount, the company needs to issue more shares to raise the same amount of new capital.

Making the scrip element explicit

A5 One can think of a rights issue at a discount as two separate transactions:

(i) The company's capital is increased from £500 million to £625 million via a rights issue at the market price. This means 25 million additional shares are issued at £5. After this transaction there are 100 million + 25 million = 125 million shares outstanding, and the share price remains unchanged at £5.

(ii) The number of outstanding shares is then further increased from 125 million shares to 131.25 million shares. This is equivalent to a 1-for-20 scrip issue, and 1-for-20 is therefore referred to as "the scrip element of a discounted rights issue". As a result of such a scrip issue, one would expect the share price to drop from £5 to £4.762 (= £5 x 20 ÷ 21).

10 In order to simplify the example, transaction costs have not been taken into account. Moreover, any movements in the market price of the shares as a consequence of market response to the rights issue or other factors have been disregarded.

11 Figures have been rounded for the purpose of this example. The theoretical value of the new shares is actually £4.76190 recurring.

Adjusting the dividend per share

A6 In the same way as the decrease in the company's share price from £5 to £4.762 does not represent a decrease in the company's value, a decrease in the dividend per share to reflect the scrip element of the rights issue would not represent a change in dividend distribution policy.

A7 Assume that the dividend before the rights issue was announced is 10 pence. If in the year following the rights issue this dividend were reduced to 9.52 pence, this would not represent a reduction in the dividend distribution policy, as the lower dividend per share simply reflects an increase in the number of shares due to the scrip element. It is for this reason that, according to the accounting standard FRS14, historical dividends and earnings per share must be adjusted for any discounted rights issue.

A8 In practice, this is done by multiplying by an adjustment factor, which reflects the scrip element of the rights issue. Historical dividends will be reduced by a factor 4.762/5.000. The dividend per share before the rights issue will therefore be restated as 10 pence x (4.762/5.000) = 9.52 pence.

A9 Thus reducing the dividend per share after the rights issue to 9.52 pence represents an unchanged dividend distribution policy. Conversely, maintaining the dividend per share after a rights issue at 10 pence represents an increase in dividend distribution policy from 9.52 pence to 10 pence.

Underwriting and advisory fees are direct costs to the issuer

A10 As explained above, the level of the discount does not represent a loss to shareholders (if they take up the rights or receive the proceeds of the sale of rights) nor a cost to the issuer (provided the issue does not fail). The level of fees, however, is a direct cost to the company, and therefore to shareholders. The sub-underwriting fee should compensate for the risk run by the sub-underwriter, which is a function (among other things) of the discount, the size of the rights issue, the duration of the underwriting period and the volatility of the share price. If £125 million of new capital is raised by the company at standard fees of 2%, this represents a direct cost of £2.5 million. Every 0.1% reduction of the sub-underwriting fee represents savings of approximately £125,000 to the company and to those shareholders who are not sub-underwriters.

Shareholder's wealth is not affected by the discount[12]

A11 Consider a shareholder who had £100,000 invested in Company X. This means that the shareholder owned 20,000 shares at £5 before the rights issue. After the rights issue is announced, the shareholder finds that her 20,000 shares are worth £4.762 each. She therefore has 20,000 x £4.762 = £95,238 invested in the company. She has also received 6,250 rights to buy additional shares in the company at £4 each.

12 Abstracting from potential CGT liabilities and frictional effects, such as imperfections in the nil-paid rights market.

A12 As the TERP is £4.762, and each right allows the shareholder to purchase an additional share at £4, the rights have a theoretical value of £0.762 each. The rights are therefore worth a total of 6,250 x £0.762 = £4,762. The value of the shareholder's holding is therefore unchanged at £95,238 + £4,762 = £100,000. This illustrates how a rights issue preserves value for existing shareholders.

A13 Consider now the options available to the shareholder. She can exercise all, some, or none of the rights.

(i) Exercising all the rights: in this case, the shareholder exercises 6,250 rights at £4 each, which represents an additional investment of £25,000. The shareholder now holds 26,250 shares with a value of £4.762 per share, which means a total holding of £125,000. Note that, by exercising her rights, the shareholder has maintained her proportionate ownership stake in the company: she initially owned 20,000 of the 100 million shares, or 0.02%. After exercising the rights, she owns 26,250 of the 131.25 million shares, still 0.02%.

(ii) Exercising none of the rights: in this case, the shareholder will sell all of her rights and receive cash proceeds of approximately £4,762. The company's rights issue has the same pre-tax impact on the shareholder as a special dividend of 23.81 pence per share.

