CITY OF LONDON LAW SOCIETY AND LAW SOCIETY RESPONSE TO HM TREASURY CALL FOR EVIDENCE: UK SECONDARY CAPITAL RAISING REVIEW

16 NOVEMBER 2021

1. **Introduction**

1.1 The views set out in this response have been prepared by a Joint Working Party of the Company Law Committees of the City of London Law Society (the **CLLS**) and the Law Society of England and Wales (the **Law Society**).

1.2 The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

1.3 The Law Society is the professional body for solicitors in England and Wales, representing over 170,000 registered legal practitioners. It represents the profession to Parliament, Government and regulatory bodies in both the domestic and European arena and has a public interest in the reform of the law.

1.4 The Joint Working Party is made up of senior and specialist corporate lawyers from both the CLLS and the Law Society who have a particular focus on issues relating to equity capital markets.

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2. **Questions**

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

The Committee notes that certain steps to improve the efficiency of the rights issue process have been taken since the publication of the 2008 Report of the Rights Issue Review Group (the **"2008 Report"**). It believes, however, that there remains significant scope for the rights issue process to be further revised and enhanced to achieve greater speed and efficiency and to lower costs for issuers without thereby prejudicing the participation of retail shareholders. Set out below are some options to modernise and enhance the current process.

Removing the need for a shareholder vote

Amending section 551 of the Companies Act

Where a shareholder vote is required in connection with the share issuance, the rights issue timetable is effectively increased by the length of the general meeting notice period – a minimum of 17 days. This is because the timetables for the general meeting and the rights offering run consecutively rather than concurrently, with the general meeting taking place first. The overall rights issue timetable could therefore be shortened by reducing the instances in which a shareholder vote is required.

The typical drivers for a general meeting in connection with a rights issue are (i) whether the directors have sufficient authority for the purpose of section 551 of the Companies Act

2006 (the **"Companies Act"**) to allot the shares and (ii) whether statutory pre-emption rights in section 561 of the Companies Act need to be disapplied.

Where a company proposes to undertake a rights issue, the size of the issue is limited by its existing (unused) section 551 authority. If a company does not have sufficient authority to allot shares for the purpose of a rights issue pursuant to section 551, it must convene a general meeting to provide the necessary authority. The Committee is of the view that the requirement for a general meeting could be removed, or substantially reduced, through amendments to section 551 of the Companies Act and to the Investment Association's Share Capital Management Guidelines (the **"IA Guidelines"**). The IA Guidelines currently advise that members regard as routine an authority to allot up to two-thirds of the existing issued share capital, with any amount over one-third of the existing issued shares being applied to fully pre-emptive rights issues only.

One possibility would be to remove the limit on allotment authorities altogether in the case of pre-emptive offers. Alternatively, in the event that an uncapped amount were to be regarded as providing too much latitude, a limit of 100 per cent of a company's issued share capital could be considered, granted that any issuance which is greater than a 100 per cent ceiling is likely to be effected in connection with a rescue fundraise, in which case a range of other shareholder resolutions would typically be required in any event.

Updating the Gazette route

Under section 561 of the Companies Act, where a company proposes to allot equity securities for cash, existing ordinary shareholders must be offered the new securities pro rata to their existing shareholdings. Section 562 of the Companies Act prescribes the manner in which the offer is to be made. Among other things, the offer may be made in hard copy or electronic form; it must be open for at least 14 calendar days; and where a shareholder has no registered address in the UK or an EEA State (and has not supplied the company with an address in the UK or an EEA State for the service of notices), the offer may be made by publishing a notice in the London Gazette. An offer that complies with the statutory requirements for a pre-emptive offer is therefore known as a 'Gazette route' offer.

Generally, companies prefer not to use the Gazette route as it imposes a number of requirements that restrict what companies can do. The main difficulties with the Gazette route are as follows:

- Although the company is not obliged to send any documents relating to the offer to non-EEA shareholders, it cannot exclude any shareholders from the offer altogether. By contrast, where statutory pre-emption rights are disapplied, companies are usually permitted to exclude shareholders who are located in jurisdictions where, broadly, the cost and burden of extending the offer to them would be disproportionate to the benefit.

