

## REPORT ON THE APPLICATION OF THE REVISED STATEMENT OF PRINCIPLES ON PRE-EMPTION RIGHTS

### Introduction

1. Pre-emption rights give existing shareholders in a company the right to subscribe for their pro rata share of any new shares in that company issued for cash, providing them with protection against inappropriate dilution of their investments. Pre-emption rights are enshrined in UK and EU company law and may be disapplied only by a special resolution of shareholders at a general meeting of the company. The Pre-Emption Guidelines were originally published in 1987 to provide guidance on disapplying pre-emption rights.
2. A review of the impact of pre-emption rights in 2004, carried out by Paul Myners on behalf of the then Department of Trade and Industry, recommended that the guidelines be updated to reflect developments in the market since 1987. As a result the Pre-Emption Group – whose members represent listed companies, investors and intermediaries – was reconvened and a new Statement of Principles was published in May 2006.
3. The Statement of Principles aims to provide clarity on the circumstances in which flexibility might be appropriate and the factors to be taken into account when considering the case for disapplying pre-emption rights and making use of an agreed authority for a non-pre-emptive share issue.
4. When publishing the Statement of Principles the Pre-Emption Group undertook to issue regular reports on how it was being applied. This is the first such report. This report looks at the implementation of the Statement of Principles for the period ending July 2007. Since then, changes in market conditions have resulted in an increased focus on rights issues; among other developments, in June 2008 HM Treasury and the Financial Services Authority announced a joint review of the processes associated with rights issues.
5. The Pre-Emption Group has offered to contribute to this review, and will reflect issues raised by the review and other recent developments in its next report. However in learning lessons from recent events it is important to distinguish between the mechanics of raising capital and the principles of transparency, engagement and equal treatment for all shareholders, as supported by pre-emption rights. While some parts of the UK system of raising capital have been placed under strain, and there may be scope for improving the speed and flexibility with which they operate, there is no evidence that the system as a whole is broken.

# Pre-Emption Group

## Application of the Principles

6. The Pre-Emption Group commissioned Manifest Information Services to analyse data for the two 14 month periods preceding and following the publication of the revised Statement of Principles in May 2006 to see whether there were any significant differences in the use being made of requests to disapply pre-emption rights by more than 5% (5% being the level below which requests are considered to be “routine”). The results of this analysis are summarised in Appendix A.
7. In total there was a 25% increase in requests to disapply pre-emption rights by more than 5% in the period ending July 2007. In both periods over half such requests were made by investment trusts and other equity investment vehicles. When these are excluded, there was a 15% increase in the total number of requests, with a notable increase in requests from companies outside the FTSE 350. This is encouraging, as one of the reasons for introducing the Statement of Principles was to make smaller companies more aware of the flexibility that was available to them. Also encouraging is the evidence that investors appear to be more willing to accede to such requests when a strong case is made.
8. However it should be noted the overall number of requests was still fairly small, perhaps reflecting general satisfaction with the rights issue regime, a historic preference for debt issues or a lack of widespread familiarity with the new guidelines. It is therefore difficult to discern any clear trend at this early stage. It is possible that a greater increase in equity issues, and consequently in requests to disapply pre-emption rights, might be seen in the future following recent market developments.
9. Comprehensive data on the outcome of resolutions is not readily available, as not all companies publish the outcome of votes at their General Meetings (although they will be required to do so in future as a result of new requirements introduced by the Companies Act 2006). However all those resolutions put forward during the period ending July 2007 for which voting figures are available received at least the 75% support necessary to approve the resolution.
10. Anecdotal evidence suggests that the Statement of Principles has led to an increase in dialogue and engagement between companies and investors where the disapplication of pre-emption rights is being considered, which is encouraging. However there remains a perception that some investors and voting advisory services continue to view the 5% figure, and the related figure of 7.5% over three years, as upper limits which should not be breached. The Statement of Principles makes it clear that the purpose of

# Pre-Emption Group

these figures is to ease the granting of authority below them, not to rule out approvals above them.

