Limits of Private Sector Solutions for Banks: Recent UK Rights Issues

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Abstract

This article reviews regulatory concerns prompted by the difficulties that were encountered by four British banks in making rights issues and other pro rata equity offerings between April and August 2008 against a background of adverse market conditions. Its conclusion that rights issues are too cumbersome and too time-consuming swims with the mainstream of current thinking. The article contributes to the debate by considering Limits of Private Sector Solutions for Banks: Recent UK Rights Issues options for change it is realistic to pursue given the confines of the existing mandatory legal framework, much of which is now set at the European level.

Keywords: banks, financial re-structuring, rights issues, pre-emption rights, disclosure

JEL Classifications: G18, G21, G28, G32, G34, G38, K22, K23

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PART I: INTRODUCTION

Rights issues have a special place in European corporate finance. Shareholders are presumptively entitled by the Second Company Law Directive to a right of first refusal in respect of new shares unless they opt out,[1] and rights issues tend to be the offering structure that companies use to fulfil these pre-emptive entitlements.[2] Member States may reinforce the EC Directive in their national laws by provisions that further strengthen the rights of existing shareholders[3] but they may not derogate from it even to cater for situations where banking, or other, companies that are of strategic importance to their economy are in financial difficulties.[4] By requiring companies that are in need of new equity to obtain it by means of a pre-emptive offer, the law protects existing shareholders against corporate actions that could erode the value of their investment and against dilution of voting control.

Member States' compliance with the Second Company Law Directive is actively overseen by the European Commission, which considers that pre-emption rights play a role in encouraging investment by providing a guarantee that existing shareholders will have the first opportunity to buy newly-issued shares.[5] The institutional investor community also greatly values these rights and guards them jealously, with only limited concessions to the argument that corporate, and in the long term their own, interests may be better served by allowing companies the flexibility to structure equity fundraising activity in whatever way most advantageously exploits prevailing market conditions at the relevant time.[6] In corporate governance terms, pre-emption rights are viewed as an

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[1] Second Council Directive 77/91 [1977] OJ L26/1, on co-ordination of safeguards which, for the protection of the interests of members and others are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited companies and the maintenance and alteration of their capital with a view to making such safeguards equivalent, art 29.

[2] For an overview of the operation of pre-emption rights in France, Germany, Italy, the Netherlands and Spain, see P Myners, *The Impact of Shareholders' Pre-Emption Rights on a Public Company's Ability to Raise New Capital* (2004), annex B.

[3] *Siemens v Nold* Case C-42/95 [1996] ECR 1-601, ECJ, establishes that the Second Company Law Directive, art 29 establishes only a minimum standard. On heightened national standards in the laws of various Member States; H Hirte, 'Issuing New Shares and Pre-emptive Rights, Recent Issues in European Corporate Statutes' (2007) 30 Rivista Delle Societa 733, 734 – 737.

[4] *Syndesmos Melon tis Eleftheras Evangelikis Ekklissias v Greek State* Case C-381/89, [1992] ECR I-2111, ECJ; *Panagis Pafitis v Trapeza Kentrikis Ellados AE* Case C-441/93, [1996] ECR I-1347, ECJ.

[5] European Commission Press Release, IP/05/939, Brussels, 15 July 2005 announcing infringement proceedings against Spain for alleged failure properly to implement Second Company Law Directive, article 29 and article 42 (on equal treatment). See further *Commission of the European Communities v Kingdom of Spain* Case C-337/06, OJ C 261, 28 October 2006, p 12; K Greacheng, 'Discriminating Shareholders Through the Exclusion of Pre-emption Rights – the European Infringement Proceedings against Spain (C-338/06) 571.

[6] Euroshareholders, *Corporate Governance Guidelines* (2000), p 3 provide that capital increases which exclude the possibility for existing shareholders to maintain their relative interest in a company should be restricted. See also Pre-emption Group, *Disapplying Pre-emption Rights: A Statement of Principles*, available at http://www.pre-emptiongroup.org.uk/documents/pdf/Disapplying Pre-

important mechanism for enabling shareholders to exercise a degree of control over management and, as such, they are frequently described as a 'core principle' or 'cornerstone' of European company law and of the capital markets.[7]

Even though the general principle giving pre-emption rights a favourable position in European law appears to be unassailable, detailed aspects of the law on pre-emption rights and accompanying regulatory requirements and market practices with regard to rights issue offering structures have come in for considerable scrutiny.[8] A brief literature survey reveals that perceptions as to the most pressing concerns tend to differ between Member States, which to some extent may reflect underlying differences in the way that EC law has been given effect in national regimes, which, of course, implies that the level of harmonisation in reality is not as high as may be assumed from an abstract reading of the text of the Second Company Law Directive.[9] One longstanding complaint in the UK

EmptionRightsStatementofPrinciples.pdf (accessed August 2008), which contains guidelines on the extent to which institutional investors will support disapplication of pre-emption rights by UK companies that are primary listed on the Main Market of the London Stock Exchange.

[7] Hirte, 'Issuing', n 3 above, 733; P Myners, *Pre-emption Rights: Final Report* (URN 05/679) 9.

[8] A case can be made in principle for dropping pre-emption rights from mandatory company law: E Ferran, 'Legal Capital Rules and Modern Securities Markets – the Case for Reform as Illustrated by the UK Equity Markets', in KJ Hopt and E Wymeersch, *Capital Markets and Company Law* (OUP, 2003), ch 5. However, it is evident from discussions leading up to limited reforms of the Second Company Law Directive in 2006 that it is not realistic to look for sweeping change in the short to medium term. See also E Ferran, *Principles of Corporate Finance Law* (OUP, 2008), ch 5.

[9] Rigidities in the procedural requirements for withdrawal of pre-emption rights under one provision of the Directive are one concern. The specific shareholder approval of withdrawal rights route under article 29.4 involves a report by the directors to the shareholders giving reasons for the withdrawal and justifying the proposed issue price of the shares. The stringency of article 29.4 was identified as a concern by the High Level Group of Company Law Experts (Winter Group) that reported on company law to the European Commission in 2002: *A Modern Regulatory Framework For Company Law In Europe*, p 84. The Winter Group endorsed the view of the Company Law SLIM Working Group, which in its report to the Commission, *The Simplification of the First and Second Company Law Directives: Proposals submitted to the European Commission* (October 1999), recommended that EC law should be changed to relax certain formalities relating to non-pre-emptive offerings of securities by listed companies provided they were done at no more than a small discount to market price. A proposal based on this recommendation was included in a draft reforming Directive published by the Commission in 2004 but the European Economic and Social Committee could see no logic for it and it did not make it into the final version of the reforming Directive. See Opinion of the European Economic and Social Committee on the Proposal for a Directive of the European Parliament and of the Council amending Council Directive 77/91/EEC, as regards the formation of public limited liability companies and the maintenance and alteration of their capital (COM(2004) 730 final) OJ EC C 25 November 2005, p 1. However, this concern receives little attention in the UK. This may be because the problem is avoidable by relying on another provision of the Second Company Law Directive (article 29.5 which provides the basis for Companies Act 2006, s 570) which facilitates the disapplication of pre-emption rights in respect of shares that the directors are generally authorised to allot by means of a special resolution of the shareholders. In this section (compare s 571, which gives effect to article 29.4) no specific reporting formalities are prescribed. Section 570 is the commonly used disapplication route in the UK.

Uncertainties flowing from national rules, found either in legislation or case law of some Member States, that go beyond the explicit wording of the Directive by providing for substantive review of the justifications for withdrawing of pre-emption rights by reference to the company's interests are another concern. S Grundmann, *European Company Law* (Intersentia, 2006) para 395 notes that the matter of how withdrawal has to be justified is debated most intensively. See also Hirte, 'Issuing', n 3 above, 734 – 743 relates to the timescales involved in rights issue.[10] Recent market events have intensified concerns on this score and given a new urgency to demands to look closely at this issue.