- There is less flexibility to deal with fractions arising. By contrast, where statutory pre-emption rights are disapplied, companies are usually permitted to aggregate fractions and sell them in the market, with any proceeds of less than £5 going to the company.

- Section 562 of the Companies Act permits the company to offer the new securities only to ordinary shareholders. By contrast, where statutory pre-emption rights are disapplied, directors can be permitted to offer the new securities also to holders of convertibles, warrants, preference shares etc. where they have a contractual right, or a right under the company's articles, to be offered new securities as if they were holders of ordinary shares.

- As set out above, section 562 of the Companies Act permits the notice of the rights issue to be published in the London Gazette. A more user-friendly approach, particularly for non-UK/EEA shareholders, would be for the notification to be made via an RIS and/or a website announcement.

If section 562 of the Companies Act were amended to remove these deficiencies, thereby aligning it more closely with the process that is usually followed where statutory pre-emption rights are disapplied, the Committee believes that companies would be more inclined to comply with the statutory requirements as to the manner in which a pre-emptive offer must be made. As a result, there would be no need to seek shareholder approval – either at an AGM or at any general meeting that is required in connection with an equity offering – to disapply statutory pre-emption rights to an offer that is in fact made pro rata to existing holdings.

In combination with the proposals set out above in respect of section 551 of the Companies Act and the IA Guidelines to permit companies to offer more than two-thirds of their issued share capital without needing fresh shareholder approval (provided the new shares are offered pro rata to existing holdings), the suggested amendments would result in far fewer companies needing to seek additional shareholder approvals for a large pre-emptive issue. This would significantly shorten the timetable for a rights issue.

Australian RAPIDS model

The Committee notes that the 2008 Report contained a recommendation that the Australian RAPIDS model be studied further in the context of potential reform of the UK regime. This proposal was not further pursued at that time. The Committee is of the view that there would be merit in looking again at this model which entails a two tranche offer to shareholders comprising (i) an accelerated institutional offer (with a short window to elect) which typically covers the majority of the shares to be issued and (ii) a retail offer which follows the institutional offer and which is open to all shareholders who were not invited to the first tranche (typically, smaller or retail shareholders). The Committee notes that the offering is structured such that the company's funding requirements are provided via the institutional tranche of the offering which is underwritten and which is settled quickly. This structure therefore provides access to capital efficiently and rapidly, mitigates any competitive disadvantage in an M&A context by providing greater funding certainty and serves to reduce underwriting costs as the underwriting period is shortened significantly. Further, the retail offer allows for full retail participation and, given that the proceeds of the retail tranche are not critical to the company's working capital position, the timetable for the retail element of the offer can be more extensive, allowing retail shareholders more time to decide what to do in terms of their investment decision, organise the necessary funds and communicate instructions to any broker/investment manager/nominee etc.

If this model is to be pursued, however, thought would need to be given to how best to address the following issues in a UK context:

- There is no prescribed timetable at all for the institutional piece under the Australian model. Institutional shareholders may therefore be confronted with a substantial capital commitment to prevent dilution and a very limited window of opportunity in which to take the necessary investment decision.

- Thought will need to be given to the precise mechanism for distinguishing between institutional and retail shareholders for these purposes, particularly in light of the complexities surrounding intermediated holdings. The Committee understands that in Australia the distinction between institutional and retail shareholdings is not a formal or legislated one. Issuers and banks are typically given a wide discretion to allocate shareholders to one category or the other. Prior to launch, the issuer and banks undertake a process of trying to establish an accurate 'beneficial holder' register and then determine which category each holder should be allocated to and, as a result, which holders should be accelerated. This gives scope for shareholders to complain that they have been allocated to the 'wrong' category. On the one hand, this could be a complaint that they have been accelerated when in fact they did not want to be, and hence that they did not have enough time to make a considered investment decision and/or find the funds to take up their rights etc. On the other hand, it could be a complaint that they were not accelerated when they wanted to be, and that – where the share price has fallen after the institutional bookbuild – they have received less from the sale of their rights than they would have done had they been treated as institutions. The latter complaint was made, albeit unsuccessfully, in RinRim Pty Ltd v Deutsche Bank AG [2017] NSWCA where the retail offer closed one month after the institutional offer, during which time the share price fell sharply, with the result that those who participated in the institutional offer and renounced their entitlements made substantially more from the sale of their rights than those who participated in the retail offer.

