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IA Response to Call for Evidence

UK Secondary Capital Raising Review

#### About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.4 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 44% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

#### Executive summary

The IA welcomes this opportunity to respond to the UK Secondary Capital Raising Review’s call for evidence.

The IA and its members have an ambition to re-energise public markets and create a savings and investment ecosystem which delivers for end savers and is attractive to both companies and global investors. We seek to widen UK and international businesses’ access to long-term pools of capital and maintain robust standards that will help deliver long-term returns to our clients and their beneficiaries, including retail and pension savers.

We welcome the establishment of the Secondary Capital Raisings Review and its focus on improving the rights issue process to ensure that the interests of existing investors in the company are protected, whilst allowing companies to raise capital quicker and there for with lower risk.

It is essential that businesses listed in the UK have access to a secondary capital raising structure that allows them to raise the required amount of capital quickly and efficiently, while preserving shareholder rights, including protection from dilution. The motivations for a secondary issue may vary from funding an acquisition or investment project, repaying debt, or to strengthen the balance sheet. In all cases providing issuers with an efficient means to raise capital will allow them to act dynamically either to respond to immediate concerns and business needs or to make the most of emerging, and potentially short-lived, business opportunities.

Public markets demonstrated their effectiveness, depth and resilience during the covid-19 pandemic, with listed companies able to use the flexibility provided by investors to use undocumented secondary capital raising frameworks to raise capital quickly to support their financial resilience during a period of uncertainty. Most issuers relied on accelerated book-builds and cash boxes which did not require that issuers respect pre-emption rights. Despite this, the majority of issuers, recognising the importance of pre-emption, did ensure that large shareholders received their pro-rata entitlement and made efforts to support retail investors to participate in these capital raisings. Investors felt this flexibility was appropriate given the unprecedented circumstances of the pandemic.

However, IA members would prefer to see a system of capital raising that provides issuers with the speed offered by undocumented deal structures but puts pre-emption rights at the heart of the process. This review provides an opportunity to readdress some of the barriers to greater use of fully pre-emptive issuances, and facilitate capital raising structures that provides issuers with ability to raise capital at speed and with flexibility they require while simultaneously maintaining the important shareholder protection of pre-emption rights.

Pre-emption rights and Rights issues are a major strength of the UK capital raising system, representing one of the most fundamental shareholder rights, key to this is the following:

* Dilution - The protection of minority shareholders from the dilutive effects of large non-pre-emptive capital raises provides investors with the confidence to invest their capital through the UK’s listed markets. Dis-applying them for larger capital raises poses a considerable threat to investors and the interests of their clients and beneficiaries, including retail and pension savers, whose savings they manage. Any weakening of pre-emption rights will therefore significantly undermine confidence in UK equity markets, adversely impacting on the ability to attract the capital of both domestic and overseas investors to the UK’s equity markets.
* Tradable rights - The ability of shareholders to trade their entitlement to subscribe to shares is a key feature of rights issues and distinguishes them from open offers. This enables shareholders to receive compensation for suffering dilution if they do not wish to increase their investment.

Any amendments made to the rights issue process should reflect the importance of pre-emption rights and ensure that there is no adverse impact.

Despite the above, and the advantageous features of rights issues for all stakeholders, there are a number of barriers and disincentives to their use as a form of capital raising which has resulted in companies opting to use other forms of structures, as demonstrated by the use of accelerated book builds and cash boxes over the pandemic.

In response to the call for evidence we address some of the specific areas of questioning and highlight some additional measures which the review should consider:

* Prospectus Regulations - The requirement for full prospectuses for rights issues above 20% of Issued Share Capital is inefficient and disproportionate when considering the information needs of investors. Instead, issuers should be required to produce a shorter document focused on the use of proceeds.
* Contingent Trading – **We would welcome member feedback**.
* Alternative Structures – **We would welcome member feedback.**
* Role of short-sellers – **We would welcome member feedback**.

