

INITIAL PUBLIC OFFERS

SUPPLEMENTARY SUBMISSION

TO THE WEINBERG COMMITTEE ON PRIVATE SHARE OWNERSHIP

by

THE UNITED KINGDOM SHAREHOLDERS ASSOCIATION

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SUMMARY AND CONCLUSIONS

The Committee on Private Share Ownership has asked UKSA to make practical proposals for encouraging private share ownership.

This submission covers Initial Public Offers. Our main concern is with equal access to new issues for private investors. We recognise that Open Offers have some shortcomings, and in our earlier paper we made some suggestions covering these concerns. We see no need to expand on those suggestions.

However, we believe that the rise of Placings - which effectively exclude private investors from the New Issues market - could only occur because of major failings in the current regulatory framework, and that these failings have to be understood and addressed.

We refer to impressive evidence, recently come to our attention, that the existing regulatory framework failed comprehensively, at enormous expense to the Exchequer, during the Privatisation issues.

We argue that Placings, which gained acceptance over the same period, are further symptoms of the same regulatory failure. Placings

- discriminate in favour of institutional investors and against private investors;
- tend to depress the issue price, at the expense of existing investors;
- do long-term damage to the liquidity of the companies concerned by creating a narrow shareholder base;
- discourage the development of alternative issue methods.

The 'Yellow Book Rules' currently provide the regulatory framework for new issues. However, it is evident from last year's rule changes that some essential principles have been forgotten or discarded over the last decade: they need to be re-established, and clearly stated.

The principle most relevant to the Committee is equal access to new issues for all investors, but there are a number of others which are essential to the fair and efficient working of the market.

Since existing methods of issue are far from perfect, we believe that the Stock Exchange should encourage the development of new methods and the improvement of existing methods.

We therefore propose that the Stock Exchange should establish and publicise a set of broad criteria that any listing method must meet, should phase out those existing methods that do not meet the criteria, should encourage company sponsors to

propose new or enhanced methods of issue and should establish a framework for rapidly assessing and permitting these methods that meet the criteria.

We suggest some appropriate criteria, of which the most fundamental are:

- **Equal access to the whole of an issue for all applicants;**
- **Fairness to existing shareholders;**
- **Creation of a broad shareholder base.**

We propose that new issue placings and part-placings be phased out over a period of a year, to allow alternative methods to be developed and tested in the marketplace. We propose that an initial ceiling of 50 million pounds be reinstated and then reduced in stages.

We argue that liquidity is an essential element in the maintenance of a healthy market for a company's shares. Poor liquidity in the secondary market creates significant difficulties for all investors, but private investors are particularly disadvantaged.

We believe that there is insufficient information available about the relationship between issue methods, liquidity and issue underpricing, and that this information would be valuable both to the Stock Exchange and to companies considering a market listing on the main or junior markets.

We therefore propose that an analysis should be commissioned showing the relationship between issue method, size of shareholder base, underpricing of issues and company liquidity in the secondary market, and that similar analyses should be made on a regular basis in future. The results should be publicly available.

We propose that order-based trading be introduced for stocks where marketmaking has failed to sustain a genuinely liquid market.

We propose the development of a simple hybrid, the Open Offer with Tender. This proposal addresses the problems of issue pricing, staggings and scaling down of applications, but maintains the traditional advantages of Open Offers.

In conclusion:

The position of the Stock Exchange as regulator is fraught with difficulty, principally because there is a natural conflict of interest between its regulatory role, in which it should act for the benefit of British industry and the investment community as a whole, and its role as a trade association owned by a small number of large institutions.

The decision to abandon mandatory Open Offers, the inadequate consultation and research that preceded it, the failure to address the arguments of private investors' representatives and the poor arguments presented in justification of it, and the decision to proceed with the rule changes before the Committee had reported, created serious doubts (not for the first time) about the Stock Exchange's willingness or ability to resolve that conflict of interest.

We believe that the Stock Exchange may now be more aware of these concerns, and more responsive to them.

We urge the Committee to present the very strong case for the phasing-out of placings and reform of new issue regulations.

These reforms are essential if private investors are to be allowed to participate on equal terms in the New Issues market.

We believe the Committee would have every prospect of success.

1. PRIVATISATIONS AND PLACINGS: EVIDENCE OF REGULATORY FAILURE

John Chown's unpublished paper 'Privatisation - The Record (J F Chown & Company Ltd), provides impressive evidence that the existing regulatory framework for new issues failed comprehensively during the Privatisation issues, starting in 1984:

- Conflicts of interest in the methods of issue that were permitted encouraged massive underpricing of many of these issues, in the order of 17%, costing the Exchequer hundreds of millions of pounds;
- Most of the resulting profits were won by a number of 'priority applicants', who were reserved an average 48% of the issues;
- Applicants for the remainder of these issues were drastically scaled down largely in consequence.

