

Rights issues – on the road to reform?

The need for reform

Rights issues have been under the spotlight recently. With debt financing becoming increasingly difficult to obtain, rights issues offer issuers an alternative fundraising method. Throughout the year a number of issuers, most notably in the financial sector, have looked to their shareholders for additional equity capital. However, some of those issuers have encountered problems: on the whole take-up rates have been unusually low; there have been claims of market abuse via short selling; some issuers experienced changes in their financial position and prospects during the rights issue process; and concerns have been raised regarding reliance by underwriters on termination clauses and other underwriting practices.

Some or all of these issues have been made worse by market conditions. This was not helped by the fact that several high profile rights issues were carried out by issuers in the financial sector, where investor confidence is particularly low. However, these issues highlighted the need for a review of the rights issue process. The Rights Issue Review Group ("**Review Group**"), an industry led group co-chaired by the Financial Services Authority ("**FSA**") and HM Treasury ("**HMT**"), was commissioned in the summer of this year by the Chancellor to consider proposals for reform. The aim of the review was not to challenge the principles of pre-emption and compensation which are embedded in rights issues, but to seek a more efficient and modern way of delivering them.

The Review Group's report to the Chancellor of the Exchequer

The Review Group's report ("**Report**") was published on 24 November 2008. In this alert, we consider some of the key recommendations made by the Review Group and look at a couple of action points for issuers contemplating a rights issue in 2009.

A common theme throughout the Report is reducing the rights issue timetable – once a rights issue has been announced, the issuer wants to receive the proceeds of the rights issue as soon as possible. In addition, the longer the period between announcing and completing a rights issue, the more vulnerable the issuer's share price can become as this is open to potential abuse whilst the rights issue is conducted. A reduction in the time period for a rights issue can be achieved by reducing actual time periods prescribed by legislation and the listing regime (such as the period the offer must be open for), and by streamlining the documentation (and consequently the preparation time) required.

The Report includes recommendations for immediate action, and actions for the medium and longer term. Reform involves changes to legislation at both a national and European level as well as changes to the Listing Rules and how the market operates. Unfortunately, much of this will take time.

Immediate actions

The Review Group's key recommendations include a number of immediate actions. These actions are:

- Reducing the rights issue subscription period from 21 to 14 days.

The FSA and the Department for Business, Enterprise and Regulatory Reform ("**BERR**") are to consult on reducing the rights issue subscription period from 21 days to 14 days. The practice of subscription periods lasting for three weeks stems from a time when communications with shareholders were far less sophisticated and the only way to deliver documents to shareholders was by hand or by post. The ability to communicate with shareholders electronically and to make documents available on the internet mean that a three week subscription period should no longer be necessary. Whilst one week might be the optimum period for a rights issue, from an issuer's perspective the Review Group felt this would not provide sufficient time to the market as it currently operates. Instead, the Review Group's recommendation is that the subscription period for both statutory and non-statutory rights issues is reduced to two weeks. This involves changes to both the Listing Rules and to companies' legislation. The Review Group recommends that any legislative change should be made after 1 October 2009 (when relevant provisions of the Companies Act 2006 ("**CA06**") are expected to come into force).

- BERR to take forward the practical transposition of the Shareholder Rights Directive ("**SRD**") to maintain the option of a 14 day notice period for companies' general meetings.

If a general meeting is required in connection with a rights issue (for example if the directors do not have an existing authority to allot all of the rights issue shares), the timetable for the rights issue will be lengthened by the notice period for the meeting. The required notice period is currently 14 days, unless the issuer's articles specify a longer period.

The SRD will increase the notice period for general meetings of traded companies from 14 days to 21 days, but allows member states to provide for meetings to be held on not less than 14 days' notice if certain conditions are met. In the UK, the proposed conditions are that:

- the relevant issuer offers shareholders the facility to vote by electronic means accessible to all shareholders; and
- a resolution reducing the notice period to not less than 14 days has been passed at the last annual general meeting or at a subsequent general meeting.

BERR is currently consulting on changes to the CA06 to implement the SRD, including whether and how to define "electronic means accessible to all shareholders".

Action points: Issuers should review their articles to ensure they do not require more than 14 days' notice to be given for a general meeting. In addition, once the regulations amending CA06 to implement the SRD have been finalised, issuers should put in place appropriate electronic voting arrangements and obtain a shareholders' resolution reducing the notice period to 14 days. Ideally this should be done before 3 August 2009 (the date by which the SRD is to be implemented in the UK).

- The Association of British Insurers ("**ABI**") to review its guidance on the ceiling on allotments in light of the Review Group's recommendation that it be increased from one-third to two-thirds of an issuer's share capital.

Before launching a rights issue, an issuer's directors need to be authorised to allot the rights issue shares (and if appropriate, to disapply statutory pre-emption rights). At each annual general meeting, issuers typically seek an authority to allot up to one-third of the issuer's issued share capital. This one-third limit is in line with ABI guidelines. Even if an issuer takes such a general authority, it may still need a separate authority if the rights issue is in respect of more than one-third of the issuer's issued share capital (or if the authority has already been used up since the last annual general meeting). The Review Group recommends the one-third limit be raised to two-thirds for compensatory pre-emptive issues of shares (subject to certain safeguards over one-third and the limits being reviewed by the ABI after three years), with the aim that fewer rights issues will be delayed by the need for a general meeting.

Action point: the one-third limit currently suggested by the ABI is a guideline rather than an actual requirement, although it is generally followed by issuers. Irrespective of any review by the ABI of its guidelines, issuers might want to consider approaching their institutional shareholders to discuss whether a general authority to allot shares with a limit above one-third of the issuer's share capital (with appropriate safeguards if necessary) would be acceptable.

- The FSA to continue to maintain oversight of its conflict of interest regimes with a view to reinforcing transparency between issuers and underwriters.
- The FSA to facilitate the development by market participants of non-prescriptive guidance on the factors that an issuer could usefully consider when embarking on a capital raising by way of rights issue. The Review Group considers this guidance may be desirable because the increased complexity of the underwriting market and the changing dynamics of risk mitigation strategies make it more difficult for issuers to make a full and informed evaluation of the terms on which an issue will be managed.
- The FSA to take forward consultation on a new form of open offer (to be treated as a rights issue, which can consequently be offered at a greater discount than a traditional open offer) which will provide compensation and which may be run over a 14 day period in conjunction with a general meeting notice period.

Medium longer term actions

The Review Group's key recommendations also include a number of medium term and longer term actions. These actions are:

- HMT and the FSA to work at the European Union level for the adoption of a short form prospectus for rights issues.
- The possible increased use of shelf registration (although as the Review Group notes, it will be for issuers to decide whether there is any value to them in this).
- The FSA to consider further a basis for conditional dealing in rights issues to allow the general meeting notice period and the rights issue subscription period to be run in parallel.
- The FSA to undertake further informal discussion on the usefulness of progressing with further work to introduce more accelerated rights issue models including for this purpose the Australian RAPIDS model (renounceable accelerated pro-rata issue with dual-bookbuild structure).
- The FSA will issue a market consultation on a more permanent position on the matter of short selling in rights issues.

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