Share Capital Management and Transaction Guidelines

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Two sets of important guidelines have recently been issued which are relevant to UK listed companies seeking to raise new capital or contemplating other types of corporate finance transaction.

The first concerns directors' authority to issue shares and share buybacks, and is issued by the Investment Management Association (to replace and update guidance last issued by the Association of British Insurers in January 2009). The guidance is not legally binding but will be routinely followed by companies with a premium listing in London.

The second is a more wide ranging and entirely new set of recommendations issued by the ABI on initial public offerings, secondary offerings and corporate transactions. The guidance closely follows the key recommendations from the ABI's **"Encouraging Equity Investment" report** published in July 2013.

Share capital management guidelines

The Investment Management Association (IMA) has recently merged with the ABI's Investment Affairs division (including the Institutional Voting Information Service (IVIS)), and has assumed responsibility for the share capital guidelines previously issued by the ABI. Published on July 28, 2014, the **IMA's guidelines** set out the expectations of institutional shareholders on various aspects of share capital management, including where companies seek shareholder authorisation at their annual general meetings for directors' authority to allot shares.

Directors' power to allot shares

The IMA has reviewed the operation of the guidelines revised by the ABI in January 2009, which provided that a resolution authorising directors to allot up to two-thirds of a company's existing issued share capital would be regarded as routine as long as any amount in excess of one-third was applied to fully pre-emptive rights issues (previously, the ABI had expected to see resolutions limited to one-third of the company's existing share capital). Approval for this additional one-third has been widely sought by premium listed companies and the IMA accepts that it has functioned well. The guidelines therefore retain the recommendation, noting (as before) that authority should be for the period until the next AGM and shares held in treasury should be excluded when calculating existing share capital.

Pre-emption rights

The IMA guidelines do not revise the existing guidance on disapplication of pre-emption rights. Like the ABI guidelines they replace, the IMA guidelines state that the terms of a special resolution to disapply pre-emption rights should comply with the provisions of the **Pre-Emption Group's current Statement of Principles**. Broadly these principles, last updated and published in July 2008, require a disapplication of pre-emption rights to be sought only in respect of shares representing 5% or less of the company's ordinary share capital in any one year (7.5% in any rolling three year period), and at a discount of no more than 5% to the company's share price.

Share buybacks

The IMA guidelines retain many of the recommendations from the previous ABI guidelines on own share purchases. The IMA states that dividend payments are the preferred method for returning surplus funds to shareholders, but continues to provide guidance for share repurchases. Authority should be sought by special resolution and renewed annually. An authority to purchase up to 10% of existing share capital is unlikely to cause concern (this figure was 5% in the previous ABI guidelines), but anything between 10%

to 15% will be noted by IVIS. The guidelines contain a new requirement to disclose buybacks in the company's annual report, including the reasons for the buyback and the effect on earnings per share, total shareholder return and net asset value per share. Although there is no statutory limit on the number of shares held in treasury, the IMA's preference is for companies not to hold more than 10% of its shares in treasury. The IMA discourages off-market share buy-backs and expects full disclosure when boards contemplate returns of capital through contingent dealings in their own shares or derivatives referenced to their shares; prior authority for such dealings should be sought and approved via a specific special resolution.

Scrip dividends

The IMA expresses concerns regarding the dilutive effects of scrip dividend issues and prefers shares offered in lieu of dividends to be sourced from the market rather than via primary issuance. Authority for scrip dividends should be renewed at least every three years and arrangements to cancel a scrip dividend are only acceptable if a clear rationale and explanation is given to shareholders.

ABI Transaction Guidelines

The ABI's new **transaction guidelines** build upon the key recommendations of its "Encouraging Equity Investment" report published in July 2013, and deal with three key areas: initial public offerings, secondary offerings and corporate transactions. They cover a wide range of issues and in many cases go significantly beyond currently regulatory requirements and market practice.

