**Rights issues**

This element explains the rules and regulations relating to rights issues.

**The FCA Handbook Glossary** contains relevant definitions:

A rights issue is ‘an offer to existing security holders to subscribe or purchase further securities in proportion to their holdings made by means of the issue of a renounceable letter (or other negotiable document) which may be traded (as ‘nil paid’ rights) for a period before payment for the securities is due.’

The right to buy further shares is offered by means of a renounceable letter (a temporary document of title), known as a provisional allotment letter (‘**PAL’**) to shareholders who own shares in certificated form. This is a temporary document of title which must comply with **UKLR 9.4.18**.

If a shareholder holds their shares through CREST, their rights will be credited to their CREST stock account. A CREST shareholder will not receive a PAL.

**Rights issues: Shareholder options**

All shareholders have the following options under a rights issue:

1. take up rights;
2. sell rights;
3. let rights lapse; or
4. a combination of the above.

These will each now be considered in turn.

**Option 1: Take up rights**

The first option for shareholders is to **take up** all of the rights that they are offered. They do this by: ​

1. sending back the acceptance form contained in the PAL; or ​
2. sending an instruction through CREST to accept the offer of rights.  ​

In each case, the shareholder also sends the subscription money to the company's registrar.​

At the end of the rights issue acceptance period, the registrar will then update the register to reflect which shareholders have taken up their rights and will either: ​

* issue share certificates to certificated shareholders; or ​
* instruct Euroclear to credit the CREST stock accounts with new shares taken up by CREST members.

**Option 2: Sell rights**

The second option available to shareholders is to **sell** the rights they are offered by renouncing (i.e. effectively assigning) them in favour of another investor in the market who is willing to purchase them. ​

Since the right is to subscribe for new shares at a discount to their market price, the right is likely to have a value reflecting (broadly) the difference between the market price and the discounted offer price. ​

A third party investor may therefore be prepared to pay the existing shareholder a proportion of this difference in order to acquire the shares at the discounted offer price.  ​

The third party investor will then accept the offer of rights as if they were the existing shareholder (as described in option 1). They will therefore do this by either (1) completing the application form contained in the PAL or (2) sending an instruction through CREST. ​

The trading of rights in this way is referred to as '**nil paid dealings**'.

**Option 2: Sell rights (Example)**

Lion plc launches a rights issue, at an offer price of 300 pence per share. Lion shares are currently trading at 400 pence per share in the market.

An existing Lion shareholder decides not to take up their rights. They find an investor in the market who is willing to pay 75 pence for the right to buy one new Lion share.

In this case the investor would pay the existing Lion shareholder 75 pence per right (the premium) and then pay to Lion the offer price for each of the shares (in other words, 300 pence per share).

The investor therefore pays a total of 375 pence per share - less than the price they would have paid if they had bought shares for 400 pence per share in the market in the ordinary way.

**Option 2: Sell rights (Summary)**

**Step 1:** Existing shareholder receives PAL or credit in CREST stock account

**Step 2:** Existing shareholder renounces rights in favour of a third party investor

**Step 3:** Third party investor pays a premium for rights (over and above offer price) to the existing shareholder

**Step 4:** Third part investor completes acceptance form and pays offer price

**Step 5:** Listed company issues the shares / credits to CREST stock account of third party investor

**Option 3: Let rights lapse**

The third option available to shareholders is to **do nothing** and to let their rights **lapse**.

In these circumstances, the listed company is obliged (by **UKLR 9.4.4**) to make arrangements with its underwriter to sell the unwanted share entitlement in the market on the shareholder’s behalf.

If demand for the shares in the market is high and the underwriter is therefore able to sell the shareholder’s unwanted share entitlement at a premium to the offer price (say for 45 pence per right), a ‘lazy’ shareholder who does not take up its rights will therefore receive some ‘compensation’ for the dilution of their holding in the company.

The amount of the premium will be sent to the original shareholder in compliance with **UKLR 9.4.4(1)** – unless it is £5 or less in total, when it can be retained by the issuer.

The listed company will also receive the offer price in respect of all those unwanted shares sold by the underwriter in the market. If the underwriter cannot sell in the market, it will purchase the unwanted shares itself, as principal.

