

Sarah Parkinson
Room 3/W2
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

London, 9th September 2008

Dear Ms. Parkinson,

HMT/FSA Rights Issue Group
"Updating the Rights Issue Process"

The CFA Institute Centre for Financial Market Integrity ("Centre") welcomes the opportunity to contribute to HM Treasury's (HMT) and the Financial Services Authority's (FSA) discussion on updating the rights issue process.

In summary, we believe the current system is an effective way for public companies to raise additional equity finance. However, we criticise the length of time required to complete the process, which we see as excessively long. The two time-consuming elements are the notice period required to call a General Meeting followed by the prescribed rights offering period. Our principal recommendation is that the UK should adopt the American method of 'shelf registration'. Here the issuer seeks authorisation from its shareholders to increase the share capital at an undetermined date through its Annual General Meeting. This would reduce the whole process by at least two weeks, and achieve significant cost savings.

The steep decline in the value of sub-prime loans and structured finance products that began in August 2007 severely damaged the global banking system. During the second quarter of 2008, three well-known British banks announced plans to raise additional equity capital through the rights issue process: Royal Bank of Scotland (£12bn), HBOS (£4bn) and Bradford & Bingley (£400m). These capital infusions were necessary in order for these banks to satisfy their ongoing regulatory capital requirements.

Despite subscription prices that more than compensated for the dilution created by the respective rights offers, the market prices for these bank stocks sank to and below the rights offer prices. This price behaviour provoked considerable media attention with accusations of insider dealing, market manipulation, and calls for a review of the rights issue process.

Security prices of the financial sector and all other sectors of the market reflect the expectations of the participants. Hence, the precipitous fall in financial stocks from the respective offering announcements to date reflects the behaviour of investors negatively reappraising the depth of the credit crisis and re-pricing the shares accordingly.

Given that a) the 'subject' rights issues were completed albeit with some stress to the underwriters and b) that as far as we are aware, no evidence has been uncovered of market abuse. We question whether there is anything fundamentally wrong with the current process, as it works even in times of market stress.

We are concerned about the length of the process. We believe this could be shortened considerably without damaging shareholder interests and at the same time, reduce the risk to underwriters. In a competitive market¹, this should reduce the cost of capital, as risk has a value. Under the Companies Act 2006, the timescale for a rights issue is prescribed under section 307 (Notice required for a General Meeting) and section 562 (Communication of pre-emptive offers to shareholders). Under these provisions, the general meeting approves an expansion of the authorised share capital and has a minimum notice period of 14 days. The communication under section 562 refers to the offer period, set at 21 days, though there is scope to reduce this to 14.

We suggest that the requirement to seek authorisation to expand the share capital could be satisfied using the American 'shelf registration' method. This authorization could be proposed and/or reaffirmed during the issuers' Annual General Meeting. Issuers would gain from the flexibility of the process, and save on the expense of calling a general meeting. The 'shelf' method would shorten the overall timetable by at least two weeks and hence reduce the underwriter's risk. If taken to its logical extension reducing the underwriter's risk should reduce the cost of new equity.

We have also read the Association of British Insurers discussion paper 'Rights Issues and Capital Raising' (21 July 2008). It provides an alternative proposal for overcoming some of the issues relating to right offerings. In particular, it calls for "... *examining further whether market trading of rights could take place on a contingent basis so that this overlapped with the notice period for the EGM*" (Page 4).

Should it be possible to run the General Meeting and Offer Period processes 'in tandem', it would again shorten the timetable by at least two weeks. This follows the practice of the 'placing and open offer' method of raising additional equity finance. We envisage a process where a company would announce a rights issue, its authorising General Meeting, with the nil-paid shares commencing trading shortly after these announcements. We would support this proposal if a shelf-registration method is not feasible.

Existing shareholders would continue to enjoy their pre-emptive rights and retain their ability to trade those rights during the offer period, under both the 'shelf' and 'in tandem' methods. However until authorised at the general meeting, acquirers of those rights under the 'in tandem' method face the risk that the offer would not be approved. This new 'buyers' risk would have a 'small impact'² on the value of those rights. However, overall reductions in the cost of the transaction would more than compensate this loss, through a shortened timetable in a competitive market.

Prior to the announcement of a 'rights issue', we see investment banks playing an important role on behalf of the issuers in the construction of an underwriting group and the preparation of documents (circular etc.). The success of their work depends on confidentiality. Sadly, the market on recent experience shows little confidence in the

¹ By a competitive market, we refer to a structure where the fees of investment banking services are actively negotiated between issuers and investment banks.

² Experience illustrates that at the General Meeting, shareholders very rarely block the authorisation of a rights issue.

integrity of this process³. Scanning the printed media confirms that very 'specific' stories circulated ahead of these material announcements. We see the maintenance, promotion and enforcement of confidentiality as an absolute priority. Further, we suggest monitoring any institution brought across 'the Chinese wall'. The aim would be to confirm that any transactions relating to the issuer (this includes derivatives, and related securities such as convertible bonds and CfDs) are either executed in response to unsolicited customer demand – passive market making in the case of an investment bank – or restricted to unsolicited non-discretionary orders in the case of fund managers.

The UK's unique corporate broking structure should reap significant timesavings in the preparation of documents. The relationship between the corporate broker and the executive board of an issuer should be such that a draft offering circular should be ready-to-hand.

Consideration should be given to distributing a 'Key Investor Information' document, in place of a full prospectus. This slimmer, more user-friendly (cheaper and more environmentally friendly) document would contain the terms of the offer, a trading update and financial position, management discussion and analysis (MD&A) of the current trading environment, the reasons for the issue, the underwriting group members and their commitment, and a reference to the full prospectus via a web link. Consideration should also be given to the introduction of quarterly reporting, this would make the updating of financial data and MD&A considerably less complex.

On a final point, we note that during the HBOS offer there was a considerable lapse in time from the public announcement of the proposed rights issue (29th April) to the publication of the circular (4th June). It is unclear why such a time lapse occurred between the two events. Our view is that this 'interregnum' in process contributed to the angst of participants and may be at the root of the current controversy.

Please do not hesitate to contact me, should you wish to discuss any of the points raised in our response.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'C Cronin', with a stylized flourish at the end.

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cc Geoff Dart, Director - Corporate Law and Governance, BERR
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Fiona Henderson, Markets Branch, HM Treasury

³ CFA Institute Centre will shortly publish its Financial Market Integrity Index report for the UK market. Membership survey data, that forms the basis of the report, reveals that 'insider trading' is a top concern of participants in the UK market.