(iii) Tail-swallowing: whereas a shareholder could sell any amount of rights, one scenario of particular interest is "tail-swallowing". It is assumed that the shareholder is not concerned with the ownership stake she has in the company (which is a reasonable assumption for small shareholders). Instead, the shareholder wants to keep a constant amount of cash invested in the company. In other words, if she owned £100,000 worth of shares before the rights issue, she wants to own £100,000 worth of shares after the rights issue. This is achieved by selling just enough rights, so that the net sales proceeds of the rights exactly cover the cost of exercising the remaining rights. The shareholder does not need to invest additional cash. In the example used here, this means selling 5,250 rights at 76.2 pence each, which will give cash proceeds of £4,000. With these proceeds, the shareholder can exercise the remaining 1000 rights at £4 each. After this "tail-swallowing" transaction, the shareholder has 21,000 shares at £4.762 each, which means an unchanged total investment of £100,000.

Capital gains tax

A14 As outlined above, when the shareholder does not exercise all her rights, some rights will be sold. In certain circumstances, these sales proceeds may trigger a CGT liability. The exact amount of the liability depends on the length of time the shares have been held, the share price performance, and other CGT liabilities a shareholder may have incurred. However, as long as the sales proceeds do not exceed 5% of the value of the underlying shares (or £3000, whichever is greater), the sale of rights is not treated as a disposal by the Inland Revenue, and no CGT liability will be incurred by any shareholder as a result of the rights issue (unless the cost of the shareholding is less than the amount received on selling

the rights, in which case the taxable gain is the excess of the sale proceeds). The Inland Revenue has issued further advice, stating that:

"Exceptionally, taxpayers may wish to suggest that receipts above these limits should nevertheless be regarded as small, in the context of their particular circumstances; or, conversely, that receipts below these limits should not be so regarded. Any such cases will remain to be resolved on their merits, having regard to the dicta in O'Rourke v Binks."[13]

A15 A company considering a rights issue might decide that it is important to avoid triggering a CGT liability for any of its shareholders, as long as those shareholders do not decrease the amount they have invested in the company. In the example given earlier, the shareholder who maintained the amount invested in the company by "tail-swallowing" needed to sell rights worth a total of £4,000. This represented 4% of the value of her original holding of £100,000 and would therefore not normally have triggered a CGT liability, as it was below the 5% limit.

A16 For each level of discount, one can calculate how much additional capital a company can raise while still allowing its shareholders to stay below the 5% limit for a "tail-swallowing" transaction. The additional capital raised is stated as a percentage of the original capitalisation. In the example used earlier, the company increased its capitalisation from £500 million to £625 million, which represented an increase of 25%. The following table[14] relates each chosen level of discount to a maximum increase in capitalisation which can be achieved without triggering a CGT liability:

Level of Discount	10%	12%	15%	20%	25%	30%
Max. Increase in Capital	100%	71%	50%	33%	25%	20%

A17 As mentioned in paragraph 21(v) above, the MMC report recommended that the Chancellor of the Exchequer should consider taking steps to amend the CGT rules so that "tail-swallowing" will not be treated as a disposal, regardless of the percentage of the original holding it represents.

13 Interpretation 157, Inland Revenue Tax Bulletin, February 1997, page 397.

14 The table relates only to the CGT rules applicable as at September 1999 and makes no assumptions about possible future changes to those rules.

APPENDIX 1

BACKGROUND TO THE GUIDANCE

1 On 24 February 1999, the Monopolies and Mergers Commission (now the Competition Commission) published its report on the supply in the UK of underwriting services for share offers. One of its recommendations was that the Bank of England should publish guidance for companies on certain aspects of share issuing good practice.

2 The Secretary of State for Trade and Industry immediately announced[15] that he would be asking the Director General of Fair Trading to discuss with the Bank of England the best way to take forward this recommendation, with the goal of increasing transparency in the market and information available to issuers.

3 The MMC report stated, in paragraph 2.178(c), that this guidance should take the form of points to consider and questions to ask advisers and should:

(i) encourage the use of tendering for sub-underwriting;

(ii) encourage the use of tenders which involve the whole of the sub-underwriting and which are open to as wide a group of potential sub-underwriters as practicable;

(iii) explain when deep-discounted rights issues are likely to be advantageous and recommend that the scrip element of such issues should always be made explicit.