  If a similar structure were to be adopted in the UK, the Committee is of the view that there might be concerns for the issuer in relation to the equal treatment of shareholders. Further, both issuers and banks are likely to be concerned about potential liability from allocating a shareholder to the 'wrong' category. Solutions to this might be:

  (i) The FCA issuing guidance to the effect that an issuer will not be deemed to have treated shareholders unequally where it makes separate, consecutive offers to its institutional and retail shareholders, provided the issuer undertakes some form of prescribed process.

  (ii) The FCA establishing rules on which shareholders should be treated as institutional or retail for this purpose - or at least publishing guidance or a list of factors that can be taken into account. These rules or guidance would need to address issues raised by having shares held through intermediaries – which might be more widespread in the UK than Australia – and should provide issuers and banks some element of discretion in view of the difficulties relating to intermediated holdings. Having such rules or guidance should reduce the risk of issuers and banks being liable for exercising their discretion 'improperly'.

  In any event, the Committee suggests that there should be an exploration of routes that help to speed-up the retail process and remove some of its current inefficiencies, for which please see our response to question 2 below.

2.2 **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?**

The Committee believes that there is merit in exploring the ways in which new technology could be used to render the rights issue process more efficient. Currently, certain aspects of the rights issue timetable are driven by the fact that not all shareholders have access to technology which allows them to receive communications electronically (rather than by post) or to make payments electronically (rather than via cheque). This inevitably increases the rights issue timetable. Whilst the Committee strongly supports the commitment to increase retail participation in secondary offerings, it is of the view that an updated timetable should be devised which assumes the electronic transmission of documentation and electronic payment. Service by post and payment by cheque would still be permissible but would not be assumed as the basis of the timetable. In this context, it would be helpful if the FCA were to clarify that any such modernisation of the process would not result in an issuer being deemed to have treated shareholders unequally.

2.3 **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 ANREO, AREO (or RAPIDS), SAREO and PAITREO structures?**

Whilst the Committee believes that it is important to look at international practice, there are few jurisdictions outside the EU where pre-emption rights apply.

<u>United States</u>

The Committee understands that a fundamentally different approach is adopted in the US (where statutory pre-emption rights do not exist) via the use of an annually updated shelf registration system pursuant to which reporting companies update their information periodically and which allows a secondary capital raise to be effected more quickly and efficiently than a comparable capital raise in the UK on the basis of such information.

The Committee has considered whether there is scope for improving the shelf registration mechanism introduced under article 9 of the UK version of the Prospectus Regulation (the **"UK Prospectus Regulation"**). The UK Prospectus Regulation permits issuers to prepare a universal registration document (**"URD"**) which can be used to launch follow-on offerings alongside the publication of the remaining constituent parts of a prospectus (i.e. the summary and securities note). URDs are rarely used for equity capital raisings in the UK and EU. This differs from the US where shelf registration is more common. In the US, implementing a shelf registration is seen as a straightforward process by frequent issuers of securities largely because the underlying periodic disclosure and financial reporting requirements under the Securities Exchange Act of 1934 (the **"Exchange Act"**) include the filing of annual and quarterly reports, which include disclosure and annual and quarterly financial information prepared on the basis required to be incorporated in a registration statement. Broadly, it is possible for US-listed issuers to incorporate by reference these Exchange Act reports into a shelf registration statement (including reports filed after the shelf registration became effective, without the need for a post-effective amendment to that shelf registration) which results in time-saving benefits when effecting a secondary offering as the registration statement and prospectus disclosure is updated periodically. As a result, US market practice has developed such that it is common for frequent issuers to implement shelf registrations given that a substantial amount of work required to prepare a prospectus to be used in connection with a capital raising has already been undertaken as part of the routine periodic reporting requirements.