PART II: RECENT CAPITAL RAISINGS IN THE UK BANKING SECTOR

Rights issues came to the foreground of policy concern in Britain in mid 2008 because of severe difficulties encountered by several banks that found themselves under credit crunch-engendered pressure to shore up their balance sheets by raising new equity. Financial institutions were forced into this activity by the turmoil in the financial markets, unleashed first by problems with the subprime mortgage market during 2007 and exacerbated by the run on Northern Rock in September 2007 and the bailout of Bear Stearns in March 2008.[11]

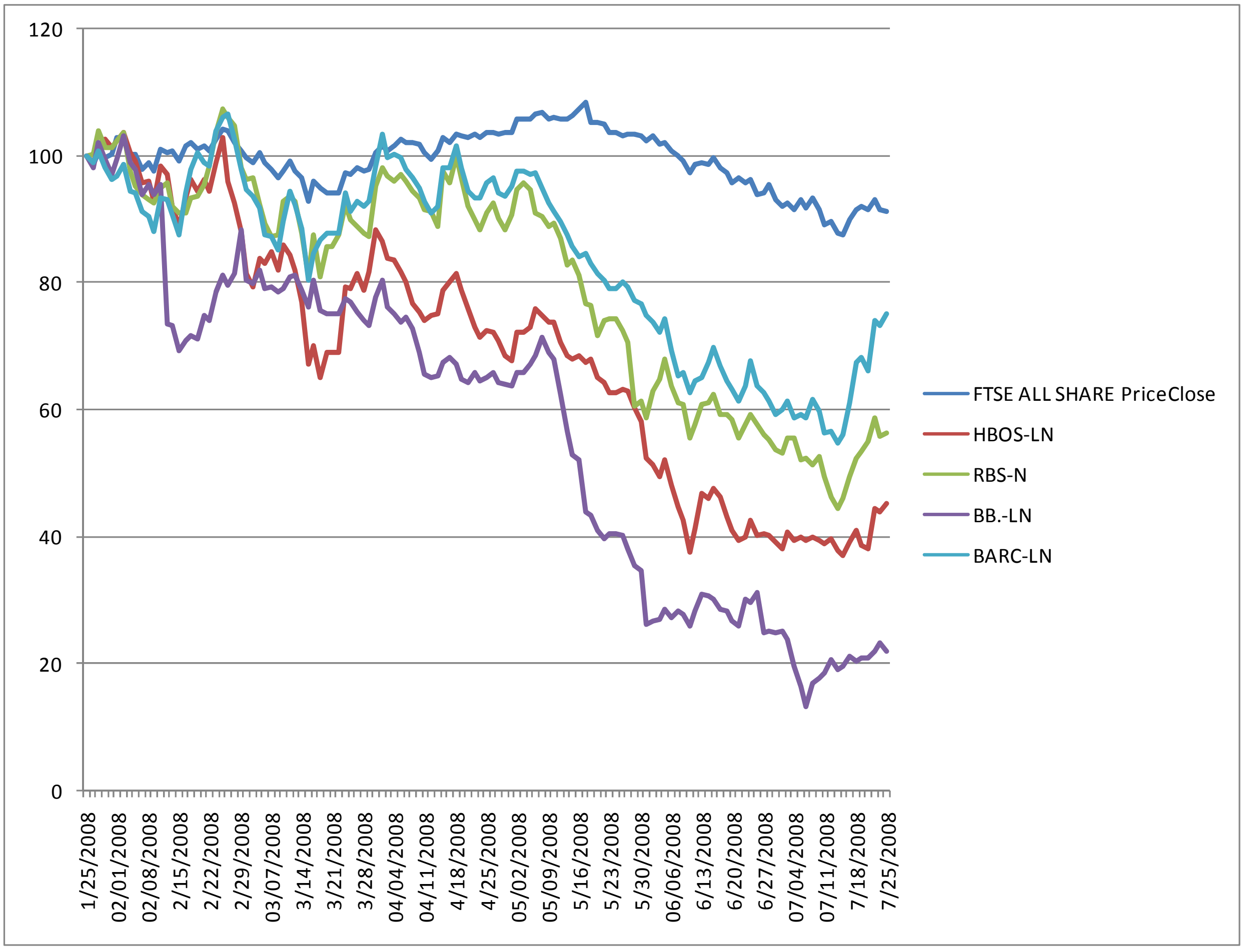
The chart below indicates the downturn in share prices of British banks that had to raise new capital during the first half of 2008 as investor concerns about the exposure of banks to the housing market and as to viability of some major institutions because of liquidity problems took their toll.

for detailed discussion of this point as it arises in German, French and Italian law. However, this issue has not attracted attention from commentators on British law and practice. Nor does it appear to be an issue for concern in the Netherlands: Myners, *The Impact*, n 2 above,50.

Overlapping with the issue of justification for withdrawal, there is the question whether market prices dictate the price of non-pre-emptive issues (so that no more than a small discount is permissible) or whether pricing is simply a matter for directors' discretion as constrained by their fiduciary obligations. The European Commission's infringement proceedings against Spain may give the ECJ an opportunity to clarify this matter.

[10] Myners, *Pre-emption Rights*, n 7 above.

[11] As well as the four high-profile transactions considered in the main text, another financial institution with exposure to the housing finance market that raised additional finance through a rights issue in the first half of 2008 was The Paragon Group of Companies (the buy-to-let mortgage lender raised £275.5 million (net) through a 5 for 2 (pre-share consolidation) rights issue that was announced in January 2008). Other rights issues in the first half of 2008 by companies in the financial sector included Intermediate Capital Group (the mezzanine debt provider raised £175 million (net) through a 2 for 9 rights issue announced in January 2008) and Cattles (the provider of consumer credit to non-standard customers raised £200 million (net) through a 9 for 20 rights issue announced in April 2008). The first half of 2008 also rights issues by companies in other sectors including Groupe Eurotunnel (transport sector, raised €875 million (net), announced April 2008), Imperial Energy (energy sector, raised £290.9 million (net), announced April 2008) and Imperial Tobacco (tobacco industry, raised £4.9 billion (net), announced May 2008). In response to press commentary regarding an equity raising, on 30 June 2008 Taylor Wimpey (construction sector) announced that it was in discussions with shareholders and other institutions regarding raising additional financing, which would most likely be via a placing and open offer; in a trading statement on 2 July 2008, it confirmed that it "had not been able to conclude a satisfactory transaction".



Source: Thomson Datastream

'First mover' among the banks, and perhaps benefitting from getting in first, the Royal Bank of Scotland (RBS) successfully raised £12 billion in a fully-underwritten rights issue that was announced on 22 April 2008 and closed on 9 June 2008.[12] RBS achieved a 95 per cent take-up from its existing shareholders and the rump of the shares was placed in the market with the result that the underwriters were not required to subscribe for any of them. This relatively straightforward capital raising exercise was facilitated by the fact that the new shares were offered at a considerable discount to the market price of existing RBS shares[13] and by market conditions, which kept the price of existing RBS shares

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[12] Except where otherwise indicated, information on the transaction is drawn from RBS announcements relating to the rights issue, available at http://www.investors.rbs.com/investor_relations/rights.cfm (accessed August 2008).

[13] The rights issue price of 200p represented a 34.9% discount to the theoretical ex-rights price and 46.3% discount to the closing price of RBS shares of 372.5 pence per share on 21 April 2008, the last trading day before the announcement.

above the rights issue price during the offer period.[14] The prospectus for the issue was published on 30 April 2008 but at that point the issue was conditional on shareholder approval.[15] This was obtained at an extraordinary general meeting of the company on 14 May 2008, whereupon the mandatory 21 day offer period, during which dealings in the nil-paid rights (i.e., the right to take the new shares) could take place, commenced.[16]

Two subsequent rights issues had a bumpier ride. On 29 April 2008 Halifax Bank of Scotland (HBOS) announced a fully-underwritten rights issue to raise £4 billion to strengthen the bank's capital base.[17] The new shares were offered at the discounted price of 275p per share. A prospectus was published in the week commencing 16 June. Distributing this document presented a particular challenge because HBOS has more than two million private shareholders across the UK, which is one of the country's biggest private shareholder bases.[18] The rights issue was approved by shareholders at an extraordinary general meeting on 26 June 2008. The period for nil-paid trading of rights began on 27 June. On 21 July 2008, after closure of the offer, HBOS announced that just under 8.3 per cent of the rights had been taken up by existing shareholders. This outcome triggered a great deal of media coverage describing the issue as a 'flop' or a 'failure',[19] which could be said to be a technically inaccurate assessment of the position given that HBOS did successfully raise the capital it had sought because the issue had been underwritten.[20] However, since the last known occasion when such a large portion of new shares had been left with underwriters was a large share offering by BP that had coincided with the 1987 stock market crash, it is readily understandable why it was widely viewed as a disaster. Since the HBOS share price dropped below the rights issue price during the offer period, there was no incentive for rational investors to take up the offer.[21] Overall the HBOS share price plunged by more than 40 per cent in the period of just less than three months between announcement and the end of the offer period.[22]

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[14] M Urrey, 'RBS Secures 95% Take-up of Rights Issue', *Financial Times, FT.com,* 9 June 2008 noting that at one point during the offer period the share price fell to 220p, "dangerously close to the 200p" offer price.

[15] Interestingly the letter to shareholders that accompanied the notice convening the general meeting did not contain all of the information required for a circular to shareholders under chapter 13 of the *Listing Rules*. The disclosure required by chapter 13 of the *Listing Rules* was included in the prospectus produced and sent to shareholders at a later date.

[16] A period of 21 days is specified in Companies Act 2006, s 562(5) and LR 9.5.6. The FSA does not allow trading in nil-paid rights before necessary shareholder approvals have been obtained.

[17] Except where otherwise indicated, information on the transaction is drawn from HBOS announcements relating to the rights issue, available at http://www.hbosplc.com/home/index.html (accessed August 2008),

[18] Most private shareholders have held their shares since the demutualisation of the Halifax in 1997. Note that there is no mandatory requirement to send prospectuses directly to shareholders: Herbert Smith LLP, *A Practical Guide to the UK Listing Regime* (ICSA Publishing, 2008) 131. On mandatory publication requirements: FSA *Prospectus Rules* PR 3.2.4. Where shareholder approval is required, there is a mandatory requirement under the *Listing Rules*, ch 13 to send to shareholders a circular containing prescribed information.