**Option 3: Let rights lapse (Summary)**

**Step 1:** Existing shareholder receives PAL or credit in CREST stock account

**Step 2:** After last date for acceptance, the listed company instructs underwriter to sell unwanted share entitlements

**Step 3:** Underwriter instructs broker to sell unwanted share entitlements

**Step 4:** Broker seeks buyers for unwanted shares

**Step 5:** Third part investors pay offer price and any premium for new shares

**Step 6:** Any premium paid to existing shareholder

**Step 7:** Listed company issues new shares issued or credits to CREST stock accounts of third party investors

**Option 4: Carry out a combination of options 1, 2 and 3**

A shareholder may elect to take a combination of all three of these options. In order to deal with their rights in different ways, a certificated shareholder will need to apply to the listed company to have their PAL ‘split’.

For example, a shareholder may decide to take up half of their rights, sell a quarter of them and then let the remainder lapse. The certificated shareholder will apply to the listed company to have their original PAL split into three. The listed company will then reissue three separate PALs so that the shareholder can deal with their rights in three different ways.

A CREST shareholder does not need to apply for splitting, they can simply send different instructions through CREST with respect to each of their rights.

**Key characteristics of a rights issue**

The following are key characteristics of rights issues. They will each be considered, in turn, on the following pages:

1. The sale price of the shares offered
2. Fractional entitlements
3. Underwriting
4. Underwriting commission on a rights issue

**Rights issues: The sale price of shares offered**

Under a rights issue, new shares are always offered at a **discount** to the market price (in other words, at a discount to the price at which existing shares are currently traded on the London Stock Exchange). This encourages shareholders to take up their rights.

As a general rule of thumb, the discount offered can be anything up to 60% of the current market price but is usually between 30% and 50%.

The discount must not reduce the price to below the nominal value of a share (**s.580 CA 2006**).

An issue made at a large discount to the market price (over 50%) is known as a ‘deeply discounted’ issue. A deep discount may indicate that the company is in financial distress.

**Rights issues: Fractional entitlements**

Rights issues tend to be undertaken on the basis of a ratio. For example:

In a **1:3 rights issue**, a shareholder will be offered the right the subscribe for **one new share** for every **three shares they already hold**.

If applied strictly, the terms of a rights issue may entitle a shareholder to receive a **fraction** of a share. For example - in a 1:3 rights issue, a shareholder who holds 10 shares would be entitled to purchase 3⅓ shares.

The ⅓ share is referred to as the ‘fractional entitlement’.

It is not possible for a listed company to allot ⅓ of a share. Instead, it is very common practice for the listed company to (1) combine all of the fractional entitlements arising from the rights issue (2) sell the resulting shares in the market and (3) keep the proceeds. Note that this option is only possible if statutory pre-emption rights have been disapplied.  A fractional entitlement would otherwise be rounded down to the nearest whole number.

Under UKLR 9.4.16 fractions must be sold for the benefit of the shareholder, except that if its value (net of expenses) does not exceed £5.00, it may be sold for the [company’s](https://www.handbook.fca.org.uk/handbook/glossary/G190.html) benefit.

**Rights issues: Underwriting**

Underwriting is used to ensure that the listed company obtains all of the proceeds it needs to receive from the issue. Rights issues are almost invariably underwritten.

As on an IPO, the terms of the underwriting agreement are agreed between the company and the underwriter(s) prior to ‘Impact Day’. The underwriting agreement is signed on the eve of Impact Day and placed into escrow.

On Impact Day, before the LSE opens for business, the underwriter(s), the brokers and the company confer and - assuming that nothing material has happened overnight which might significantly affect the market - the underwriting agreement is released from escrow. The underwriters are then ‘on risk’ until the rights issue closes.

Either in advance of Impact Day or shortly after the rights issue has been announced on Impact Day, the brokers will line up sub-underwriters on behalf of the underwriter(s). These sub-underwriters will assume the obligation to subscribe for a given number of shares not taken up in the rights issue: this allows the underwriter(s) to offload as much of the risk as possible of being left holding a large number of shares if the issue is unsuccessful.

**‘Sale of the rump’**:

After the rights issue closes, the lead underwriter instructs the broker to attempt to sell in the market any shares that have not been taken up by shareholders. These shares are known as the ‘rump’. Underwriting agreements usually provide for the sale of the rump to be completed within two working days of the end of the rights issue acceptance period.

**‘Purchase of the stick’**:

If the broker is unable to sell all of the rump in the market, the lead underwriter is obliged to purchase the shares which remain. (These remaining shares are known as the ‘stick’.) However, it is likely that sub-underwriters will have agreed with the lead underwriter to purchase a proportion of the stick. Underwriting agreements usually provide for the sale of the stick to be completed within five working days of the end of the rights issue acceptance period (so three working days after the deadline for the sale of the rump).

**Rights issues: Underwriting commission on a rights issue**

In recent years in the UK, underwriters have typically charged issuers underwriting commission of between 2 and 3% of the total value of the issue, elements of which may be payable only at the discretion of the issuer.