11. The Pre-Emption Group wishes to emphasise that all requests to disapply pre-emption rights should be considered on their merits against the usual investment criteria. Where the request exceeds the guideline figures set out in the Statement of Principles, there is a greater onus on the company to ensure that shareholders have the information they need to reach an informed decision. In these cases, early dialogue is strongly encouraged.

## Amendments to the Principles

12. Since the publication of the Statement of Principles the Pre-Emption Group has received a number of requests either for clarification of, or additional guidance on, some aspects of the Statement. Having considered these requests, the Group has made three changes to the Statement of Principles. These are highlighted in the marked up version of the Statement of Principles at Appendix B, and copies of the updated Statement of Principles are available on the Pre-Emption Group website at <http://www.pre-emptiongroup.org.uk/principles/index.htm>.

13. The effect of the changes is to:

- a. clarify that convertible instruments are covered by the Statement of Principles, and that they should be counted for the purposes of the guideline levels at the time the authority was sought, not at the time they were converted [*paragraph 13*];
- b. acknowledge that shareholders would not normally have concerns if there was no dilution of value as a result of the proposed issue, for example where shares were issued at a premium to net asset value [*paragraph 16*]; and
- c. recommend that companies should not seek an authorization for more than a maximum of 15 months [*paragraph 19*]. This is in line with current practice.

14. The Group recognises that there is a degree of inconsistency in the way that the Statement of Principles treat shares held in Treasury, recommending that they should be included when calculating the annual guideline level of 5% but not when calculating the cumulative three-year level of 7.5%. There are legitimate arguments both for including and excluding them from the guideline levels. On the one hand it has been argued that as they are not “new” shares they should not be subject to the

# Pre-Emption Group

same constraints as other non-pre-emptive issues, and further that loosening the constraints on a company's ability to reissue shares held in Treasury might make companies more willing to buy back shares in the first case. On the other hand it has been argued that most investors would probably assume that any shares bought back by the company would normally be cancelled rather than reissued, and would be concerned if too much flexibility was granted.

15. The Group understands that BERR intends to consult later in 2008 on whether to revise the current statutory limits on holding shares in Treasury. At present UK company law prescribes that a maximum of 10% of shares may be held in Treasury; under the Second Company Law Directive Member States can set any limit up to the level of the company's distributable reserves. The Group considers it would be appropriate to wait to see whether the outcome of this consultation has any implications for the way shares held in Treasury are treated in the Statement of Principles, and therefore proposes to defer making any decision on this issue under its next review. Any comments on the issue are nonetheless welcome.

## **Contacting the Pre-Emption Group**

Any comments on this report and the changes to the Statement of Principles, and any other correspondence, should be addressed to the Secretary of the Group. His contact details are:

Chris Hodge  
Secretary, Pre-Emption Group  
Financial Reporting Council  
5th Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

E-mail: [secretary@pre-emptiongroup.org.uk](mailto:secretary@pre-emptiongroup.org.uk)

# Pre-Emption Group

## APPENDIX A

### REQUESTS FOR DISAPPLICATIONS ABOVE 5%

*These tables have been compiled using data provided by Manifest Information Services. Manifest holds data on most but not all companies listed on the Main Market, so while the data should be reasonably comprehensive it is not complete.*

The Group looked at data for the two 14 month periods preceding and following the publication of the revised Statement of Principles in May 2006 to see whether there were any differences in the use being made of requests to disapply pre-emption rights above 5%.

In both periods over half such requests were made by investment trusts and other equity investment vehicles, as shown in the table below. When they are excluded, there was no significant increase in the total number of requests, although there was a notable increase in requests from companies outside the FTSE350 (from 22 to 32).

Company Type	Number of requests	
	2005-2006	2006-2007
FTSE 100	4	2
FTSE 250	5	4
FTSE Small Cap	16	25
FTSE Fledging	6	7
No longer listed	2	0
Investment Trusts	34	47
<b>Total</b>	<b>67</b>	<b>85</b>
<b>Total (excluding Investment Trusts)</b>	<b>33</b>	<b>38</b>

## Pre-Emption Group

A sectoral analysis of requests shows that, after investment trusts, disapplications of above 5% were most frequently sought by pharmaceuticals and biotechnology companies.

