

Further Letter to the Association of British Insurers (6 Feb 2004)

Michael McKersie Esq.
Manager of Investment Affairs,
Association of British Insurers
51 Gresham St
London EC2V 7HQ

Dear Michael,
Your reply on behalf of ABI to our open letter raises important questions.

It seems we all agree that the values of many share schemes are being enhanced by the adjustments made, or their lack, following a variation of share capital. It is your contention that what is objectionable is the 'essentially artificial - but no doubt costly- share consolidation process that redenominates...(shares)...into...(a)...smaller number'. You claim that the 'fair' way of adjusting share schemes reducing the option price avoiding objectionable share consolidations, is not being allowed by the Inland Revenue. As an alternative, you suggest share buybacks, which you admit to be an enhancing adjustment involving a 'modest degree of over-compensation'.

The Inland Revenue saw our open letter before it was sent to you. They approved the reference made to them in our letter. If they are really preventing the 'fair' adjustment of share schemes, they need to explain why. They say that as a general principle, the adjustment should be fair - in their words one 'which ensures (that) the value of the share option reflects what it would have been had the new share structure been in place when the options were first granted'. After a special dividend, that can only be by an adjustment to the option price.

We question your assumption that the degree of employee over-compensation is only modest. Take the case of Mitchells & Butlers (M&B). On September 30th there were 736m shares in issue and 34.8m share options with an option price between £1 and £3.64. The December share consolidation following the special dividend reduced the number of shares by 29%.

There is evidence from the US that the effect of buying back an average of 6.93% of a company's share capital raised subsequent share prices by 2.5%. On the same basis a 29% buyback would raise prices by 10%. A measure of the over-compensation might therefore be to attribute to the exercised share-options a 10% enhancement over the exercise price. If only a fraction of the options were exercised the over-compensation is likely to be millions of pounds. This is not modest and is probably much more than was being spent on M&B's share consolidation.

Our open letter to the ABI asked what principles they believed should govern share scheme adjustments. If the General Principle of the Inland Revenue was adopted in all circumstances, there could only be one way of making adjustments as is set out in the paper "[Share-Option Neutral Adjustments](http://www.uksa.org.uk)" published on the Web [See www.uksa.org.uk]. You say that the ABI thinks it is 'better if option holders could be fairly compensated...rather than over-compensated'. Why then do your guidelines not authorise this as the only acceptable form of adjustment? As we pointed out in our last letter, your guidelines are being used by companies to tell their shareholders that their proposed adjustments have your seal of approval. Because it is not mentioned in your guidelines, companies never admit that their adjustments are ever option enhancing. It is surely time there was proper openness with shareholders about this, particularly when companies routinely ask permission from shareholders for share buybacks.

Yours sincerely

J N Stevens

Robert Muriel