As with IPOs, commissions are negotiated on a deal-by-deal basis and therefore depend on the particular transaction, market conditions and the financial condition of the issuer.

Certain types of transaction, where the issuer is in more need of the funds and/or the timetable is longer may lead to higher commissions being payable.

**Rights issue: What documentation must be produced?**

The key documents are:

* The prospectus
* The circular
* The provisional allotment letter (PAL)

These will each now be considered in turn.

**Rights issue: Prospectus**

A prospectus is required for a rights issue:

TEST 1: A rights issue will usually constitute an ‘offer of transferable securities to the public’ and is unlikely to fall within any of the exemptions that apply for Test 1 set out in **PRR 1.2.3/Art. 1(4) UK Prospectus** **Regulation** (as referenced in **s. 86(1) FSMA**).

TEST 2: As the listed company will be applying for the new shares arising from the rights issue to be traded on the Main Market of the LSE, a prospectus is also required under Test 2, and the relevant exemptions may not apply.

Note that the exemption contained in **PRR 1.2.4/Art. 1(5)(a) UK Prospectus Regulation** (which provides that a prospectus will not be required if the shares being issued represent ‘over a period of 12 months, less than 20% of the number of securities already admitted to trading on the same regulated market’) might apply to a rights issue, but often will not, as rights issues generally involve the issue of 20% or more of the existing share capital. In addition, even if it does apply, there is no exemption that would apply to Test 1, given that a rights issue involves an offer to all the issuer’s existing shareholders (however many of them there are), and not just those who are institutions.

There is a simplified disclosure regime for publishing a less content-heavy prospectus where an issuer has been listed for at least 18 months and is undertaking a secondary issue (see **PRRs 2.5.1** and **2.5.2**).

**Rights issue: Circular**

If the number of shares to be issued exceeds the company’s existing authority to allot (or, if relevant, the existing disapplication of pre-emption rights), the company must send notice to shareholders of a GM to approve the issue.

Although some companies choose to produce a separate circular containing a notice of GM in this situation, market practice is generally for the circular to be combined with the company’s prospectus in a single, larger document.

**Rights issue: Provisional allotment letter (PAL)**

The PAL is sent to certificated shareholders once any shareholder approval (if required) has been obtained.

**Rights issue: Timetable**

The timetable for a rights issue is determined by the number of shares the listed company is planning to issue and the approvals, if any, which the listed company needs to obtain from its shareholders at a GM in order to issue such shares.

Therefore, a key factor that will impact on the rights issue timetable is whether a GM is required and - if it is required - what the relevant **notice period** will be.

**Rights issue: Notice period for general meetings other than AGMs**

If a general meeting is required to pass any additional shareholder resolutions, the company and its advisers will need to check whether the company has met the conditions set out in **s.307A CA 2006** in order to determine what the length of the notice period will be.

**Rights issue: Is a GM required?**

In order to determine whether a listed company needs to convene a GM in respect of its intended share issue, the company and its advisers will need to:

* review the resolutions passed by the company’s shareholders at the company’s most recent AGM; and
* check whether any shares have been issued since the date of the AGM; and
* check if the company is under an obligation to issue shares under any existing agreements (for example, acquisition agreements or share option schemes).

The two key questions that the listed company will need to answer before it can issue the shares are:

Question 1: Do the company’s directors have authority to allot such shares?

Question 2: Does the company need to disapply pre-emption rights in relation to such shares?

**Question 1: Do the company’s directors have authority to allot such shares?**

If the directors require additional authority to allot the shares required for the rights issue, the company will need to convene a GM to pass an ordinary resolution under **s.551 CA 2006**.

**Question 2: Does the company need to disapply pre-emption rights in relation to such shares?**

When issuing new equity securities for cash, a listed company must comply with pre-emption rights contained in **s.561 CA 2006** and **UKLR 9.2.1**. Both provisions have the same practical effect in that, before a listed company issues any new shares for cash, it must offer them first to all its existing shareholders in proportion to their existing shareholdings.

If pre-emption rights need to be disapplied, the company will need to convene a GM to pass a special resolution under **s.570 A 2006**. This special resolution will disapply the statutory and, consequently the Listing Rule pre-emption rights (**UKLR 9.2.2**).

However, in the context of a rights issue (or open offer), it may not always be necessary to disapply pre-emption rights. In principle, a rights issue preserves shareholders’ pre-emption rights as it is an offer to all shareholders, in proportion to their existing shareholdings, to buy further shares in the company. It may not, however, always be practical for a listed company to offer shares to all of its shareholders on a strictly pre-emptive basis. The reasons for this will be explored on the next pages.