Sector	Number of requests	
	2005-2006	2006-2007
Industrial Engineering	3	1
Pharmaceuticals & Biotechnology	7	9
Software & Computer Services	3	4
Support Services	3	3
Technology Hardware & Equipment	3	1
General Retailers	1	4
Media	0	3
Others	13	13
<b>Total</b>	<b>33</b>	<b>38</b>

There is also evidence that requests for disapplications above 5% are increasingly being considered at AGMs rather than EGMs.

Type of Meeting	Number of requests	
	2005-2006	2006-2007
AGM	13	22
EGM	20	16
<b>Total</b>	<b>33</b>	<b>38</b>

As noted in paragraph 9 of the report, comprehensive data on the outcome of resolutions is not readily available. However, all those resolutions put forward during the 14 months following publication of the Statement of Principles for which voting figures are available received at least the 75% support necessary to approve the resolution

## APPENDIX B

### REVISED STATEMENT OF PRINCIPLES

*Note: Changes to the 2006 version of the Statement of Principles are shown in bold italics.*

#### OVERARCHING PRINCIPLES

1. Pre-emption rights are a cornerstone of UK company law and provide shareholders with protection against inappropriate dilution of their investments. They are enshrined in law by the 2<sup>nd</sup> Company Law Directive and the Companies Act 1985, which provides that they may be disapplied only by a special resolution of shareholders at a general meeting of the company.
2. Whilst not undermining the importance of pre-emption rights, a degree of flexibility is appropriate in circumstances where new equity issuance on a non-pre-emptive basis would be in the interests of companies and their owners.
3. The principles set out in this paper aim to provide clarity on the circumstances in which flexibility might be appropriate and the factors to be taken into account when considering the case for disapplying pre-emption rights and making use of an agreed authority for a non-pre-emptive share issue.
4. Companies, institutional investors and voting advisory services all have an important role to play in ensuring the effective and flexible application of this guidance:
  - Companies have a responsibility to signal an intention to seek a non-pre-emptive issue at the earliest opportunity and to establish a dialogue with the company's shareholders. They should keep shareholders informed of issues related to an application to disapply their pre-emption rights.
  - Shareholders have a responsibility to engage with companies to help them understand the specific factors that might inform their view on a non-pre-emptive issue by the company. They should review the case made by companies on its merits and decide on each case individually using the usual investment criteria. Where a shareholder does intend to vote against a resolution to disapply pre-emption rights, the Institutional Shareholders' Committee

# Pre-Emption Group

Statement of Principles<sup>1</sup> on the responsibilities of shareholders makes clear that it is best practice to explain in advance the reasons for the decision.

- While companies should in any case consult their main shareholders, advisory services should be prepared to receive representations from companies. In such circumstances the advisory services should explain any recommendations made in light of the reasons provided. This should involve setting out the pros and cons of the proposal so that the ultimate decision maker can take an informed view.

## APPLICATION OF THE PRINCIPLES

5. The principles set out here relate to issues of equity securities for cash other than on a pre-emptive basis pro rata to existing shareholders by all UK companies which are primary listed on the Main Market of the London Stock Exchange. Companies quoted on AIM are encouraged to apply these guidelines but investors recognise that greater flexibility is likely to be justified in the case of such companies.
6. These principles are supported by the ABI, NAPF and IMA as representatives of owners and investment managers. These associations hope that the guidance they contain will be helpful to companies in approaching requests for disapplication and in gauging the likely reaction of shareholders to proposals they may wish to make.

## ROUTINE DISAPPLICATIONS

7. In a significant number of situations a request for disapplication is likely to be considered non-controversial by shareholders. While this does not reduce the importance of effective dialogue and timely notification, routine requests are less likely to need in-depth discussion and shareholders will be more inclined in principle to support them.
8. Requests are more likely to be routine in nature when the company is seeking authority to issue non-pre-emptively no more than 5% of ordinary share capital in any one year.

