



Pre-emption rights

Introduction

The question of whether shareholders' pre-emption rights adversely affect a company's ability to raise cash by issuing new shares has become increasingly contentious. Public companies need to be able to raise new capital cheaply and effectively to fund innovation and growth, but, at the same time, shareholders need to be able to protect themselves from a dilution of their existing investments. Pre-emption rights prevent dilution by giving existing shareholders the first right to subscribe to a new share offer. Pre-emption rights also ensure that voting rights of existing shareowners are protected by preventing transfers of ownership to new shareholders occurring without the prior agreement of existing shareholders. The share price thus reflects the value of the voting rights, as well as the anticipated earnings of a company.

Under the UK Companies Act 1985, a company can put forward a special resolution not to apply pre-emption rights, called a 'disapplication of pre-emption rights'. This applies to one issue only, and a further resolution is needed if similar conditions are to apply to another share issue. A 75% majority vote at a general meeting is required for pre-emption rights to be disapplied and further shareholder approval after a maximum period of five years. We believe the UK principle of pre-emption is a significant strength of the UK system.

Calls for review

In 1999, the Monopolies and Merger Commission reviewed pre-emption rights. The review failed to demonstrate that significant costs were associated with a rights issue over other forms of capital-raising but rather found that there were significant advantages to doing so.

Later, in 2000, pressure was brought to bear by the biotechnology industry, which asserted that the current application of pre-emption rights in the UK made it difficult for companies to finance research and product development. Following this representation, Paul Myners was asked by Lord Sainsbury, DTI Innovation and Science Minister, in 2004, to examine whether the application of pre-emption rights hindered certain public companies from raising finance for growth.

Paul Myners' Report on Pre-emption Rights, published in February 2005, made the following recommendations:

- (1) New pre-emption guidelines should be issued with emphasis on treating each company on a case-by-case basis, providing a clear justification for disapplication to shareholders.
- (2) The current 5% level for non pre-emptive right authorisation level should be kept as a benchmark for individual applications.
- (3) A new pre-emption group, made up of representatives from corporate, investment, and advisory constituents should be formed to take a more proactive approach in monitoring the application of the guidelines.

Insight's policy on pre-emption rights

Insight's policy is to support listed companies that apply a standard disapplication of pre-emption rights of 5% of issued capital over one year, or no more than 7.5% over any three year period. There are cases where companies have requested support for disapplication of pre-emption rights of up to 20% at the AGM. It is Insight's view that the AGM is not the appropriate forum

for companies to use to request an authority from shareholders for larger disapplications.

We believe it is more appropriate for companies to request larger scale pre-emption authority at an EGM. Companies should communicate this intention to shareholders prior to the EGM and provide a detailed explanation for the proposal: the larger the disapplication, the greater the requirement for shareholder consultation.

The pre-emption guidelines originally introduced in 1987 by a group of companies, investment institutions and corporate finance practitioners, theoretically apply to all listed companies. However, in practice, they do not apply to those listed on AIM. Many companies, such as those in the bioscience sector, list on AIM rather than the main market due to concerns over pre-emption rights. Insight's policy is to support companies on the AIM market seeking an authority to disapply pre-emption rights for 10% for cash and 25% for acquisitions. Companies that are listed on AIM are typically growing fast and, therefore, need to raise more cash. As they are also smaller in size, a 5% share issue would be a relatively small amount of money in absolute terms. It is therefore important for investors to show a greater level of flexibility with AIM stock.

A practice that we have raised concerns about in some cases is the 'cashbox' transaction. Some companies have raised cash for shares by acquiring a shell company whose only asset is cash. It is argued that this is covered by section 89 on disapplication rights, which allow for an issue of up to 25%. Although within the letter of the disapplication guidelines, we believe such transactions breach their spirit.

Following Insight's review of the company's explanation in the Annual Report & Accounts, we decided to vote against the proposal. We wrote to the company stating our view that the it's rationale for extending pre-emption rights beyond the guideline limit for routine disapplications was unconvincing. This, together with consideration of the company's specific circumstances, in particular recognition of the cash the company had available, suggests that the larger authority was not justified. Also, there did not appear to be a statement assuring shareholders that in any three-year period no more than 7.5% of the issued share capital would be issued on a non pre-emptive basis.

A number of companies put forward proposals for an authority to disapply pre-emption rights over 10% of their issued share capital. One such company was Cambridge Antibody Technology Group which put forward such a proposal at an AGM. Prior to the AGM, the company consulted with shareholders and the ABI.

Case study: Cambridge Antibody Technology Group

The company's stated reasons for asking for 10% were:

- a) "Markets in bioscience stocks can be extremely volatile and windows of opportunity for fundraising can open and close very quickly. Consequently, the length of time for which pre-emption issues have to remain open can prejudice the success of an issue. This is exacerbated by the fact that for a company such as Cambridge Antibody Technology Trust where the investment proposition is relatively complex and requires detailed and time-consuming analysis, underwriting may not always be available. Because sub-underwriters are not able to make the necessary underwriting decisions within the narrow time window which is available to them, the combination of pre-emption without underwriting makes for a materially increased risk of failure of the issue.
- b) Other than in cash placing, or as a non pre-emptive tranche of a pre-emptive issue, one of the ways in which the headroom could be used is to issue equity in connection with the acquisition of assets and/or product opportunities which will advance the company's strategic objectives. It is often the case that the company will be competing directly with other companies who are not subject to the same restrictions imposed by pre-emption and who are therefore able to respond to such opportunities more quickly.
- c) This level of disapplication would allow a non pre-emption issue to be made up to the maximum size of issue which is possible without the requirement to issue a prospectus."

Conclusion

As an investor, Insight values open dialogue with companies, as well as transparency. We believe that companies should provide an explanation for routine disapplications over 5%, because of the potential for major dilutions of shareholder rights. When Insight considers companies' requests to disapply pre-emption rights, we show flexibility and review each proposal on a case-by-case basis. However, we recognise the need of some companies, including those in the biotechnology sector, to raise cash quickly and we hope to continue to support continued growth and innovation.

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