The rise of Placings began in 1986, two years after the first British Telecom issue, and are symptomatic of the same regulatory failure. Prior to this date, they were considered an unacceptable method of issue, except for the smallest of issues. Since then Placings have gradually displaced Open Offers, as the Yellow Book rules have been progressively relaxed.

We believe that this has been a disastrous development for existing shareholders in these companies, for private investors and for the market as a whole, for the following reasons:

Placings discriminate against private investors, and in favour of institutional investors.

Traditionally, very few private investors have had access to Placings. Even where private investors are allowed to participate via intermediaries, the allocation made available to them is entirely at the discretion of the company sponsor; where an issue is oversubscribed, private investors have frequently been drastically scaled down compared to institutional participants (the VERO issue being an instance of this).

Placings allow discrimination between individual applicants.

There is no requirement on the company sponsor to make a Placing available to all interested parties, even at the institutional level. The dangers, and conflicts of interest, associated with this power of patronage are described in a later section.

Placings do not realise fair value for existing shareholders.

Our analysis of new issues demonstrated that new issues are often placed at an excessive discount to the market value, unduly diluting the holdings of existing shareholders.

Placings produce poor liquidity in the secondary market.

There is a strong case for associating Placings with poor liquidity in the secondary market:

Recently, two junior markets, where public offers were not required, have been closed down primarily because there was not sufficient liquidity to sustain them.

There is clearly a major problem of liquidity in smaller companies on the main market today, ten years after Yellow Book rules were first loosened to allow Placings.

But the strongest argument is the logical one: if a company is initially sold to 1,000 investors, there will be very few wishing to sell at any given time. If there are an initial 100,000 investors, there will usually be some wishing to sell, and a steady supply of shares will become available in the market.

We believe that a proper analysis - proposed later in this paper - would provide strong statistical evidence of the link between Placings and poor liquidity.

Placings tend to discourage the development of alternative issue methods.

Placings have become popular with company sponsors because they are a cheap short-cut to a main market listing. In allowing a deeply unsatisfactory method of issue that undercuts all other methods, the Stock Exchange is allowing other methods to be driven from the marketplace and is preventing the development of methods that might satisfy the needs of the broader investing community and a healthy Stock Market.

2. DEVELOPING A NEW REGULATORY FRAMEWORK

The 'Yellow Book Rules' currently provide the detailed regulatory framework for new issues. However, it is evident from last year's rule changes that some essential principles have been forgotten or discarded over the last decade: they need to be re-established, and clearly stated.

We therefore propose that the Stock Exchange should adopt and publicise a set of broad criteria that any listing method should meet, should phase out those existing methods that do not meet the criteria, should encourage company sponsors to propose new or enhanced methods of issue and should establish a framework for rapidly assessing and permitting those methods that meet the criteria.

We propose the following list of criteria that we believe any method of issue should meet. The list covers principles rather than detail, because it is the principles that have been forgotten. The Committee may wish to add to this list.

- **Equal access to all applicants**

An issue method must not discriminate between classes of applicant. For example, private investors or intermediaries must not be allocated a set proportion of a share issue but must receive their allocations on the same basis as other applicants.

An issue method must not discriminate between individual applicants: all investors should have the opportunity to apply for shares, and must be allocated shares on a common basis.

John Chown's paper indicates the dangers of 'priority applicants' procedures, in encouraging the underpricing of issues.

There are also significant corporate governance implications: if a company's board can effectively choose to which potential investors shares are offered, it can ensure that shares are placed with sympathetic parties who will not challenge the board's position. This is a recipe for complacent, immovable boards of directors and poor corporate governance. It also allows the board to deliberately dilute the influence of existing minority shareholders who are known to be unsympathetic to the board.

It should be noted that sponsors of Public Offers have traditionally discriminated between sizes of application, by limiting the maximum and minimum size of application, and have varied the degree of scaling-down of applications by application-size. We do not consider this practice should be unduly restricted.

- **Fairness to existing shareholders**

An issue method should not carry a significant risk of excessive underpricing, which unduly dilutes the holdings of existing shareholders.

- **Association with liquidity**

An issue method should be likely to generate healthy liquidity in the secondary market over the long term.

- **Clarity**

An application form should not be forbidding or unintelligible.

- **Clear indication of price**

An applicant must never be asked to commit to the purchase of shares at an open-ended price, without being able to specify the maximum price per share that he or she is willing to pay.

- **Advance announcement of issues**

An issue must be publicised in good time, via the appropriate official channels, and this information must be freely available for publication.

- **Quality and timeliness of issue documents**

Issue documents must be made available on request and in good time, and must meet the appropriate standards.

There will be other factors that company sponsors would themselves wish to pursue, such as reducing administrative costs (particularly for smaller issues). These are matters of detail, provided that they do not conflict with the stated principles.