As it would be necessary to change the UK financial reporting regime in order to implement a shelf registration system similar to the one which applies in the US, the Committee was divided over whether or not to advocate reforms in the UK which would make URDs more attractive. If any new regime is crafted as an 'opt-in' regime – for example, if an issuer formats their annual report risk factors in such a way, the issuer's annual report could also be used as its shelf registration document, supplemented in due course by an announcement or cleansing notice (please see below for further details) - this would minimise costs and changes for the routine financial reporting workload of issuers if they did not want to opt-in. Some Committee members felt this route should be explored alongside streamlining the offering documentation for secondary offerings (please see below for further details). The Committee does not, however, advocate re-introducing quarterly reporting requirements as exist in the US.

Australia

Please see the response to question 1 above in respect of the Australian RAPIDS structures.

In relation to the form of offering documentation in connection with a rights issue, the Committee is supportive of a simpler form of document, appreciating the existence of the simplified disclosure regime for secondary issuances under article 14 of the UK Prospectus Regulation and noting that there may be additional disclosure considerations where access to US investors is desired. The Committee is of the view that rights issue prospectuses tend to be lengthy documents with significant time and cost implications and even simplified prospectuses require a substantial amount of disclosure. The Committee notes that any revisions to the documentational framework would clearly need to be considered in the context of the proposed HMT and FCA reforms, including the proposal to exempt all rights issues from the restrictions imposed by the public offering rules, and the circumstances where a prospectus is required for the admission of securities to a regulated market.

Some members of the Committee felt that, in lieu of a prospectus, a simple cleansing notice of the kind used in an Australian context on secondary capital raisings should be considered. A notice of this type would, at a minimum, confirm that the issuer has complied with its continuous disclosure obligations under the UK version of the Market Abuse Regulation (**"UK MAR"**) and include details of any inside information it has been delaying announcing thereunder. This model would therefore allow a rights issue to be carried out on a very compressed timetable, partly due to the fact that the offering can be made on the basis of the notice, thereby obviating the need for the approval and publication of a prospectus.

The Committee notes however that the Australian cleansing notice model is linked closely to and relies on a particularly onerous statutory continuous disclosure regime. This regime takes a strict liability approach in respect of criminal (and, until very recently, civil) breaches of continuous disclosure obligations set out in the ASX Listing Rules and the Australian Corporations Act – it does not allow for any safe harbours or exemptions. The Committee understands that one unfortunate consequence of the Australian strict liability regime is that it can lead to significant shareholder class actions which have considerable cost implications for the companies concerned.

In addition, whilst a prospectus is not required in an Australian context, offering documents are nevertheless commonly produced in conjunction with the cleansing notice, although their content is not mandated or prescribed in any way either by statute or by the ASX Listing Rules - and this ambiguity has wider implications. A prospectus, even in a shortened form, has a defined status in law and is based on a clearly articulated liability regime, which helps to provide clarity as to the responsibilities, liabilities and protections (including those being considered by HMT in the context of forward-looking information) available to the parties involved.

If the cleansing notice approach were to be adopted (together with an Australian-style offering document), another concern that would need to be addressed is in respect of the scope of the related due diligence exercise and the extent of any third party comfort that would be available to issuers and investment banks, noting that third parties typically only deliver comfort in this context when required to do so by corresponding regulatory provisions. Some members of the Committee believe that a system could be devised which required a shorter form of prospectus (the significantly reduced content requirements for which would fully take into account information previously disclosed to the market by the issuer) and which would be linked to a defined liability regime. This would provide a clear framework for the diligence process and the related comfort package. This document would also be subject to Regulatory review, ensuring consistency of approach and the maintenance of high standards of investor protection. Please see the Committee's comments previously made in its response to HMT's Consultation on the Prospectus Regime as to the central role of a prospectus in the context of both IPOs and secondary offerings and the importance of retaining the FCA prospectus approval process.