**Rights issue: Pre-emption rights**

A company making a rights issue therefore has two alternatives with respect to pre-emption rights:

1. to comply with statutory and UK Listing Rule pre-emption rights by following the pre-emptive offer procedure contained in **s.562 CA** **2006** (the ‘**Gazette Route**’); - this is rarely used in practice; or
2. to disapply statutory and UK Listing Rule pre-emption rights completely by asking its shareholders to pass a special resolution (either at an AGM or at a specially convened GM) under **s.570 CA 2006** (the ‘**Disapplication Route**’).

**Rights issue: The ‘Gazette Route’**

This option **is rarely used** in practice. It entails making a pre-emptive rights issue offer under **s.562 CA 2006** – in other words, to all shareholders.​

1. It may be made in hard copy or electronic form (**s.562(2) CA 2006**). A certificated shareholder will receive an offer of their rights by means of a PAL. A CREST shareholder will receive their offer in electronic form.​
2. It may be made, if a shareholder does not have a registered address in the UK or the EEA, by causing it to be published in the Gazette (s.562(3) CA 2006).​
3. It must state a period of not less than 14 days during which it may be accepted (and the offer may not be withdrawn during that period) (**s.562(4) and (5) CA 2006**).​
4. The 14 day period will begin with the day on which the offer is sent if made in hard copy or electronic form and the date of publication if made by publication in the Gazette (**s.562(5) CA 2006**).

**Rights issue: The ‘Disapplication Route’**

The disapplication route is most used in practice.

The disapplication route involves carrying out a rights issue but **disapplying** statutory and UK Listing Rule pre-emption rights.

A listed company can therefore choose to disapply the statutory pre-emption rights contained in **s.561 CA 2006** and **UKLR 9.2.1** by passing a special resolution under **s.570 CA 2006**. This would give a listed company additional flexibility when structuring its rights issue, even though the terms of the rights issue itself would still give most shareholders a contractual right to subscribe for shares in proportion to their existing holding.

There are two principal reasons why a company would want to disapply pre-emption rights in relation to otherwise pre-emptive issues:

1. **Overseas shareholders**; and
2. **Fractional entitlements**.

These will each now be considered in turn.

**Rights Issue: The ‘Disapplication Route’ - Overseas shareholders**

The main reason why companies elect to disapply pre-emption rights is that a listed company which has disapplied pre-emption rights will be able more easily to exclude certain overseas shareholders from subscribing for shares in the rights issue. The company may find this beneficial as it clearly avoids the obligation to comply with onerous securities laws in a variety of jurisdictions.

The directors of the company will generally seek authority to exclude overseas shareholders in a disapplication route rights issue, by including appropriate wording in the **s.570 CA 2006** resolution passed at the AGM. Typically, this resolution will refer back to the full allotment resolution and thereby allow the board to issue shares in a disapplication route rights issue that comprise up to two-thirds of the existing share capital, as long as those shares are still offered first to existing shareholders in proportion to their holdings (apart from shareholders resident in ‘difficult’ jurisdictions).

If overseas shareholders are excluded from subscribing for shares in an issue, the company will usually make arrangements for its underwriter to sell those shares that would have otherwise been allotted to such overseas shareholders in the market. The company receives the offer price in respect of each such share and the overseas shareholder receives any premium obtained for the shares in excess of the offer price (in accordance with **UKLR 9.4.4**).

**Rights issue: The ‘Disapplication Route - Fractional entitlements**

If pre-emption provisions have been disapplied, a listed company will combine the fractional entitlements and then sell the resulting shares in the market. These shares do not have to be offered to the company’s other shareholders before sale. Typically, the company will retain the entire proceeds from the sale of these shares, including any premium.

Again, the directors of the company will invariably seek authority to deal with fractional entitlements by including appropriate wording in the **s.570 CA 2006** resolution passed at the AGM.

**PEG Statement of Principles**

As their name suggests, pre-emptive issues - such as rights issues and open offers - are pre-emptive in nature; they give existing shareholders the opportunity to participate in share issues and to ensure that their existing shareholdings are not diluted.

The PEG Statement of Principles is **not** therefore relevant in the context of pre-emptive issues. This is irrespective of the fact that pre-emption provisions may actually have been disapplied (for the reasons and to the extent mentioned previously) in relation to such pre-emptive issues.

**Rights issue timeline where no GM is required**

For a company which already has in place the authority to allot and disapplication resolutions in place necessary to undertake its intended rights issue, it must simply comply with **UKLR 9.4.6**. This rule provides that the rights issue must remain open for acceptance for at least 10 business days, starting with the date on which the offer is first open for acceptance.