[19] e.g. J Finch, The Wrongs of Rights Issues', *The Guardian*, 22 July 2008, 23; A Hill, HBOS Flop is a Poke in the FSA's Eye', *Financial Times (FT.com)*, 21 July 2008; S Bain, 'Institutions Left to Mop Up After HBOS Rights Issue Flops', *The Herald,* 21 July 2008, 28.

[20] Lex Column, 'Crisis Capital Raising', *Financial Times*, 18 July 2008, 14.

[21] J Waples, 'HBOS Faces Rights Issue Disaster' *Sunday Times*, 20 July 2008, Business Section, 1.

[22] P Thal Larsen, C Hughes and D Shellock, 'Banks' Cash Calls Shunned', *Financial Times,* 19 July 2008, 1.

Disclosures of substantial short positions, as required by FSA rules introduced in June 2008, gave credence to the view that considerable short selling activity during the period of the rights issue had added to the downward pressure on the HBOS share price.[23] Even before the rights issue was announced, the HBOS share price had been in difficulties and had fallen sharply during March 2008. It was strongly suspected that false rumours that it was about to apply for emergency support from the Bank of England contributed to this decline but although market abuse to drive down the share price was widely suspected,[24] an FSA inquiry on that matter failed to find sufficient hard evidence for a prosecution.[25]

On 14 May 2008 Bradford & Bingley (B&B) announced a rights issue to raise approximately £300 million.[26] The proposed offer price was 82 pence per share, compared to a market price of 158.75 pence for existing B&B shares on the last trading day before the announcement.[27] However, following a trading update and an approach from private investment firm TPG Capital, on 2 June 2008 B&B announced a restructured financing arrangement whereby it proposed to raise additional capital of approximately £400 million through a combination of a restructured rights issue for £258 million and an investment of £179 million by TPG in return for 23 per cent of the company. All of the shares were to be issued at an offer price of 55 pence per share. The existing B&B shareholders were to be asked to give up pre-emption rights in respect of shares to be issued to TPG and to approve the discounted issue price.[28] This proposed arrangement with TPG collapsed in early July 2008 when, in response to a downgrading of B&B's senior unsecured and long term debt by Moody's, TPG enforced its right to terminate the subscription agreement.[29] On 3 July 2008 B&B announced that it would therefore proceed with the capital raising it had announced on 2 June 2008, but by way of an enlarged rights issue with net proceeds of approximately £400 million. The enlarged rights issue had an unchanged subscription price of 55 pence per share and was fully underwritten. The original prospectus that had been published on 24 June 2008 was updated by a supplementary prospectus on 11 July 2008, which recorded TPG's withdrawal, the consequential enlarged rights issue and some technical changes to be

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[23] S Farrell, 'Hedge Funds' £1bn HBOS killing', *The Independent*, 22 July 2008. This article quotes research from Data Explorers that almost 15 per cent, or about 550 million, of the bank's shares were out on loan and notes that this stock will mainly have been lent to funds who had sold the shares expecting to buy them back cheaper.

[24] R Sunderland, H Stewart, N Mathiason and R Wachman, 'Shares Scandal: Inside the Hunt for the City's Bank Raiders', *The Observer*, 23 March 2008, 22.

[25] M Flanagan, 'No Charges Expected in HBOS Share Price Inquiry', *The Scotsman*, 23 June 2008, 25. The FSA subsequently confirmed this: 'FSA Concludes HBOS Rumours Investigation', FSA/PN/086/2008, 1 August 2008.

[26] Except where otherwise indicated, information on the transaction is drawn from B&B announcements relating to the rights issue, available at http://www.bbg.co.uk/bbg/ir/shareservices/rightsissue/ (accessed August 2008).

[27] The offer price thus represented a 48% discount to the market price, and also a 36% discount to the theoretical ex-rights price.

[28] Pre-emption Group, *Disapplying Pre-emption Rights*, n 6 above, para 20 stipulates a 5% discount in respect of non-pre-emptive offerings. B&B already had in place the standard shareholder disapplication of pre-emption rights in respect of 5% of its shares but this authority was inadequate to cover the full amount, and discounted issue price, of the proposed TPG investment.

[29] On MAC clauses: C Band and K Anderson, 'Materiality in Times of Change' (November 2007) International Financial Law Review 57.

basis on which the offering was to be made. The rights issue was approved by shareholders at an extraordinary general meeting of the company on 17 July 2008. The offer became unconditional and the period for trading in nil-paid rights commenced on 18 July 2008. The offer closes on 15 August 2008.

It is also relevant to consider here a share issue by Barclays, which was announced on 25 June 2008 and closed on 17 July 2008.[30] This offering, which raised around £4.5 billion, did not take the form of a conventional rights issue. There had been press speculation that Barclays would come to the market with a rights issue but instead Barclays chose to follow a structure that was similar to one it had used previously to raise funds for its (failed) bid for ABN AMRO.[31] Barclays raised approximately £0.5 billion by placing firm a tranche of shares with the Sumitomo Mitsui Banking Corporation. The shares were priced at 296 pence per share, a discount of 4.7 per cent to Barclays closing price on 24 June 2008. The remaining new capital (approximately £4.0 billion) was raised through a placing and open offer of new shares at 282 pence per share, a discount of 9.3 per cent to Barclays closing price on 24 June 2008. These shares were placed with a group of strategic and institutional investors, including sovereign wealth funds, but the principle of pre-emption was respected by combining the placing with an open offer structure that gave existing Barclays shareholders the opportunity to clawback the placed shares by subscribing for them on a basis pro rata to their existing holdings. A prospectus was issued on 25 June 2008 but no general meeting of the company to approve the offering was held. Upon completion the new ordinary shares from the firm placing and the placing and open offer represented approximately 19.4 per cent of the enlarged issued share capital.

The need for shareholder approval arises where directors do not have an adequate existing authority to issue new shares, the structure does not comply with pre-emption rights and an appropriate opt-out is not already in place, or there is some other feature that does not satisfy regulatory or investor expectations.[32] The Barclays share issue was within the limit of the directors' existing authority to allot shares (last refreshed at its annual general meeting on 24 April 2008). So far as pre-emption rights were concerned, the non-pre-emptive firm placing to Sumitomo was covered by an existing shareholder opt-out, and the 4.9 per cent discount on price was within the limit of 5 per cent set by institutional investor *Pre-emption Guidelines* for non-pre-emptive placings.[33] The placing and open offer element was also covered by an opt-out from statutory pre-emption rights (it being a standard part of UK corporate finance practice in listed companies for shareholders to disapply the statutory regime to the extent of allowing directors to follow instead provisions in the FSA *Listing Rules* on rights issues and other forms of pre-emptive offering). The pricing of the open offer complied with the requirements of the

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[30] Except where otherwise indicated, information on the transaction is drawn from Barclays announcements relating to the share issue, available at http://www.offer.barclays.com/index_main.php?type=video&task=register&language=en&section=press&cnt=bb&med=asx (accessed August 2008).
[31] H Bartholomew, 'Barclays Turns to SWFs', International Financing Review, 21 June 2008, 84.
[32] For a valuable summary see Herbert Smith LLP, *A Practical Guide*, n 18 above, ch 10.
[33] Pre-emption Group, *Disapplying Pre-emption Rights*, n 6 above, para 20.

Listing Rules, which stipulate that discounts on such offers should not exceed 10 per cent without shareholder consent.[34] There are no formal guidelines relating to the upper limit of the size of offering for which an open offer may be used instead of a rights issue, although the Association of British Insurers has stated that a rights issue is more appropriate for a share offering representing more than 15 to 18 per cent of existing share capital.[35] In the Barclays case, the open offer represented more than 20 per cent of the existing issued capital.[36] Under the London Stock Exchange's *Admission and Disclosure Standards* the minimum period for which an open offer has to remain open is fifteen days[37] compared to the minimum of twenty-one days that is stipulated in the Companies Act 2006 and the *Listing Rules* in respect of rights issues.[38]

As it turned out, just nineteen per cent of Barclays existing shareholders took up their pre-emptive entitlements to the new shares[39] but this relatively low take up did not attract the degree of negative media attention as was meted out to HBOS. Two particular features of the Barclays offering may have helped it to be perceived in a more positive light: its shorter timescale[40] and the presence of strategic investors firmly committed to taking up the shares not wanted by existing shareholders, which could be presented as being less destabilising than the traditional underwritten rights issue structure.[41]

PART III: REGULATORY CONCERNS PROMPTED BY RECENT EVENTS

The standard criticism of rights issues is that they are cumbersome and time-consuming. Extended offer periods are particularly problematic in bear market conditions because of the strong likelihood of downward pressure on the share price during the offer period. Much of this pressure will stem from legitimate market activity but there is also concern that the structures are vulnerable to market abuse, in particular the spreading of false rumours which are designed to drive down issuers' share prices unnecessarily and artificially, so as to inflate the profits available on short selling. Market abuse considerations caused the FSA to intervene on an emergency basis in June 2008 to impose new disclosure obligations in respect of short positions in securities that were the

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[34] LR 9.5.10.