4 The MMC report added that the guidance should be endorsed and promoted by the following organisations:

(i) The Confederation of British Industry;

(ii) The Association of British Insurers;

(iii) The National Association of Pension Funds;

(iv) The Fund Managers Association (formerly, the Institutional Fund Managers Association);

(v) CISCO (formerly, the City Group for Smaller Companies);

(vi) The Association of Corporate Treasurers;

(vii) The Hundred Group of Finance Directors.

15 "MMC Report recommends changes to underwriting practices", Department of Trade and Industry Press Release P/99/161, 24 February 1999.

5 In drawing up the guidance, the Bank has engaged in detailed discussions with all the above organisations and has also consulted a number of other interested parties. The guidance has indeed been endorsed by the above associations, who have agreed to promote it to their members.

6 The original terms of reference of the MMC inquiry covered both new share issues by listed companies and initial public offerings (IPOs). Following changes to the London Stock Exchange's listing rules in January 1996, however, IPOs have increasingly been made by means of a placing, rather than through an offer for sale or subscription involving an underwriting fee structure similar to a rights issue. IPOs were not included in the MMC's complex monopoly situations and hence were not the subject of public interest findings. They are therefore outside the scope of this guidance.

7 An amendment to the MMC's terms of reference was also made to bring within their scope offers of convertible unsecured loan stock, providing for the automatic conversion of the stock into shares on the happening of a specified event within a year. Such loan stock is sometimes issued on a similar basis to rights issues and as an alternative to them. The guidance should therefore be taken to cover both rights issues and offers of convertible unsecured loan stock. The types of new share issues by listed companies included in the relevant MMC recommendations are rights issues in this broad context, open offers, and cash underpinnings. Definitions of these issue types are given in Appendix 2.

8 As indicated in the MMC recommendation, the guidance focuses on the two subjects of, firstly, tendering for sub-underwriting, and, secondly, deep discounted issues. Where "hypothetical remedies" listed by the MMC in its interim report of May 1998 were not the subject of public interest findings, they have been excluded from the scope of the guidance. The guidance is also intended to be fully consistent with existing and proposed rules, guidelines and practices.

APPENDIX 2

METHODS OF BRINGING FURTHER SECURITIES TO LISTING

1 There are 13 methods included in the Listing Rules ('Yellow Book') of the London Stock Exchange (LSE) for companies whose securities are already listed to bring further securities to listing (known as new issues by listed companies). These are:

- An offer for sale
- An offer for subscription
- A placing
- An intermediaries offer
- A rights issue
- An open offer
- An acquisition or merger issue
- A vendor consideration placing
- A capitalisation (or bonus) issue in lieu of dividend or otherwise
- An issue for cash
- A conversion of securities of one class into securities of another class
- An exercise of options or warrants to subscribe securities
- Such other method as may be accepted by the Exchange either generally or in any particular case

It is not unusual for a share offer to involve more than one method.

2 The MMC report (paragraph 2.38) defined the relevant group of issues for its purposes, and hence for this guidance, as rights issues, open offers and cash underpinnings. The latter is a method of providing shareholders of a company being acquired with a cash alternative to an offer of shares in a takeover. Brief definitions of these issue methods, based on the 'Yellow Book', are as follows (for more details, see the 'Yellow Book' itself):

(i) **A rights issue** is an offer to existing holders of securities to subscribe or purchase further securities in proportion to their holdings made by the issue of a

renounceable allotment letter (or other negotiable document) which may be traded (as nil-paid rights) for a period before payment for the securities is made. In a rights issue the LSE grants a listing for the securities in nil-paid form. The MMC includes within its definition of rights issues such offers of convertible unsecured loan stock (CULS) that provide for the automatic conversion of the stock into shares on the basis of the happening of a specified event within a year and which are issued on a similar basis to rights issues and as an alternative to them.

(ii) **An open offer** is an invitation to existing holders of securities to subscribe or purchase securities in proportion to their holdings, which is not made by means of a renounceable allotment letter (or other negotiable document).

(iii) **An acquisition or merger issue** (or vendor consideration issue) is an issue of securities in consideration for an acquisition of assets, or an issue of securities on an acquisition of, or merger with, another company as consideration for the securities of that other company. In the case of takeovers, particularly hostile takeovers, it is common for a cash alternative to be available for shareholders in the offeree company. Where shareholders in the offeree company elect for the cash alternative rather than taking shares, the sponsor of the issue arranges for the shares to be purchased at the underpinning price and this can effectively amount to a form of underwriting (such arrangements are referred to as cash underpinnings).