**Questions**

1. **Can and should the overall duration and cost of the existing UK rights issue process be reduced? In what ways?**

IA members support the Review’s ambition to seek ways to reduce the overall duration and costs of the existing rights issue process. The current duration of a rights issue exposes the share price to increased risk, which jeopardises the completion of the offer and drives a larger discount, serving neither the issuer nor shareholders. The elongated time-frame also means that issuers are unable to raise capital at sufficient speed when they need access to emergency funds. This creates an incentive for issuers to raise capital through alternative, non-pre-emptive means.

The high costs and duration of the current rights issue process in the UK can be attributed to different sources at different stages:

1. Prospectus Regulations

The requirement to produce a full prospectus in connection with any rights issue that would exceed the 20% threshold, as outlined in Article 1(5) a of the current [Prospectus Regulations](https://www.handbook.fca.org.uk/handbook/PRR.pdf) is a significant contributor to the overall costs and duration of the rights issue process. The process of preparing an FCA approved prospectus regularly takes several weeks, making it far longer than other methods of raising capital.

In light of this, the IA and our members welcomed proposals within HMT’s consultation on the UK Prospectus Regime to exclude offers directed at existing security holders from public offer rules. This will remove a key barrier for issuers who wish to do the right thing by raising capital on a pre-emptive basis, thereby protecting their shareholders from dilution.

A full prospectus has little additional marginal value to existing shareholders who will already be familiar with the issuer, and its business model. Furthermore, the same securities are already freely trading on a highly-regulated market, and are allowed to do so because the market is deemed to be well informed. Issuers are subject to a number of ongoing disclosure obligations that ensure they inform shareholders and the wider market of any developments which are material to the value of the securities.

Prospectuses prepared in connection with a rights issue often contain large amounts of duplicated publicly available information. Requiring that this information is repeated in a full prospectus not only increases the time and costs burden for issuers, but makes them increasingly long and may even detract from any important new or offer-specific information within the document. In the context of a rights issue, the cost and time burden of producing a full prospectus is disproportionate with the marginal value of the disclosures within.

In lieu of a full prospectus, the disclosure requirements placed on issuers ahead of a rights issue should be reflective of and meet the information needs of investors. As such issuers should be required to provide their shareholders with the information they most require when deciding whether to participate in the rights issue and invest more capital. Some form of disclosure will always be necessary in connection with a rights issue. A use of proceeds statement informing shareholders how the company intends on using the capital along with a timetable should always be required.

Working capital statements give confidence to shareholders that a company will have a sustainable approach to capital management under different scenarios and secures the longevity of the capital raise. Such statements are particularly useful where a rights issue is held in connection with an emergency capital raise where the issuer either does not have, or is struggling to maintain enough working capital, and so the statement includes how the rights issue will be used to remedy the issue. They are also valuable as part of the required disclosures in a Class 1 circular when the company is seeking to complete a major transaction.

Working capital statements, will provide less valuable insights to investors considering a rights issue which is not in connection with an emergency capital raise or a Class 1 transaction. In these circumstances the statements, which are costly and lengthy to produce, will be disproportionately burdensome for issuers.

1. Shareholder Approval for the disapplication of pre-emption rights

The second contributing factor to the overall duration and costs of the process is the requirement that shareholder approval be gained for an authority to allot shares.

Following the recommendations of the Rights Issue Review Group, the ABI guidelines on power to allot shares (now the responsibility of the IA), were amended in 2009 such that an authority to allot up to two-thirds of the existing issued share capital was considered ‘routine’, provided the second 1/3 was raised through a fully pre-emptive rights issue. This amendment resulted in a change in market practice with a majority of FTSE All-share companies regularly submitting a resolution at their AGM for an authority to allot shares up to 2/3 of issued share capital. Since the establishment of the Public Register which tracks shareholder dissent of 20% or more on any resolution held at a FTSE All Share AGM in 2018, there have only been 5 instances of significant shareholder dissent (greater than 20%) against a resolution to approve an authority to allot a further 1/3 of the issued share capital.