[35] Herbert Smith LLP, *A Practical Guide*, n 18 above, 317.

[36] Barclays had 6,567,992,032 existing issued shares and it issued 1,407,426,864 new shares pursuant to the placing and open offer.

[37] Para 3.9.

[38] LR 9.5.6. Had shareholder approval been required, the open offer period could have run concurrently with the notice period for the shareholder meeting. This contrasts with rights issues where the offer period can only commence after necessary shareholder approvals have been obtained. This is because the applicable rules do not permit conditional dealing in nil paid rights.

[39] Barclays PLC, *Result of Placing and Open Offer* 18 July 2008, available at http://www.investorrelations.barclays.co.uk/INV/A/Content/Files/Barclays_PLC_announces_result_of_Placing_and_Open_Offer.pdf (accessed August 2008).

[40] P Aldrick and K Griffiths, 'Barclays Shareholders Applaud £ 4.5bn Fundraising Package', *Daily Telegraph*, 26 June 2008, City Section, 1, quoting the director of the Association of British Insurers, which represents major institutional investors, as being in favour of the structure as being a mechanism that would allow the bank to raise substantial capital over a relatively short time frame.

[41] J Warner, 'Barclays Hopes to Avoid Pitfalls of Other Banks by Taking Strategic-Investor Route', *The Independent*, 17 June 2008, 34.

subject of a rights issue.[42] A few days later the Chancellor of the Exchequer announced the instigation of wider review of the efficiency of British capital-raising structures.[43] This Part considers some of the key issues that are currently being reviewed by the Treasury and the FSA. However, before examining specific issues, it identifies some important underlying considerations.

The widespread investor unwillingness to take up pre-emptive entitlements that was apparent in the HBOS rights issues and in the Barclays offering runs counter to customary expectations on investor reaction to such offerings. Yet since the essence of a pre-emptive offering is that it affords existing shareholders the right of first *refusal* in respect of new shares, this outcome, however unusual or unexpected it may be when viewed against long-term historical experience, and however unwelcome it may be to underwriters that have guaranteed the funding, can be said to be simply a manifestation of the market at work. In the first four months of 2008 alone, seven rights issues announced by UK Main Market listed companies aimed to raise some £17.7 billion. This huge demand from seasoned issuers over a short time period was on a scale not seen in the UK markets at any time in the previous ten years and, in those particular circumstances, it was not that surprising that the market struggled to absorb all of it.[44] In a similar vein, a robust response to short selling activity that drives down share prices is to view it as a legitimate and beneficial activity that exposes managerial shortcomings such as, in the case of banks, failure to maintain an adequate capital base.[45] With regard to the timescales involved in obtaining shareholder approvals for new share issues and in making pre-emptive offerings, whilst it is certainly true that unfavourable comparisons can be drawn with more nimble capital raising techniques employed in the United States, in less unstable times these shareholder rights are often held up as a strength rather than a weakness, being valuable elements of the European corporate governance system, which is culturally different from the US model in relying more on real decision-making powers being vested in shareholders and less on the discipline of shareholder/investor litigation.[46]

These considerations imply that government officials and regulators should take care not to decide prematurely that there are substantive or procedural features of the regulatory

[42] Discussed further below. See ns 104 – 119 and accompanying text.
[43] Speech by the Chancellor of the Exchequer, the Rt Hon Alistair Darling MP, at Mansion House, 18 June 2008, text available at
http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/chancellorexchequer/speech_chx_180608.cfm
(accessed August 2008).
[44] Between January 1998 and December 2007, there were 223 rights issues by UK Main Market listed companies raising some £34.8 billion.
[45] 'Look Ma, No Capital', *The Economist*, Apr 24th 2008, discussing capital concerns relating to RBS, Barclays and HBOS.
On the benefits of short selling: FSA, *Short Selling: Feedback on DP17* (April 2003).
[46] A Hilton, 'A Treasury in Thrall to Bankers', *Evening Standard*, June 19, 2008, 29; M Costello, 'City Investors Fear Treasury Will Ban Pre-emption', *The Times*, June 18, 2008, 46; J Warner, Campaign to Ditch Pre-emption Rights is Led by Vested Interest - Beware the Siren Calls', *The Independent*, June 13, 56.

framework relating to pre-emption rights and rights issues that impede the efficiency of equity fundraising and which it would be in the public interest to address through intervention. Furthermore, the disciplines of better regulation and of accountability in the rule-making process should not be lightly discarded: emergency powers that override those disciplines should be used sparingly. On the basis of favouring solutions that are as close as possible to the market as possible, to the extent that beneficial change can be achieved through fostering modifications in institutional investor practices with regard to disapplication of pre-emption rights, that, rather than the adoption of new legislation or regulatory rules, should be considered. The constraints of EC law (which is unlikely to be easily changed) must also be kept in mind.

On the other hand, it is not rushing headlong into unfamiliar territory to suggest that aspects of law and practice relating to rights issues and other pre-emptive offerings have not kept pace with dynamic modern securities markets and the emergence of readily-available, virtually instantaneous methods of communication. After all, the Myners Report to the British government in 2004 highlighted many difficulties with a cumbersome system and, since the Report's recommendations were not fully implemented, many of those difficulties persist.[47] Whether something needs to be done about them is a question that has intensified in importance because the harsh economic conditions of 2008 and the spike in rights issue issuance activity, in terms of both the number and the size of the cash calls, have shown that weaknesses in the system may be vulnerable to exploitation by unscrupulous, as opposed to merely commercially aggressive, investors and that such conduct may have a seriously destabilising effect where it affects systemically important financial institutions.

Rights issue offer periods

In a conventional rights issue existing shareholders are given 21 days to decide whether to take up their rights. This period is specified in the Companies Act 2006 for rights issues effected in accordance with the statutory framework.[48] The legislation implements the Second Company Law Directive right of pre-emption but on a 'super-equivalent' basis because the minimum offer period under the Directive is 14 days.[49] The statutory regime followed London Stock Exchange regulations in force at that time, which provided for a 21 day period in respect of rights issues by listed companies.[50] The Myners Report in 2004 recommended that the statutory offer period should be reduced to 14 days, in line with the Directive.[51] The government's initial response to this was half-

[47] As Paul Myners himself has noted: P Myners, 'We're Still Going the Wrong Way on Rights Issues', *Daily Telegraph*, 25 June 25 2008, City Section, 6.
[48] Companies Act 2006, s 562. A 21 day offer period is also prescribed by the *Listing Rules*. This will apply to non-Companies Act rights issues. See further n 64 below and accompanying text.
[49] Second Company Law Directive, art 29.3.
[50] Hansard, HL, vol 400, col 1241. London Stock Exchange, *Admission of Securities to Listing* (1979), Sch II, Pt B, para 8(b). Standard form model articles (Table A) in force between 1862 and 1948 provided for pre-emption rights but did not specify a particular time period, leaving this to be determined by the directors: Table A (1862), reg 27; Table A (1908), reg 35.
[51] Myners, *Pre-emption Rights*, n 7 above, 6. In 1999 the possibility of reducing the offer period (was referred to the Company Law Review Steering Group by the UK's competition authorities: *Underwriting*

hearted: rather than simply giving effect to the Myners Report's suggestion, it chose instead to follow an alternative recommendation to take power in the Companies Act 2006 to adjust the statutory period, subject to the Directive minimum period of 14 days.[52] In the light of recent experience that has brought home the seriousness of the pricing risk involved in extended offer periods, and also developments in other countries, there is now a very strong case in favour of exercising this power.

In Australia, a jurisdiction to which it is useful to refer in this context because it has progressively modernised its regulatory framework relating to rights issues,[53] the minimum mandatory timescale for a traditional form of rights issue is now 17 days from announcement to closing, with provision for offers to be dispatched as early as day 7 and closure 10 days afterwards.[54] Non-traditional forms of pre-emptive offering, where offers to institutional holders are accelerated to enable the issuer to raise funds more quickly, have also been developed and have received regulatory endorsement.[55] Since EC law imposes a minimum offer period of 14 days, the UK does not have the option of being as radical as Australia in revising its statutory framework but it can nevertheless draw constructively on its experience. The underlying rationale for changes to Australian law was to benefit retail shareholders by encouraging listed entities to make greater use of rights issues rather than other forms of fundraising that exclude retail holders (such as institutional placings).[56]

Should the UK press for change to the timescale prescribed by EC law? In principle the argument for reviewing time limits that were set before the emergence of modern communication methods has merit but pragmatic considerations suggest that this option should not be prioritised. The Second Company Law Directive, which includes the

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Services for Share Offers: A Report on the Supply in the UK (Monopolies and Mergers (now Competition) Commission) (Cm 4168) (February 1999). The underlying issue that drive consideration of the issue at that time was the scope for reducing the period when underwriters of an issue were "on risk" and hence securing possible savings in underwriting costs. Thereafter the Steering Group suggested that the period should be capable of change and set by *Listing Rules* or their equivalent: *Modern Company Law for a Competitive Economy: Developing the Framework* (URN 00/656) para 4.167. However, after consultation which revealed divided opinion, the Steering Group modified its recommendation and proposed the retention of statutory minimum period of 21 days for the acceptance of rights offers, but with a power for the Secretary of State to vary this by secondary legislation, subject to the minimum of 14 days for public companies laid down by Article 29.3 of the Second Company Law Directive: *Modern Company Law for a Competitive Economy: Completing the Structure* (URN 00/1335) para 5.52.