---

<sup>1</sup> 'The Responsibilities of Institutional Shareholders and Agents – Statement of Principles'; Institutional Shareholders' Committee; June 2007 [available at: <http://www.institutionalshareholderscommittee.org.uk/library.html> ]

# Pre-Emption Group

9. This principle applies whatever the structure of the proposed issue. For example, an issue of shares which contains both a pre-emptive and non-pre-emptive element (“combination issues”) would normally be considered routine provided that the non-pre-emptive element met the criteria specified for routine applications within these guidelines. This would include issues that comprised a placing of shares with a partial clawback by existing shareholders.
10. In the absence of (a) suitable advance consultation and explanation or (b) the matter having been specifically highlighted at the time at which the request for disapplication was made, companies should not issue more than 7.5% of the company’s ordinary share capital for cash other than to existing shareholders in any rolling three year period.
11. Where a request is made for the disapplication of pre-emption rights in respect of a specific issue of shares, the price at which the shares are proposed to be issued will also be relevant. Shareholders’ approach to the pricing of non-pre-emptive issues is set out in paragraphs 18 and 19 below. Companies should note that a discount of greater than 5% is not likely to be regarded as routine.
12. Treasury shares issued for cash will be counted within the guideline levels set out in paragraph 8, but not those in paragraph 10.
13. *Convertible instruments will be counted within the guideline levels set out in paragraphs 8 and 10, and should be counted at the point when authority to issue the instruments is sought, not the point at which they are converted to ordinary shares. [new paragraph]*
14. **These principles are intended to ease the granting of authority below those figures, not to rule out approvals above them. Requests which, if granted, would exceed these levels should be considered by shareholders on a case by case basis.** In these instances it is particularly important that there is early and effective dialogue, and that the company is able to communicate to shareholders the information they need in order to reach an informed decision. The considerations set out in the following section are critical to making a decision.

# Pre-Emption Group

## CRITICAL CONSIDERATIONS RELATING TO NON-ROUTINE REQUESTS FOR DISAPPLICATION

15. It is neither possible nor desirable to define all the circumstances in which shareholders might be willing to agree to disapply pre-emption rights above the level set out in paragraphs 8 and 10 above. Nevertheless, there are some general considerations that are likely to be relevant in the majority of cases; these are set out below. Companies should ensure they are in a position to communicate such information to shareholders to help them make an informed decision.

16. The critical considerations are likely to include:

- **the strength of the business case:** In order to make a reasoned assessment shareholders need to receive a clear explanation of the purpose to which the capital raised will be put and the benefits to be gained - for example in terms of product development or the opportunity cost of not raising new finance to exploit new commercial opportunities - and how the financing or proposed future financing fits in with the life-cycle and financial needs of the company.
- **the size and stage of development of the company and the sector within which it operates.** Different companies have different financing needs. For example, shareholders might be expected to be more sympathetic to a request from a small company with high growth potential than one from a larger, more established company.
- **the stewardship and governance of the company.** If the company has a track record of generating shareholder value, clear planning and good communications, this may give shareholders additional confidence in its judgement.
- **financing options.** A wide variety of financing options are now available to companies. Companies should explain why a non-pre-emptive issue of shares is the most appropriate means of raising capital, and why other financing methods have been rejected.
- **the level of dilution of value and control for existing shareholders.** *If there would be no resulting dilution, for example if an investment trust sought authority to issue shares at a premium to the underlying net asset value per share, this would not normally raise any concerns; [new wording]*

# Pre-Emption Group

- **the proposed process following approval:** Companies should make clear the process they would follow if approval for a non-pre-emptive issue were to be granted, for example how dialogue with shareholders would be carried out in the period leading up to the announcement of an issue.
- **contingency plans:** Company managers should explain what contingency plans they have in place in case the request is not granted, and the implications of such a decision.