If no GM is required to be held, on ‘Impact Day’ of the rights issue:

(a) the issue will be announced through an RIS (**UKLR 9.4.5(1)**);

(b) the prospectus will be published; and

(c) the PALs posted to shareholders.

The day after Impact Day, the new shares are admitted to listing on the Official List and to trading on the London Stock Exchange in ‘nil paid’ form so that trading in the rights can begin. The stock accounts of the company’s CREST shareholders are credited with the appropriate number of nil paid rights. When the shares are paid for, the listing will continue without any need for further application for a listing of the fully paid shares (UK**LR 9.4.3**).

**Rights issue timeline where no GM is required**

1. Impact Day: (Day 0)
   * Announcement made to RIS (**UKLR** 9.4.5(1))
   * PALs posted
   * Prospectus approved and published
2. Business day after Impact Day (Day 1):
   * Shares admitted to listing and trading in nil paid form (at 8:00 a.m.)
   * CREST stock accounts credited (at 8:00 a.m.)
   * Offer now open for acceptance
3. Last date for acceptance (approx. Day 15), being the business day after the 10th business day (**UKLR** 9.4.6) **i.e. the 11th business day.**

[Diagram illustrating the above three points.]

**Rights issue timeline where a GM is required: Disapplication Route**

1. If a GM is required to approve the rights issue, the notice of GM will often be incorporated in the prospectus (or, less commonly, sent as a separate circular to shareholders on Impact Day).
2. The PALs can only be sent out to shareholders and shareholders’ CREST accounts can only be credited **after** shareholder approval to the share issue has been obtained at the GM. This is because trading in the nil paid rights can only take place once shareholder approval has been received to avoid any completed trades in the nil paid rights having to be undone.
3. If passing a special resolution under **s.570** or **s.571 CA 2006** to disapply pre-emption rights, the offer must still stay open for at least 10 business days under **UKLR 9.4.6**. This means that the offer cannot close until the 11th business day - Day 32. The offer usually closes at 11:00 a.m.

**Alternative notice periods:** Note that, as regards the notice periods for Option 1 or 2 above, if the company did not satisfy the conditions set out in **s307A(2)-(4)**, 21 clear days’ notice would need to be given of the meeting (**s.307A(1)(b)** and **s.360 CA 2006**). This would mean that the timetable would be extended and that the offer period would not be able to close until Day 39.

If the company had been proposing to pass the necessary resolutions to carry out a rights issue at an AGM and then carry out a rights issue as soon as possible afterwards, the statutory notice period would be 21 clear days’ notice (**s.307A(1)(b)** and **s.360 CA 2006**) plus 2 days’ posting (**s.1147(2) CA 2006**). However, in order to ensure compliance with paragraph 36 of the FRC Guidance on Board Effectiveness, the AGM notice would need to be sent at least 20 working days before the AGM which would extend the length of the timetable further.

The 48 hour period for deemed service of notices in **s.1147(2) CA 2006** includes only ‘working days’ (see **s.1147(5) CA 2006**) and is also subject to any contrary provision in the company’s articles (see **s.1147(6)(a) CA 2006**). Many listed companies have provisions in their articles providing that service is deemed to have occurred the day after posting if first class post is used.

The results of the rights issue must be announced to an RIS as soon as possible under **UKLR** 6.4.4(4) and **UKLR 9.4.5(2)**. In the case of an underwritten offer, this announcement may be delayed for up to two business days under **UKLR 6.4.5** , i.e. until the number of ‘stick’ shares has been determined.

**Summary**

* A rights issue is ‘an offer to existing holders of securities to subscribe or purchase further securities in proportion to their holdings’.
* A rights issue must be kept open for acceptances for at least 10 business days (UKLR 9.4.6). The offer period cannot run concurrently with a GM notice period (if a GM is required). If a GM is needed, this will cause the overall timetable to be approximately twice as long (around four weeks instead of two weeks).
* A prospectus is required under both ss.85(1) and 85(2) FSMA. As rights issues are offered to all shareholders, it is unlikely the company will be able to rely on the exemption in s.86(1)(aa) FSMA and PRR 1.2.3.
* All shareholders participate in the offer as this is a pre-emptive offer (except overseas shareholders in problematic jurisdictions).  As the nil-paid rights are tradeable, they can either take up, trade, or allow the nil-paid rights they receive to lapse.
* Shareholders who do not take up the offer receive ‘compensation’ (UKLR 9.4.4(1)).