[52] Companies Act 2006, s 562(6)(a).

[53] ASIC, *Disclosure Relief for Rights Issues* (Regulatory Guide 189, May 2008).

[54] ASX, *Listing Rules*, appendix 7A. Historically in Australia there was an average 31-40 day lag between the announcement and issue date: SA Owen and J Suchard, 'The Pricing and Impact of Rights Issues of Equity in Australia' Applied Financial Economics, Forthcoming, Available at SSRN: http://ssrn.com/abstract=1011541 (accessed August 2008).

[55] ASIC, *Disclosure Relief*, n 55 above.

[56] ASIC, *Non-traditional Rights Issues* (Consultation Paper 91, September 2007), 5; ASIC, *Disclosure Relief*, n 55 above, 5. A study of Australian capital raising exercises between July 1996 and March 2001 found that companies were turning increasingly to non-pre-emptive placings rather than rights issues and sought to test whether this trend was linked to regulatory changes lifting the ceiling on the proportion of shares that could be issued in a placing: HW Chan and R Brown, 'Rights Issues Versus Placements in Australia: Regulation or Choice?' (2004) 22 Corporate and Securities Law Journal 301.

provision for mandatory pre-emption rights, divides opinion across Europe and, as a result, meaningful change has not been easy to achieve.[57] Past initiatives to modernise its approach to pre-emption rights have not succeeded.[58] Recent thinking in relation to the Second Company Law Directive suggests that it may be more worthwhile to channel effort into working round its imperfections so that they do not impede economically worthwhile commercial activity.[59] Corporate finance practitioners in Europe have shown considerable ingenuity in achieving this goal.[60] Following this line of thinking, a sensible strategy is therefore to focus on the fact that EC law permits opt-outs from pre-emption rights and to examine whether desirable changes to UK regulation and practice could be achieved by making greater use of opt-outs. The fact that EC lawmakers have recently settled on 14 days as the minimum period for the exercise of certain other shareholder rights indirectly reinforces the view that a proposal for the adoption of a shorter pre-emption rights timetable is unlikely to make much progress at the EU level.[61]

Opted-out rights issues by listed companies are subject to the FSA *Listing Rules*. Under the *Listing Rules* the minimum offer period for a rights issue is also 21 days.[62] That period could be shortened to benefit listed companies that have disapplied the statutory pre-emption rights.[63] Since it would operate only in opt-out situations, the minimum period under the *Listing Rules* could in principle be less than the 14 days prescribed by the Second Company Law Directive but whether a shorter period would be acceptable in practice requires further investigation.[64] A key consideration is that the timetable needs to allow enough time for retail shareholders to trade some of their nil-paid rights to provide the cash needed to take up their remaining rights. Some practitioners have suggested that a period of 10 business days would be adequate to accommodate this need.

Could differential time limits be introduced into the *Listing Rules* so as to facilitate accelerated offers to institutional investors, along the lines of the Australian model? It is open to question whether a change to that effect would be practically possible given the open and diffuse character of the UK markets and whether it would command support

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[57] Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital, [2006] OJ L264/32, made some changes to the Second Company Law Directive but they are very modest. For a largely criticial assessment of the impact of the reforming Directive: E Wymeersch, 'Reforming the Second Company Law Directive' (November 2006). Available at SSRN: http://ssrn.com/abstract=957981

[58] See material cited in n 9 above.

[59] E Ferran, 'The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union' [2006] European Company and Financial Law Review 178; L Enriques, 'EC Company Law Directives and Regulations: How Trivial Are They?' (2006) 27 University of Pennsylvania Journal of International Economic Law 1.

[60] Ferran, ibid; Enriques, ibid. In relation to pre-emption rights, Enriques notes that opting out is hardly an 'insurmoutable obstacle' for most companies.

[61] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, [2007] OJ L184/17. Discussed further at ns 72 73 below and accompanying text.

[62] LR 9.5.6.

[63] In which case the 15 offer period for open offers, which could also be reviewed.

[64] ABI, *Rights Issues*, n 56 above, 3.

among institutional investors.[65] So far as the technical legal position is concerned, there is nothing in EC law relating directly to pre-emption rights that would appear to prevent an opt-out regime being framed in this way. However, another principle of EC law also needs to be brought into the discussion at this point. This is the principle of equal treatment, which appears in a number of different Directives[66] and which features in the European Commission's ongoing legal action against Spain alleging infringements of EC law in the way that its national regulatory framework provides for opt-outs in respect of pre-emption rights.[67] Concerns about equality of opportunity meant that, in the first instance, certain Australian initiatives to streamline rights issues were limited to traditional rights issue structures and it was only after careful consideration that they were extended to non-traditional structures that involved differential offer periods, on the basis that the differences in terms were minimal and did not infringe the spirit of the equality principle.[68] Points made in the Australian debate could be useful in countering objections based on the EC equal treatment principle; in particular, a teleological interpretation of the equality principle could derive some support from the argument that accommodating modest differences in terms between institutional and retail investors supports rather than undermines equality, because it encourages issuers to use rights issue structures rather than non-pre-emptive placings. Retail shareholders could also be said to benefit from the price stabilising effects of the greater certainty afforded by an earlier closing date for the institutional offering. Arguably, however, these arguments would be best pursued after the ECJ's judgment in *European Commission v Spain* is known. If the idea were to be pursued in detail at some point, there are numerous complex issues that would need to be addressed, including disclosure requirements in respect of the institutional investor take-up and the timing of those disclosures.

Shareholder resolutions

It is apparent from the transactions reviewed in Part II that another factor that can prolong a rights issue or other equity offering is the need to obtain shareholder approval. Aside from having sufficient authorised share capital to accommodate any proposed issue of new shares, the directors of a company must be authorised by the shareholders to allot new shares and that authority will need to be refreshed if the new offering is too big to fit within the directors' existing authority. In addition, where the offering structure cannot be accommodated within the statutory scheme or where any existing opt-out is inadequate to accommodate the offering, shareholder authority will be needed to opt out of statutory pre-emption rights.

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65 Ibid, 5 – 6.

66 e.g., Second Company Law Directive, art 42; Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, [2004] OJ L390/38, art 17; Shareholder Rights Directive, art 4. See also Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, [2004] OJ L 142/12, art 3.1(a) (equivalent treatment).

67 See material cited in n 5 above.

68 See material cited in n 58 above.

A point that can be raised but quickly dismissed relates to the notice periods in respect of shareholder meetings. It is not realistic at present to press for a reduction of these periods. They were recently reviewed in the UK and the Companies Act 2006 modified the position by setting a minimum notice period of 14 days for meetings other than the annual general meeting, which remains subject to a 21 day notice period.[69] Even more recently, the EC Shareholder Rights Directive now mandates a 21 day notice period (which can be reduced to 14 days provided certain requirements are fulfilled) for shareholder meetings in companies with securities admitted to trading on a regulated market.[70] These moves reflect policy choices on the framework that needs to be in place to support properly-informed voting by shareholders[71] and they are unlikely to be revisited in the foreseeable future.

Any attempt to dismantle the legal framework that empowers shareholders by giving them a say in capital-raising decisions[72] is also likely to run up against considerable difficulties but there may be some mileage in exploring whether practice with regard to how shareholders exercise these rights could be relaxed to give management more room for manoeuvre. The impact of limits on the number of shares that can be issued freely by management is, of course, likely to be harder in bear market conditions as falling share prices mean an increase in the number of shares that a company must allot in order to raise a particular amount of capital. It is for shareholders to decide whether to change their practices and that would not be achieved through mandatory intervention.[73] However, if public officials were to determine that persisting with established practices was contrary to wider public interests there can be no doubt that they would have the leverage to force shareholder representative bodies to engage in serious dialogue aimed at achieving consensual change. In such discussions, the constraining effect of the need to comply with the EC equal treatment principle should not be overlooked.