The IA and our members believe that this approach has worked well, it provides issuers with the flexibility to conduct moderately large rights issues at speed, whilst maintaining the appropriate shareholder protections afforded by existing pre-emption rights, and the requirement to obtain shareholder approval ahead of a Class 1 transaction.

The IA and our members continue to believe that this ceiling is appropriate and that shareholder approval should be required for any allotment greater than 66.7% of issued share capital. This limit is an important element of governance around share capital management, and ensures that shareholders are consulted ahead of a capital raise that would raise a transformational amount of capital. The 66.7% ceiling also restricts the size of discount applicable to the rights as issuers seeking to raise a specific amount of capital only have a limited amount of shares to allot.

1. Rights Offer Duration

The final contributing factor to the duration and costs is the duration of the rights offer period, being 10 business days. The IA and our members believe that this is an appropriate duration; it strikes an appropriate balance between providing shareholders, especially retail shareholders, enough time to make an informed decision on how to exercise their rights, whilst limiting market risk and possible share price volatility, and so limiting the cost of capital to the issuer.

A further shortening of the offer period would have adverse implications on the ability of institutional investors to consider the rights issue and conduct a meaningful engagement with company board and management teams on how the rights issue will contribute to the long-term value. This is particularly the case, where a rights issue is held in connection with a class 1 transaction, or any other matter which requires shareholder approval, the decision making process will require more extensive consideration and engagement with the Company.

* **In the engagements we have had so far, members have not expressed a wish to shorten the rights offer duration. However, we would like to hear more views on** 
  + **if members are happy with the current 2-week duration; or**
  + **if members would like the duration period shortened? (and if so, by how much?)**

The existing framework for a right issue process does provide issuers with some degree of flexibility; issuers who apply for a further authority to allot shares up to 2/3 of the company’s share capital do not require further approval for a rights issue where it falls within this threshold and so shortens the process by the 14 day GM notice period. However, we believe that more can be done to make the process more efficient to the benefit of issuers and shareholders.

For example, we do not believe the current prospectus regulations are proportionate to the information needs of investors. Issuers should not be required to produce a full prospectus which is predominantly a duplication of information which is already publicly available. Instead, disclosure requirements in connection with a rights issue should focus on new information that is material to shareholders considering how to exercise their entitlements. In all cases, this would consist of a use of proceeds statement and an accompanying timetable. However, where rights issues were conducted in connection with a transaction or as an emergency raise to strengthen a company’s balance sheet more extensive disclosures should be required including a working capital statement.

Whilst the IA believes that both the rights offer duration and requirements for shareholder approval should remain we do believe that the review should consider and examine further whether the rights offer period could take place on a contingent basis that runs consecutively with the notice period for a GM to approve the rights issue/allotment of shares. The traded rights would therefore only be affected when shareholder approval is gained. This would reduce the duration of the rights issue process by at least 14 days.

* **We welcome member feedback on contingent rights trading**

1. **Should new technology be used in the process to ensure that shareholders receive relevant information in a timely fashion and are able to exercise their rights and, if so, how?**

Issuers should be allowed to make the best use of the technological advances and capabilities available to ensure that the rights issue process works as efficiently and quickly as possible ensuring that all shareholders represented on a company’s register are able to participate, whilst reducing as far as is possible the administrative burden on issuers.

1. **Are there fund-raising models in other jurisdictions that should be considered for use in the UK? For example, the use of cleansing notices in lieu of prospectuses on secondary capital raisings in Australia and also the Australian, AREO (or RAPIDS), SAREO and PAITREO structures?**

***Cleansing Notices in lieu of Prospectuses*** *– Cleansing Notices are statements released by issuers that informs the market of any information that is material to the value of the traded securities that have not been disclosed, or that confirms that there is no such information.*

*They are prominently used on the ASX where they inform market participants that issuers have been and continue to be in compliance with disclosure obligations and so facilitate an issue of securities without the need for a prospectus.*

As mentioned in response to question 1 above, we believe that the current prospectus regulations are a barrier to conducting a rights issue efficiently. Whilst investors want to have sufficient information to make informed investing decisions, existing holders of securities will already be familiar with the issuer, and a full prospectus adds little relevant information. In the context of a rights issue the cost and time burden of prospectus disclosure requirements is disproportionate with the marginal value of the disclosures within.