3. PHASING OUT PLACINGS

The Committee asked for our views on a suitable ceiling above which Placings might be prohibited.

After some consideration, and in the light of the arguments presented earlier, we do not believe that there is any role for Placings in a healthy and well-ordered main market.

In our earlier submission, we drew attention to an alternative method for handling some smaller issues: the **Introduction and Placing**. Later in this paper we present the very strong case for the **Open Offer with Tender**.

We believe that the marketplace is equally capable, with suitable encouragement, of developing new methods of issue and improving on existing methods

We also believe that the cost of Open Offers can be significantly reduced by largely regulatory measures, as described in our earlier submission.

It is certainly true that Placings provide the most administratively cheap and convenient means of bring a company to market (at a considerable hidden cost), and that companies raising only small sums may not consider that the benefits of listing justify the expense of a public offer.

However, these companies are the whole *raison d'être* of junior markets: if companies cannot accept the costs and controls associated with genuinely 'going public', they may choose the lesser benefits, and the easier standards, of the Alternative Investment Market. Large number of companies have chosen this route already.

We therefore propose that new issue Placings, and part-Placings, be phased out over a period of a year, to allow time for alternative methods to be developed and tested in the marketplace.

We propose that an initial ceiling on the total issue size of 50 million pounds be reinstated, and then reduced in stages.

There is little benefit in removing Placings if other equally inadequate methods are allowed to continue, or to be introduced.

We therefore strongly urge that other issue methods not satisfying the criteria set out earlier be phased out over the same period.

4. THE IMPACT OF POOR LIQUIDITY ON PRIVATE INVESTORS

There is extremely poor liquidity in many of the smaller companies listed on the main market.

We have already noted that Placings lock private investors out of the market in new issues. The poor liquidity with which Placings are associated locks us out of the secondary market for these companies almost as effectively.

While we are unable to provide statistical evidence based on the number and size of trades, we have spoken to the Committee of the extremely wide spreads and the very low normal market sizes that appear in the Smaller Companies pages of the Investors Chronicle.

In the year to date (5 January to 23 February), the Chronicle has reported on 98 smaller companies, with an average spread - the difference between the quoted buying and selling prices - of 12.3%, and an average normal market size - the value of shares which the market-maker must guarantee to buy or sell on request - of 786 pounds. In seven cases, the spread was 33% or more.

This evidence is far from authoritative: it covers only those companies that have appeared in the Chronicle over a very limited period (because of the short time available in preparing this submission). However, it does indicate a significant problem.

While these are fairly small companies, with average capitalisations of around 13 million pounds, they are traded on the main market, which is supposed to ensure liquidity for all listed companies, and they are not particularly exceptional.

A large spread makes it impossible for private investors to acquire or dispose of a holding at a price that reflects the market value of the shares, and generates a substantial immediate loss when the shares are bought.

A very low normal market size means that broking charges, as a proportion of the size of the trade, may also be prohibitive.

Institutional investors are frequently able to overcome this problem by arranging direct trades of shares. However, this method is not available to any but the largest and best-connected private investors.

So while poor liquidity creates significant difficulties for all investors, it is private investors who are most affected, being unable to buy into the affected companies at reasonable cost.

While order-based trading in smaller companies would improve the situation, no method of trading can produce a steady market in a company's shares if there are too few existing investors willing to sell. We do not believe that order-based trading in smaller companies would resolve current liquidity problems.

5. PROVIDING RELIABLE DATA ON LIQUIDITY AND UNDERPRICING

We have provided evidence that Placings are generally underpriced, and carry a high risk of gross underpricing.

There is also a strong logical case, described earlier, for associating Placings with poor liquidity in the secondary market.

However, the Stock Exchange's Quality of Markets office advises us that the Exchange does not provide any statistical information about the relationship between issue methods and company liquidity in the secondary market.

We therefore propose that the Stock Exchange produces and publishes a regular analysis showing the relationship between issue method, length of time since issue and company

capitalisation on the one hand, and secondary market liquidity (size and number of trades, and spread) and size of shareholder base on the other hand.

Similar regular analyses of the relationship between issue methods, size of issue and underpricing should also be produced.

These analyses should also cover the Alternative Investment Market, where the problems of underpricing and liquidity are inevitably greater.

The information provided would be an essential tool to the Stock Exchange in establishing which methods of issue are consistently associated with poorer or better liquidity in a given size of company.

It would also be of enormous benefit to companies wishing to make a more informed choice between available methods of issue.

All the necessary information for producing these reports is already available to the Stock Exchange on a daily basis. Based on our experience of developing and maintaining management information systems, we believe that the cost and effort of producing these reports should be minimal.

6. INTRODUCING ORDER-BASED TRADING

The Committee asked whether order-based trading might resolve the problems private investors experience when dealing in smaller companies.