Initial public offerings

A number of features of the initial public offering (IPO) process are dealt with by the guidelines:

- **Syndicate size.** The ABI recommends that no more than three bookrunners should be appointed for transactions above £250 million (excluding any over-allotment option) and that there should generally be no more than two bookrunners for transactions below this size. Including syndicate members solely on the basis of past or future services to the issuer or vendor is discouraged but where this occurs, companies should specify the responsibilities of each syndicate member, including those with entirely passive roles. Issuers should scrutinise allocations to ensure that shares are distributed to those most likely to be long-term shareholders. Issuers and vendors are also encouraged to include a retail tranche when listing in the premium segment.
- **Fees.** The ABI would like to see greater disclosure in the prospectus of all fees paid for an IPO, including the maximum incentive fee, if any. This should include a breakdown of fees as a percentage of the size of the offering, and those fees that are independent of size such as those paid to independent advisers, lawyers and accountants. Final determination and payment of incentive fees should be made either at the release of the issuer's first quarterly results as a listed company or three months after listing (whichever is later), and the amount paid should be disclosed to the market at the time of award. Considerations in determining the amount paid should include share price stability, the stability of the share register in the aftermarket, the investor's perspective on the extent and quality of syndicate research and the continuity of research coverage post-IPO. The ABI wants to see a mechanism for investors to give anonymous input into the allocation of the incentive fee.
- **Prospectus.** The ABI repeats its view that prospectuses are too detailed to be understood by retail investors; that they contain too many generic risk factors that obscure more important risks and opportunities, and are too time consuming to read. Issuers, sponsors and lawyers are strongly encouraged to work with the UK Listing Authority (UKLA) to provide a document that is more distinct and relevant.
- **Sponsor regime.** ABI members expect clarity on the role of the sponsor in an IPO, and the guidelines suggest that sponsors should consider including an institutional 'stamp of approval' in

relation to the suitability of the company for listing. It expects the key adviser for issuers seeking a flotation on the High Growth Segment to be an approved sponsor.

- **Role of the independent advisor.** The ABI notes the rise in use of independent advisers and encourages them to ensure that the syndicate is well managed, that the right information and advice is provided both to and by the issuer, and that the syndicate and issuer's interests are protected.

Secondary offerings

The ABI considers that there is sufficient primary and sub-underwriting capacity in the UK market for secondary offerings, but wants to see greater reconciliation between risk and reward.

In particular, it says that companies should employ deep discounts in rights issues to reduce underwriting fees and that where possible, they should obtain firm undertakings from sub-underwriters before announcing the transaction to reduce the primary underwriting fees. The ABI would also like to see disaggregated disclosure of fees, broken down into document preparation, primary underwriting and sub-underwriting, plus separate disclosure of fees paid to lawyers, accountants and independent advisers. Tendering for both primary and sub-underwriting should be pursued only if the unbundling of fees does not lead to a lowering of overall fee levels. The ABI encourages the market to develop standard sub-underwriting agreements.

For non-pre-emptive placings, the ABI would like disclosure in the pricing announcement of the aggregate fees charged, and the discounts to the mid-market price at the time of agreeing the placing.

In relation to timing, the ABI encourages efforts to shorten a pre-emptive timetable by examining ways to eliminate the physical distribution of documents and by reducing the time needed by custodians to enact their clients' instructions to exercise.

Finally, it would like the UKLA to consider introducing a fast-track review process for time critical offerings, which could be funded by higher UKLA fees paid by issuers.

Corporate transactions

The third part of the ABI's paper deals with corporate transactions generally, and highlights in particular the role played by non-executive directors.

Key recommendations include:

- **Corporate transactions and independence.** Non-executive directors should be given sufficient time and information to consider the merits of a transaction, as well as the opportunity to provide their views to shareholders when they are first made insiders. Executive directors should inform the appropriate non-executive director of the proposed transaction when an approach is received from a possible bidder or when management first actively considers a transaction requiring shareholder approval. Non-executive directors should be provided with a description of discussions with the counterparty, which should be disclosed in summary form in the circular to shareholders. Non-executives should be given direct access to the company's financial and legal advisers and, where they decide to seek separate independent advice on the merits of a proposed transaction, advisers should be paid on a fixed fee basis.
- **Independent committees.** Where a transaction may give rise to a conflict of interest (such as management buyouts), a special independent committee comprising only non-conflicted directors should be formed to consider the transaction. The committee should take independent financial and legal advice; an information wall will not suffice. A clear mandate should be disclosed in any circular or annual report, as is currently required.

A number of the ABI's recommendations for capital raisings and corporate transactions will require changes to market practice, and some – such as the change in approach to prospectuses and increased disclosure of fees – will require issuers and their advisers to be prepared to be innovators rather than follow usual practice.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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