The ability for issuers to produce an offering document such as the Australian ‘Cleansing Notice’ should provide a suitable alternative to producing a prospectus that only duplicates already publicly available information.

Where a rights issue is held in connection with a class 1 transaction or to provide emergency funds to strengthen a company’s balance sheet, there will be a range of relevant information that is material to the value of securities that the shareholders will need access to, to ensure they are able to make a fully-informed rights trading decision. However, a significant portion of this material will already be publicly available and known to shareholders. A ‘cleansing notice’ type document in lieu of a prospectus would allow for issuers to produce a document including only the relevant additional information, therefore reducing the time and costs associated with a prospectus and ensure that shareholder have access to all relevant disclosures whilst enabling them to focus on the salient new information.

The benefits to issuers will be even greater in instances where the market is already informed of all the material information relating to the value of the securities, where a cleansing notice would consist of a a statement confirming that the market was already fully informed.

As previously mentioned we note that in all cases investors still expect that issuers provide shareholders with disclosures relating to how it intends on using the proceeds of the capital raise and a timetable for the use of those proceeds.

* **Do members have any experience with cleansing notices in the Australian Market? Do members believe that they provide for enough disclosures to make an informed voting decision?**

**Different Accelerated/non-traditional rights issues** – The below structures are non-traditional rights issue processes whereby securities are issued to institutional and retail investors separately [[1]](#footnote-2),[[2]](#footnote-3).

*Renounceable accelerated pro-rata issue with dual book build structure (RAPIDS) – A renounceable offer to Institutional investors is held under accelerated timetable with participants receiving their entitlement ahead of a subsequent retail offer (which occurs on the normal timetable). Shareholders who do not take up their entitlements have them sold through an institutional and retail book build and receive the value of the entitlements. (Any premium above the offer price is returned to the investors who did not take up their rights).*

*Accelerated renounceable entitlement offer (AREO) – A renounceable, off-market, accelerated pro-rata issue with dual book build structure offered to institutional shareholder which is accelerated ahead of the retail offer. Rights not taken up by institutions are offered to other institutional shareholders and new institutional investors under a bookbuild undertaken after the close of the institutional offer. The bookbuild price is above the fixed offer price, the excess is remitted to non-participating institutions on a pro-rata basis. A similar bookbuild and remittance process occurs for the retail offer.*

*Pro-rata Accelerated Institutional Tradeable Retail renounceable Entitlement Offer (PAITREO) – A variation on the AREO structure where rights-trading is available for retail shareholders. Retail shareholders have the opportunity to either take up their entitlements through the offer period or sell their rights through the rights trading period. The rights trading period commences immediately upon lifting of trading halt. The retail book build is the same as that of a traditional rights issue where retail shareholders who renounce their entitlements receive the excess amount of the book build price over the issue price*

*Simultaneous Accelerated Renounceable Entitlements Offer (SAREO) – a variation on the AREO. Accelerated entitlement offer carried out in 2 tranches (offer to institutional holders followed by the offer to retail holders) but with “off-market renounced” entitlements (if there is any) carried out in a single book build after the retail offer is completed.*

* **Do members believe that a one week offer period for institutional investors provides enough time to consider the matter and engage with companies?**
* **Do members believe that the differential treatment of retail and institutional investors is appropriate for the UK market? (is this consistent with the stated ambitions of HMT and the Listings Review to increase retail participation in corporate actions and further issuances?**
* **Do members have any experience and views on the various structures used in the Australian Market?**

1. **Has the greater transparency around short selling that was introduced after the financial crisis benefited the rights issue process and is there more that can and should be done in this area?**

IA members have expressed concerns about the activity of short-sellers during the rights issue process. A greater prevalence of short selling leads to increased risk of price destabilisation and volatility during the offer period and is particularly damaging to issuers who conduct a right issue to strengthen their balance sheets. The practice of short-selling during rights-issues also discourages issuers from raising capital pre-emptively as the longer duration exposes them to short sellers, who look to supress the share price, which can jeopardise the completion of the capital raise. This results in issuers having to accept a heavily discounted offer price, requiring them to issue a greater number of shares, and an increased cost of capital.