Established practice is for shareholders to give directors headroom to allot new shares up to a limit of one-third of the existing capital. This ‘norm’ is recorded in guidelines that were published by the Association of British Insurers in 1995, and which appears not to have been updated in any substantial way since then.[74] Its operation seems to be uncontroversial. One way of interpreting the fact that this aspect of practice has not attracted critical attention over the years is to conclude that it reflects a broad consensus on a reasonable allocation of power between directors and shareholders. Certainly it is not hard to see why shareholders might balk at giving directors general authority to allot

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[69] Companies Act 2006, s 30. Previously a 21 day notice period also applied to general meetings other than the AGM to consider passing special (75% majority) resolutions.
[70] Shareholder Rights Directive, art 5.
[71] Shareholder Rights Directive, rec 6.
[72] Second Company Law Directive, art 24 (shareholder authorisation), implemented in UK by Companies Act 2006, s 551; Second Company Law Directive, art 29 (pre-emption rights), implemented in UK by Companies Act 2006, s 561. See above for discussion of the difficulties involved in seeking change in this area.
[73] Note ABI, *Rights Issues*, n 56 above, 3 which rules out changes to pre-emption opt-out thresholds. This was an early contribution to the 2008 review of capital raising practices in the UK, and could be interpreted as an attempt to shape the debate in a particular direction.
[74] See http://www.ivis.co.uk/ShareholdersPreemptionRight.aspx (accessed August 2008).

shares representing more than one-third of the existing share base. However, an implication is that any large-scale rights issue, such as those considered here, will require specific shareholder approval. [75]

The standard opt-out in respect of pre-emption rights is 5 per cent of the company's existing capital in any one year, with an additional limit of 7.5 per cent in any rolling three year period.[76] This aspect of practice, which has a quasi-formal status by being set out in a *Statement of Principles* that is overseen and updated from time to time by the Pre-emption Group, whose membership includes institutional investors and finance directors and which is supported by input from the Financial Reporting Council, the public body responsible for oversight of corporate governance in the UK, is more controversial. The Myners review, which concluded in 2004, was prompted by concern that pre-emption rights could be hindering certain public companies, especially high-technology science-based companies, from raising finance flexibly for innovation and growth. To address that problem, Myners recommended that more emphasis needed to be placed on the flexibility of the guidelines: the 5 per cent threshold was not meant to be a rigid cut-off point and companies could approach their shareholders for on opt-out of more than 5 per cent based on the merits of their particular case.[77] However, it is a very imperfect solution to the more recent problems to say that companies can always approach their shareholders with a fact-specific, merits-based case to be allowed to allot more than 5 per cent of their shares on a non-pre-emptive basis because dialogue of that sort takes time and engaging in it against of a background of adverse trading conditions could exacerbate pricing risks. The key issue now is whether the default practice should evolve towards a higher threshold, such as 10 per cent, which Myners himself has recently advocated.[78] There is a good case for this to be considered: again the Australian example, where up to 15 per cent of new shares can be issued otherwise than on a pre-emptive basis, may be instructive.[79] But it is important to note that after that ceiling was raised to 15 per cent (from 10 per cent) in 1997 there was a trend for companies to prefer placings over rights issues.[80] This promoted a further regulatory rethink[81] resulting in

[75] The RBS resolution was framed on the basis that that, assuming the rights issue took place, the directors would then have authority to allot 20.7 per cent of the total enlarged issued ordinary share capital. The HBOS resolution was to similar effect: assuming the rights issue took place, the directors would have a remaining authority allot 32.4 per cent of the total enlarged issued ordinary share capital. In the case of B&B, the shareholder resolution authorised the directors to allot shares up to a limit representing approximately 124% of the existing issued shares but that authorisation was only for the purpose of the rights issue.

[76] Pre-emption Group, *Disapplying Pre-emption Rights*, n 6 above.

[77] e.g., at the EGM on 26 June 2008, the HBOS shareholders approved a resolution that disapplied pre-emption rights up to 7% of the existing issued ordinary share capital as at 2 June 2008 (being the latest practicable date prior to the publication of this circular) and representing approximately 5% of the issued ordinary share capital following the rights issue. The directors stated that other than in connection with the rights issue, they did not intend to issue more than 7.5% of the issued ordinary share capital for cash on a non pre-emptive basis in any three year period and gave an undertaking to that effect.

[78] Myners, 'We're Still Going the Wrong Way', n 49, above.

[79] ASX, rule 7.1, discussed JP Hambrook, 'Shares', in *Australian Corporation Law Principles and Practice* (Butterworths, looseleaf) para 2.60075.

[80] Chan and Brown, 'Rights Issues Versus Placements', n 58 above.

intervention in 2007/8 to reduce the disclosure burden associated with rights issues, a reform that was specifically aimed at ensuring that companies would make greater use of rights issues.[82] Drawing from the Australian experience, it would be sensible for discussion in the UK to be on a holistic footing, with the possibility of a move to a higher threshold being viewed as just one aspect of a larger reform package that includes other measures that could have a counterbalancing effect by making rights issues a more attractive financing choice. Trade-offs of this sort could help to make a move to increase the opt-out threshold more palatable to institutional investors.

EC law would not prevent an increase in the opt-out threshold unless it is somehow thought to contravene the equal treatment principle. The ongoing infringement action against Spain, where the European Commission has objected on equal treatment grounds to a pre-emption opt-out framework that allow shareholders in listed companies to authorise a non pre-emptive issue of new shares at any price, provided that this exceeds the net asset value of the company as stated in an auditor's report, indicates that controls relating to the price of non-pre-emptive offers may play an important role in satisfying EC law.[83] It may be prudent to await the final outcome of those proceedings before reviewing the limit on discounts on non-pre-emptive issues, which currently stands at 5 per cent from the market price.[84]

Open offers are pro rata offerings of new shares but they differ from traditional rights issues in a number of respects and they require an opt-out from statutory pre-emption rights. Standard practice is for shareholder opt-out resolutions not to include a threshold above which an open offer cannot be used but in exercising their powers of allotment, directors will be mindful of the fact that the Association of British Insurers has said that individual cases need to be justified because of the absence of tradeable rights[85] and has indicated its preference for rights issues for pro rata offerings representing more than 15 to 18 per cent of share capital.[86] These reservations reflect investor sentiment that in general the relative merits of a fully pre-emptive issue increase as size of issue and depth of discount increase.[87] Open offers may have a discriminatory effect on retail shareholders because they are less likely to be able to afford to take up their rights than institutional investors, yet are unable to monetise their entitlements by selling their rights as they could in a traditional rights issue. The FSA *Listing Rule* that allows open offers at up to a 10 per cent discount to market price may require careful scrutiny at some point, depending on how the European Court of Justice interprets the equal treatment principle.[88]

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[81] Australian Government, The Treasury, *Corporate and Financial Services Regulation Review – Proposals Paper* (November 2006), ch 5.
[82] See material cited in n 58 above. The market impact of the disclosure reforms (made in 2007 and 2008) has yet to be tested empirically.
[83] See material cited in n 5 above.
[84] This limit is provided by the Pre-emption Group, *Statement of Principles*, n 6 above.
[85] ABI, *Rights Issues*, note 56 above, 5.
[86] Herbert Smith LLP, *A Practical Guide*, n 18 above, 317.
[87] ABI, *Rights Issues*, note 56 above, 5.
[88] LR 9.5.10.

One of the striking features of the British approach, as outlined in this section, is the extent to which important aspects rely on formal or informal guidelines from institutional investors rather than legally-enforceable rules. In many respects this is entirely positive: the law empowers shareholders and they have helpfully articulated their general approach to using those powers, which promotes certainty and predictability. However, it is conceivable that the patchwork of statutory rules, regulatory rules and guidance could fall short of EC law in certain respects by not providing legally enforceable safeguards in respect of pre-emption opt-outs.[89] This is one reason for raising the question whether the *Listing Rules* should be amended to incorporate more of the framework. Yet, even if the current position is fully compatible with EC law, there is another reason for raising the possibility of more being done in the *Listing Rules*. If a balance of public interest considerations points to the conclusion that current institutional investor practice is too restrictive, for example with regard to the opt-out threshold, the *Listing Rules* could be changed to sanction a more flexible approach (to the extent compatible with EC law). This would not necessarily give directors a free hand up to any new limits set by the *Listing Rules* as they would still need to obtain shareholder approval to dis-apply statutory pre-emption rights and such approval could be subject to more restrictive limits set by institutional investors. However, a framework that has the imprimatur of the FSA behind it would have considerable influence and could help to nudge institutional investor practice.

Conditional trading of nil-paid rights

The combination of the rules relating to notice periods for shareholder meetings and the FSA's refusal to allow the 21 offer period, and hence the period for trading of nil-paid rights, to start until all necessary shareholder approvals have been obtained can prolong rights issue timetables significantly. One option that could be considered, therefore, is for the FSA to relax its position so as to permit conditional trading of nil-paid rights. This would align the rights issue position more closely with open offers, where the offer period and the notice period for the shareholder meeting can run concurrently. However, the proposal raises some challenging issues. Trading of nil-paid rights is a mechanism that safeguards shareholders from an erosion in the economic value of their investment and it is particularly beneficial for retail shareholders. Relaxing the framework to permit conditional trading would expose retail shareholders to new risks, and could have unpredictable consequences. In considering the merits of this idea, differences between rights issues and open offers need close attention: in particular, there is no nil-paid trading of rights in an open offer and so the particular issue identified here as problematic does not arise.