We do not believe that it can fully resolve the problems created by too narrow a shareholder base.

We have not had time to form a view on order-based trading as a whole.

However, we would argue that, if an investor cannot acquire a reasonable size of holding in a company at a reasonable price, the marketmaking mechanism has failed to sustain a genuinely liquid market.

We propose that order-based trading should be introduced permanently for any stock where either

- the spread is over a defined level (say 10%); or
- the marketmakers only undertake to buy or sell less than a defined value of shares (say 1,000 pounds).

Order-based trading cannot create liquidity, but it will allow patient buyers and sellers to acquire or dispose of holdings of a reasonable size and at reasonable cost.

7. ALTERNATIVE METHODS OF ISSUE

In our earlier submission, we argued that the Stock Exchange, in deciding to end mandatory Public Offers, had failed to consider the practical alternatives of improving on existing methods or of exploring different methods of issue.

Since the Committee has asked us to present practical suggestions, we wish to demonstrate that there are very practical alternatives to Placings available, and that the traditional Public Offer can be much improved on.

In our earlier submission, we made suggestions for reducing the costs of Public Offers, and drew attention to the Introduction and Rights Issue method.

We also wish to state the very strong case for Tenders, which were briefly mentioned during our meeting with the Committee. This option has never been fully exploited. We believe that the Open Offer with Tender presents a very practical solution to all the substantive problems associated with Placings and Open Offers, and might be considered as the method of choice in many instances.

We believe other methods will emerge from the marketplace once a suitable regulatory environment is in place.

7A. THE OPEN OFFER WITH TENDER

This proposal shows how a traditionally unpopular method of issue, the Tender, can be made much more acceptable to private investors, and therefore more successful, by a change of emphasis and presentation.

An Open Offer is generally an effective means of realising close to the true market value of new issue shares, but runs into significant problems when it is generally perceived to be underpriced.

The result is highly unsatisfactory to all parties (except the stags): the original investors see a part of their company sold off cheaply, the large number of opportunistic applicants greatly increases administrative costs and the serious applicants may receive an unviably small allocation of shares, or may receive nothing at all.

These problems can be addressed by presenting the Open Offer with a Tender option that will only be exercised in the event of a significant oversubscription: the applicant is invited to apply for the shares at the **OFFER PRICE**, in the normal way, but also has the option of stating a **MAXIMUM PRICE** that he/she would be willing to pay in the event of a major oversubscription.

If the offer is undersubscribed, all applications are fully met at the Offer Price. If the offer is modestly oversubscribed, applications are scaled down in the usual way.

However, if the offer is heavily oversubscribed, the Tender is activated, and a **STRIKING PRICE** is determined at which, after eliminating all applications below this price, the supply of shares on offer comes close to meeting the demand.

All applicants not eliminated then receive their allocations, with relatively modest scaling-down, at the Striking Price.

It should be emphasised that in most instances all applicants will receive their allocations at the Offer Price in the normal way: Only if the issue is significantly oversubscribed will the Tender be activated.

The Open Offer with Tender has significant advantages over the ordinary Open Offer, as follows:

With most issues, where the Tender is not activated, modern technology means that the additional administrative expense (once prohibitive) is negligible, and staggung, with its associated costs, is significantly reduced.

Where the Tender is activated, the extra cost is now insignificant relative to the additional payment received and will decline much further in the near future.

Since all successful applications receive a generous allocation of shares, no unrealistically small holdings are created, reducing the cost of maintaining the share register.

Applicants are able to control their risks by setting their own Maximum Price, but know that they will not end up paying over the market rate even if they offer too high a price.

The interests of existing shareholders are protected, since the new shares are issued at a price determined by the market rather than by the issuer's advisers.

Three issues need to be addressed: how should such offers be presented, how should the basic Offer Price be determined and, when a Tender is activated, how should the additional amounts due be payable.

Presentation is critical: the variable pricing of a tender will frighten off private investors unless an issue is presented primarily as an Open Offer, in which there is no obligation for the applicant to bid above the offer price, and in which no investor will end up paying above the market rate. The Application Form can and should be kept simple.

Pricing remains important: the Offer Price should be pitched in exactly the same way as it would be for a normal Open Offer, since this is the price that is actually applied in most instances. It is generally accepted that Offer Prices need to allow for a small discount to market value, not only to protect against a decline in the general market during the offer period but also to compensate for the costs incurred by unsuccessful applicants (who are generally out of pocket in the interval between their cheques being cashed and later refunded). The same will be true of the Striking Price.

Finally, if the Tender is activated an additional payment per share will be due. This can be handled by scaling down the allocation proportional to the increased cost per share, so that the value of the allocation matches the original payment. Alternatively, the shares can be issued part-paid, with the additional payment due at a later date.