Not only does this adversely impact shareholders, issuers and their underwriters, but it reduces trust in the capital raising process and UK capital markets more generally. It also detracts from the attractiveness of London as a listings venue, especially for high-growth companies who will often undergo capital raisings as their business grows.

Whilst short-selling may play a role in assisting price discovery and contribute to prices more reflective of a companies true value in normal market conditions, it is increasingly questionable whether this is true during a rights issue, and it may be claimed that short-selling practices during a rights issue lead to more distorted pricing.

**In response to these concerns some members have suggested a ban on short-selling during a rights-issue should be implemented.**

* **Do members have any views on such a ban?**
* **In lieu of a ban, do members believe that there should be restrictions on the activities of short sellers during a rights issue?**

1. **Are there any refinements that should be made to the undocumented secondary capital raising process in light of recent experiences during the Covid-19 pandemic?**

As mentioned above, public markets demonstrated their effectiveness, depth and resilience during the covid-19 pandemic, with listed companies able to use the flexibility provided by investors to use undocumented secondary capital raising frameworks to raise funds to support their financial resilience during this period of uncertainty at pace. This experience also demonstrated that shareholders were willing to support issuers through a capital raise without the prior publication of a full prospectus. For the majority of these transactions, investors were willing to permit and participate in the offerings with only the publication of a trading update along with investor-issuer dialogue, this provided sufficient information for investors to make informed investment decisions.

Whilst the use of undocumented secondary capital raisings worked relatively well during the pandemic with the majority of issuers respecting the principle of pre-emption, making efforts to support retail investors to participate in these capital raisings, this should not be seen as a permanent solution. Instead, issuers should be able to raise capital from issuers at speed through a fully pre-emptive rights issues, thereby protecting minority shareholder from dilution.

Investors supported extra flexibilities for larger non-pre-emptive issuances for companies seeking to raise capital at pace due to uncertainties caused by the pandemic, but we note that these flexibilities are unlikely to be supported outside of those exceptional circumstances.

Whilst an undocumented secondary capital process or 'cashbox' transaction may be structured as an issuance of equity securities for non-cash consideration falling outside the scope of statutory pre-emption (and S561 of the CA 2006), they nonetheless, have many of the same effects as a non pre-emptive issuance of equity shares for cash.

The IA believes that a review of the secondary capital raising process should focus primarily on ensuring that the rights issue process should be made as efficient as possible with issuers raising capital at speed on a fully pre-emptive basis, before considering possible refinements the undocumented secondary capital raising process.

1. **Are there any other recommendations or points made by the Rights Issue Review Group in 2008 that should be investigated further?**

We have referred to several of the suggestions of the RIRWG above, namely conditional dealing in rights issues in question 1, accelerated rights issue models in question 3, and short-selling in question 4. Were prospectus requirements amended (as outlined in question 1) to reduce the burden on issuers so that only new and decision-making-useful information is required it would address the issue that shelf-registration seeks to resolve – addressing the outstanding recommendation.

1. **In what other ways should the secondary capital raising process in the UK be reformed?**

**We welcome member comments.**

1. https://data.allens.com.au/pubs/pdf/cm/papsep09.pdf [↑](#footnote-ref-2)
2. https://www.asxonline.com/content/dam/asxonline/public/documents/ReferencePoint/Accelerated%20Entitlement%20Offer%20Frequently%20Asked%20Questions%20V1%20.pdf [↑](#footnote-ref-3)