Issuer disclosure

The usual obligations to publish an approved prospectus when securities are offered to the public or when securities are admitted to trading on a regulated market apply in

[89] e.g., in respect of discounts , where legally-enforceable rules kick in only at 10 per cent.

relation to rights issues and open offers.[90] Although there are various exemptions from the mandatory prospectus requirements, none of the current exemptions is likely to be of much use in a rights issue by an issuer of economically significant size.[91] In a report to the European Commission in September 2007, the European Securities Markets Expert Group (ESME) noted that the cost and complexity of preparing a prospectus for a traditional rights issue could be extremely high.[92] Prospectus passporting procedures that must be followed where non-exempt offers are made on a cross border basis to shareholders located in a number of Member States add to these burdens.[93] Complex issues take time to work through, and it is this aspect of the prospectus requirements that has been especially troublesome in the recent issues.

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[90] Directive 2003/71/EC of the European Parliament and of the Council of 4th November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, [2003] OJ L435/64, art 3. UK implementation: Financial Services and Markets Act 2000, s 85. For CESR guidance on the application of the Prospectus Directive to rights issues, see CESR, *Frequently Asked Questions Regarding Prospectuses: Common Positions Agreed by CESR Members* (6th update, August 2008), Q 60.

[91] Herbert Smith LLP, *A Practical Guide*, n 18 above, 318.

[92] ESME, *Report on Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading* (September 2007), 17. ESME is a formally established group of market experts, which performs the function of providing legal and economic advice on the application of the EU securities Directives: 2006/288/EC: Commission Decision of 30 March 2006 setting up a European Securities Markets Expert Group to provide legal and economic advice on the application of the EU securities Directives [2006] OJ L106/14.

[93] ESME, *Report*, ibid. On the operation of passporting procedures in the context of a large cross-border offering: E Ferran, 'Cross-border Offers of Securities in the EU: the *Standard Life* Flotation' (2007) 4 European Company and Financial Law Review 461.

The following table briefly summarises the application of the mandatory prospectus requirements in relation to the RBS, HBOS, B&B and Barclays share offerings.

	RBS	**HBOS**	**B&B**	**Barclays**
Prospectus published?	Yes	Yes	Yes	Yes
Prospectus passported?	Yes – France, Germany, Ireland, the Netherlands and Spain	Yes – Belgium, Cyprus, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Norway, Portugal, Spain and Sweden	Yes – Belgium, Cyprus, France, Ireland and the Netherlands	Yes – Belgium, France, Germany, Ireland, Italy, the Netherlands and Spain
Date of announcement of transaction	22 April 2008	29 April 2008	14 May 2008	25 June 2008
Date of prospectus publication	30 April 2008	19 June 2008	24 June 2008 (with a supplementary prospectus on 11 July 2008)	25 June 2008

ESME suggested that in general, all share offerings to existing shareholders by the way of a rights issue should be exempt from the prospectus requirement.[94] Its reasoning was that these investors do not need the special protection provided for by a prospectus as they should be familiar with and confident in the company in which they are already invested. It suggested that secondary market trading of rights and of the new shares could be accommodated by other new exemptions, based on an existing exemption in the Prospectus Directive for shares representing less than 10 per cent of shares of the same class already traded but with a higher percentage threshold (20 or 25 per cent) or a fixed financial threshold because two years experience had shown that the current threshold satisfied neither issuers, nor market needs, nor the objective of investor protection. This thinking is similar to that which underpinned reforms to Australian law to reduce the disclosure burden in rights issues. When the Australian Treasury first suggested the possibility of removing the requirement to issue a prospectus or equivalent document for rights issues in the case of listed entities, it noted that the combination of an original prospectus on listing and the continuous disclosure rules, supplemented by additional specific disclosure, would ensure the provision of an appropriate flow of information to members necessary for informed decision-making.[95]

ESME's proposal is embryonic. Questions that would need to be addressed before it could be adopted include the scope of any exemptions (e.g. should only traditional rights issues benefit or should they also apply to non-traditional pro rata offerings such as open offers), whether exemptions should be unconditional or alternatively should require issuers to comply with some limited short-form disclosure obligations, and, if so, the prescribed content of those disclosures, where responsibility for short-form disclosure statements should lie, the liability position in respect of them, and whether they should be subject to regulatory approval.[96] Yet the basic idea of dispensing with full prospectus requirements in rights issues has considerable merit and clearly deserves to be examined carefully. Issuers should not be burdened with time-consuming requirements that provide no significant added value in information to investors, especially where there are significant pricing risks associated with an extended timescale.

Establishing new exemptions or lighter disclosure requirements for rights issues would require changes to the Prospectus Directive. Up to this point, this article has struck a rather pessimistic note about whether it is worthwhile to seek change at the European level and has suggested that a more productive strategy may be to concentrate on finding ways of accommodating existing EC law so that it does not impede economically worthwhile activity. However, there is room to be more optimistic at this point. While it is certainly true that aspects of EC company law have proved resistant to reform

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[94] This paragraph is drawn from ESME, *Report*, 16 – 17.
[95] Australian Government, The Treasury, *Corporate and Financial Services Regulation Review*, n 84 above, ch 5. The additional specific disclosure required at the time of the rights issue includes a statement as to the potential effect of the rights issue on control of the body, and the consequences of that effect, and disclosure of any material information not previously disclosed because it was covered by an exception under ASX Listing Rule 3.1A. See R Baxt, A Black and P Hanrahan, *Securities and Financial Services Law* (LexisNexis Butterworths, Sydney, 7th edn, 2008), para 4.29.
[96] ESME, *Report*, annex, 13 begins to develop some of these ideas.

initiatives, EC securities law, of which mandatory prospectus requirements in the Prospectus Directive are a part, has a more dynamic feel. One the perceived advantages of the Lamfalussy process, which governs the making of EC securities law, is that it is meant to provide a more efficient mechanism for changing sub-optimal rules than the more traditional methods for making EC laws.[97] The possibility of change has powerful support from ESME, which has ranked the need for an amendment to the Prospectus Directive to facilitate rights issues as a high priority.[98]

Yet even if the prospects for changes to EC securities law are reasonably good, that process may not move quickly enough to address immediately pressing concerns. As an interim measure, opportunities for advance planning through a type of shelf registration structure introduced by the Prospectus Directive may be usefully exploited.[99] This structure allows issuers to file a registration document containing information relating to the issuer and to have it approved by the competent authority at the time of filing. The document is valid for up to 12 months. An issuer which already has a valid registration document approved by the competent authority has only to draw up only a securities note and a summary note when securities are offered to the public or admitted to trading on a regulated market. In this case, the securities note provides information that would normally be provided in the registration document if there has been a material change or recent development which could affect investors' assessments since the latest updated registration document or any supplement was approved. The securities and summary notes are subject to a separate regulatory approval but, once that process is complete, the three documents together comprise a valid tri-partite prospectus.[100] However, this is only a second-best solution: continuous disclosure obligations make the concept of a registration document somewhat anomalous and costs associated with preparing and maintaining such a document 'just in case' an urgent need to make a cash call may arise are thus unlikely to be outweighed by any substantial gains in overall transparency.

Short selling and market abuse

Short selling is a legitimate technique which assists liquidity and is not of itself abusive.[101] Spreading false rumours with the aim of driving down a company's share price is illegitimate and abusive conduct that distorts normal price discovery processes and which can threaten to disrupt market stability where significant financial institutions are the rumour-mongers' targets.[102] Taken in isolation each of these statements is broadly uncontroversial but, considered together, difficulties emerge. It is not realistic (or even

[97] On the Lamfulussy process generally: E Ferran, *Building an EU Securities Market* (CUP, 2004) ch 3.
[98] ESME, *Report*, annex, 13.
[99] Arts 5 and 12. The ABI has indicated broad support: ABI, *Rights Issues*, n 56 above, 5.
[100] The use of a tri-partite prospectus in a transactional context is discussed in E Ferran, 'Cross-border Offers of Securities', n 96 above.
[101] FSA, 'Financial Services Authority Introduces Disclosure Regime for Significant Short Positions in Companies Undertaking Rights Issues', FSA/PN/057/2008, 13 June 2008.
[102] Securities and Exchange Commission, 'Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action To Respond To Market Developments', (Securities Exchange Act of 1934 Release No 58166, 15 July 2008).

desirable) to rely solely on reactive enforcement activity to stamp out abuse[103] and proactive regulatory strategies aimed reducing the opportunities for abuse to take place are also required. However, proactive regulatory intervention in respect of short selling needs to be carefully designed so that it does not impede legitimate activity that performs a valuable corporate governance disciplining function more than is necessary to achieve public interest goals of stable, clean markets.