## TIMING OF REQUESTS FOR DISAPPLICATION

17. Companies should signal the possibility of their intention to seek a non-pre-emptive issue at the earliest opportunity. For example if, at the time of the initial public offering, a company is aware that it is likely to have a need relatively quickly for additional cash, it should alert potential investors to this in the prospectus. In other cases it might be appropriate for the company to signal a potential request in its annual report. In some cases it may be appropriate for companies to consult a small number of major shareholders before making any announcement. Companies and shareholders should be mindful of the possible legal and regulatory issues in doing this.
18. Authority to disapply pre-emption rights following a 'routine' request would normally be granted by shareholders' approval of an appropriate resolution at an AGM. As discussed above, shareholders will not generally agree to a non-routine disapplication request without a sufficiently strong business case for this course of action. Thus, non-routine requests would be made at an AGM only when the company is in a position to justify this approach by providing relevant information such as that set out in paragraph 16; otherwise a specially convened EGM would be needed.
19. *Authorities should be granted for no more than 15 months or until the next AGM, whichever is the shorter period. [new paragraph]*

# Pre-Emption Group

## **OTHER CONSIDERATIONS RELATING TO NON PRE-EMPTIVE ISSUES**

20. Companies should aim to ensure that they are raising capital on the best possible terms, particularly where the proposed issue is in the context of a transaction likely to enhance the share price. Any discount at which equity is issued for cash other than to existing shareholders will be of major concern. Companies should, in any event, seek to restrict the discount to a maximum of 5% of the middle of the best bid and offer prices for the company's shares immediately prior to the announcement of an issue or proposed issue.
21. Where an issue is priced on a date after the announcement date, the level of discount should be assessed at the time of pricing rather than the time of announcement. Companies should also have regard to any adverse impact on the share price of the earlier announcement, which may create the potential for a significant loss or transfer of value, in deciding whether to proceed with an issue in such circumstances.
22. The principles and critical considerations set out above apply to requests for the disapplication of pre-emption rights. Once a request to disapply pre-emption rights has been approved, shareholders expect companies to discharge and account for this authority appropriately. It is recommended that the subsequent annual report should include relevant information such as the actual level of discount achieved, the amount raised and how it was used and the percentage amount of shares issued on a non-pre-emptive basis over the last year and three years.

## **ROLE OF THE PRE-EMPTION GROUP**

23. The Pre-Emption Group will monitor the development of practice in relation to disapplying pre-emption rights. It expects that this Statement of Principles will inform the way in which all interested parties participate in this process. It will monitor and report annually on the application of these principles. The Pre-Emption Group will not express a view on or otherwise intervene in specific cases.

# Pre-Emption Group

## CONTACT DETAILS

More details of the Pre-Emption Group and its activities can be found at:

[www.pre-emptiongroup.org.uk](http://www.pre-emptiongroup.org.uk)

To contact the Pre-Emption Group please e-mail:

[secretary@pre-emptiongroup.org.uk](mailto:secretary@pre-emptiongroup.org.uk)

or write to:

Chris Hodge  
Secretary, Pre-Emption Group  
Financial Reporting Council  
5<sup>th</sup> Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

## APPENDIX TO THE STATEMENT OF PRINCIPLES

### DEFINITIONS

#### Clawback

Clawback as it is referred to in paragraph 9 is the right of existing shareholders to subscribe for a share of an issue at the pre-agreed price. This differs from a full rights entitlement since it is non-renounceable and therefore does not permit the shareholder to sell this entitlement to another investor.

#### Discounts

In general terms, the "discount" (paragraphs 20 and 21) is defined as the aggregate of (a) the amount by which the offering price differs from the market price, and (b) expenses directly relevant to the making of the issue. In the case of issues of a new class of deferred equity in the form of convertibles, warrants or other deferred equity, the amount of the opening market price above the issue price and any difference at point of pricing of the instrument to underlying fair value will be regarded as part of the discount.

#### Market Movements

Where the pricing takes place at a time later than that of the announcement of the proposed issue (paragraph 21), it is recognised that the achievable price of the placing may vary in accordance with general market conditions. For the purposes of these guidelines the measurement of discount therefore relates to the time and date of the pricing rather than the time and date of the announcement of the issue.