2.4 **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?**

The Committee believes that the Short Selling Regulation (the **"EU SSR"**) introduced after the financial crisis and now on-shored in the UK post-Brexit (the **"UK SSR"**) has been effective at increasing transparency, particularly since the lower 0.1 per cent threshold was introduced in the UK in February 2021, allowing the FCA to closely monitor short selling. The Committee agrees with the FCA's view that short selling can contribute usefully to liquidity and price discovery, supporting open, effective markets that operate with integrity and provides sufficient information to allow the orderly functioning of the market. The Committee also acknowledges that it is not appropriate or the role of the FCA to afford to issuers general protection from the lawful actions of short sellers or more broadly from legitimate market activity.

However, the Committee notes that the high threshold for the imposition of restrictions or temporary bans on short selling does not give the FCA the power to protect issuers in rights issue processes from the negative impact from short selling in circumstances where there is not a serious threat to financial stability or market confidence. This creates a risk that issuers, particularly in circumstances where there has been a leak or a pre-announcement of a potential rights issue, could be subject to speculative shorting activity which takes the issuer's share price outside of the parameters in which a rights issue can be executed within a particular target window. This in turn increases the risk of company failure or a need for alternative financing or restructuring, which could impact shareholders, employees and other stakeholders.

In the Committee's view, there may be a case for the FCA to be given the power to introduce restrictions or temporary bans on short selling in a wider range of circumstances than is permitted by the current UK SSR. This could include an ability for the FCA to grant an issuer a temporary period of protection from short selling activity in the period between a leak or announcement of a possible rights issue and the announcement of a priced deal. However, the Committee acknowledges that further analysis is required to determine whether such a power would have been beneficial during the Covid-19 crisis, noting that a number of rights issues were successfully executed in distressed scenarios, even having been leaked prior to pricing.

2.5 **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?**

The Committee believes that the granting by the Pre-Emption Group of the temporary additional flexibility in respect of placings of up to 20 per cent of a company's issued share capital worked smoothly and effectively. It allowed companies facing a liquidity crisis as a result of the pandemic to raise capital rapidly on a non-pre-emptive and undocumented basis. This was sometimes linked to a separate but parallel retail tranche which was limited to EUR8 million to avoid triggering the need for a prospectus. Whilst the Committee thinks that there is merit in introducing this flexible undocumented approach for placings of up to 20 per cent of a company's issued share capital on a permanent basis, there is a question as to whether this flexibility achieved the right result from the retail shareholder perspective. For example, only a limited number of retail investors could participate in the offering, and thereby avoid dilution, only those retail investors who had already subscribed to certain platforms were able to participate in the offering and those who were able to participate had to make their investment decision very quickly. In light of this, the Committee considers that, in the event that a modernised, effective and rapid process for a fully pre-emptive offering is implemented, this might be preferable in the context of larger equity fundraisings - for example, those above 15 per cent of a company's issued share capital - to a regime that facilitates larger undocumented fundraisings without fully accommodating the pre-emption rights of retail shareholders.

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

There are no other points that the Committee wishes to raise at this stage.

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

In addition to the options set out in the responses above, the Committee has the following comments relating to the market soundings regime.

UK MAR imposes certain prescriptive procedural and record-keeping requirements on market soundings (as such term is defined under UK MAR) which often arise in the context of follow-on offerings undertaken by UK-listed issuers. Although these requirements may reduce the likelihood of improper disclosure of inside information (as well as other forms of market abuse behaviour), they may also have the effect of deterring certain investors from participating in pre-marketing activities that have a valuable role in the price discovery process which is important for managing market volatility in the context of underwritten offerings.

The Committee suggests that the market sounding requirements be reviewed by the FCA for the purposes of optimising the proportionality and clarity of the existing framework. This review might include the following:

- In collaboration with institutional bodies and market participants, the FCA could issue guidance to clarify the scope and application of the market sounding requirements.

- A review of the existing regime and particularly which elements, if any, should be mandatory (rather than conditions to be satisfied in order to fall within the safe harbour).

- Consideration of whether more proportionate record-keeping requirements should apply to SME issuers.

- Consideration of whether (and to what extent) the existing requirements should apply in the context of the communication of information which is not inside information.