It is open to question whether the FSA struck the right balance between competing considerations when in June 2008 it introduced a new disclosure requirement in respect of short positions relating to securities which are the subject of a rights issue that represent an economic interest of at least 0.25 per cent of the issuer's capital.[104] This measure was taken in response to volatility in the shares of companies conducting rights issues, which was believed to result at least in part from short selling activity. In introducing it, the FSA acknowledged the basic legitimacy of short selling but said that its view was that there is greater potential for abusive conduct during a rights issue process and that improved transparency would prevent the creation of a false and misleading impression of supply and demand in those securities.[105] The FSA sought to justify its intervention by reference to its statutory objective to maintain market confidence.[106]

The measure was rushed through under emergency powers that allow the FSA to override its normal statutory obligation to consult before introducing new rules.[107] Had the FSA been challenged on procedural grounds, the fact that around the same the SEC also intervened by introducing emergency measures in respect of short selling in the shares of specified financial institutions would have been a compelling point in support of the view that there was indeed a need for swift action to maintain orderly and fair markets.[108] The international character of the capital markets means that increasing convergence in how

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[103] The FSA's explanation of its decision to conclude its investigation into HBOS rumours without bringing any enforcement actions illustrates some of the problems that investigators face. The FSA concluded that there was no doubt that false and damaging rumours were circulating and that these would have had some impact on HBOS' share price. However, it could not say how much impact, as the share price was also affected by the interaction of a number of other complex factors on the day, including a lack of liquidity in the order book with parties unwilling to enter buy or sell orders, particularly after the automated trading halt and the effect of algorithmic trading strategies, which amplified the impact of the initial downward trend in the HBOS share price. Despite the likelihood that the rumours contributed to the fall in the share price, the FSA was unable to uncover evidence that they were spread as part of a concerted attempt by individuals to profit by manipulating the share price. FSA, 'FSA Concludes HBOS Rumours Investigation', FSA/PN/086/2008, 1 August 2008.

[104] FSA, *Handbook*, MAR 1.9.2A E.

[105] FSA, 'Financial Services Authority Introduces Disclosure Regime', n 104 above.

[106] Financial Services and Markets Act 2000, s 3.

[107] Financial Services and Markets Act 2000, s 155. See in particular s 155(7), which dispenses with the consultation procedures where the FSA considers that the delay involved in complying with them would be prejudicial to the interests of consumers.

[108] Securities and Exchange Commission, 'Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action To Respond To Market Developments', (Securities Exchange Act of 1934 Release No 58166, 15 July 2008).

individual countries respond to regulatory concerns is only to be expected.[109] However, the FSA's intervention was flawed in certain important respects. Some teething problems were caused by uncertainties in the detailed drafting of the new disclosure rules,[110] to which the FSA had to respond by means of a supplementary announcement clarifying the original requirements.[111] A deeper concern is that the effect of the changes is that *any* undisclosed short selling over the threshold will now be regarded as market abuse by the FSA, a sweeping conclusion that arguably fails to give adequate weight to the beneficial role that short selling can play in many circumstances.

The FSA's new disclosure rules were always intended as only a stopgap measure pending the more wide-ranging review into how capital raising by listed companies could be made more orderly and efficient that was launched subsequently.[112] Given the raft from criticism that they attracted from lawyers, investors and others,[113] and a negative assessment of the impact of the changes in achieving their unofficial aim of preventing rights issue 'failures' or at least buying time for proper discussion of capital raising,[114] it may be that in due course they will be withdrawn or at least substantially revised. In reviewing the rules on the disclosure of short selling, it would seem sensible to consider them in conjunction with the general disclosure and transparency framework. Apparent anomalies, such as the striking asymmetry between the FSA disclosure thresholds in respect of short (0.25 per cent in rights issues) and long (generally 3 per cent) positions, should to be carefully explained by reference to their different policy aims, or else modified if they cannot be justified. A wide-ranging review may also identify other areas where intervention could usefully be targeted, for example to enhance transparency in respect of underwriting and sub-underwriting activity.

Yet, despite their flaws, the new disclosure rules may have served a useful purpose to the extent that their adoption (in combination with hints from the FSA that more stringent restrictions on short selling might be in the offing), served as a catalyst for the development of alternative views on the control of short selling in rights issues, such as the suggestion of a self-regulatory code of best practice with regard to the behaviour of investors during rights issues,[115] and their operation helped to inform this thinking by triggering disclosure of certain activities that could be regarded as falling below best practice standards.[116] Another potentially enduring, and beneficial, legacy of the

[109] ME Tahyar, J Willeumier, EJ Pan, HE Jackson and E Ferran, *Draft Report of the Securities Law Subcommittee of the Task Force on Extraterritorial Jurisdiction of the International Bar Association* (January 1, 2008). Available at SSRN: http://ssrn.com/abstract=1109061.
[110] K Chellel, 'Lawyers Lambast FSA's New Short Selling Rules', *thelawyer.com*, 23 June 2008.
[111] FSA, 'Short Selling Instrument 2008 – Frequently Asked Questions 20 June 2008 Update'.
[112] FSA, 'Financial Services Authority Introduces Disclosure Regime', n 104 above.
[113] For a favour of the adverse commentary see P Taylor, 'FSA Under Fire Over New Short-selling Rules', *Daily Telegraph*, 10 July 2008, 3.
[114] Hill, 'HBOS Flop', n 19 above.
[115] ABI, *Rights Issues*, note 56 above, 5.
[116] Morgan Stanley, one to the underwriters to the HBOS rights issue, surprised the market with its disclosure, made in compliance with the FSA rules, that it had taken out a 2.35 per cent short position in HBOS on the day the rights issue closed. ABI, *Rights Issues*, note 56 above, 5 suggests that best practice

experience may be to discourage the FSA from seeking to repeat the precedent of dispensing with consultation about draft rules except where there is a crystal-clear need for urgent action. Transparent use of regulatory power not only serves accountability goals, it gives regulators access to market experience and expertise that can help them make better informed decisions and avoid mistakes.

PART IV: CONCLUSION

This article has reviewed regulatory concerns prompted by the difficulties that were encountered by four British banks in making rights issues and other pro rata equity offerings between April and August 2008 against a background of adverse market conditions. Its conclusion that rights issues are too cumbersome and too time-consuming swims with the mainstream of current thinking. The article contributes to the debate by considering what options for change it is realistic to pursue given the confines of the existing mandatory legal framework, much of which is now set at the European level.

EC company law contains two principles of particular importance in this context: the pre-emption principle, and the principle of equal treatment to all shareholders who are in the same position. Both principles are firmly embedded and are unlikely to be easily dislodged. EC securities law governs mandatory prospectus disclosure requirements but there is room for more optimism about the chances of making a successful case for reform of these rules than in the realm of company law.

Key recommendations that are supported in this article are as follows. As well as reducing the statutory period for which offers of new shares in rights issues must be kept open to the 14 day minimum set by EC law, consideration should also be given to shortening further the offer period set by the FSA *Listing Rules*, to benefit issuers that have opted out of the statutory regime. The prescribed period needs to be sufficient to give retail investors the opportunity to trade some of their nil-paid rights in order to raise funds to subscribe the remainder. There is a question whether differential time limits for institutional and retail shareholders would be compatible with the EC equal treatment principle. Other concerns, such as disclosure obligations in respect of the level of institutional investor take-up, would have to be thought through before this idea could be implemented. It does not seem feasible to press for the procedure for obtaining shareholder resolutions to be streamlined by shortening the notice periods for company meetings because this issue has been recently reviewed at national and EC level and is unlikely to be re-opened. Allowing conditional nil-paid trading of rights in the period before shareholder approvals have been obtained could speed things up but there are challenges in exposing retail shareholders to the risks of conditional trading and further analysis is needed to establish whether this would be a beneficial change overall. A more streamlined process could be achieved by increasing the standard opt-out threshold for non-pre-emptive offerings. That would require a change to institutional investor practice

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should be formalised in the direction of underwriters and sub-underwriters agreeing to refrain from shortselling of shares and, possibly, stock lending, throughout the issue period.

rather than law (although there may be scope for fostering change through the *Listing Rules*), but it could be made more palatable to investors by coupling it with changes to rights issues procedures so as remove features that make companies less willing to use them. In developing changes to law or practice that would make it easier for companies to issue shares otherwise than on a fully-emptive basis, the constraining effect of the equal treatment principle needs to be kept in mind because such developments could be viewed as having a discriminatory effect on retail shareholders.

With regard to the disclosure burden associated with rights issues and other types of pro rata offering, as an interim measure, opportunities for advance planning through the shelf registration, tri-partite prospectus structure that is now available may be usefully exploited. Tailor-made changes to exempt rights issues from prospectus disclosure obligations or to provide a lighter disclosure regime would involve amendments to EC law. However, in this area it does not seem unduly optimistic to rate the chances of making a successful case for reform as being reasonably good, and some the groundwork has already been done by the European Securities Markets Expert Group. The article does not make any specific suggestions with regard to market abuse and short selling. It identifies some merits in the FSA recent intervention to impose new disclosure obligations but also some shortcomings. Some of the difficulties might have been avoided had the FSA consulted on draft proposals and, with that point in mind, it could be said that the experience yields lessons on the value of operating within the disciplines of better regulation.

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