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Dear Ms Clarke

## **IIC Rights Issue Fees Enquiry (RIFI)**

We thank the Chairman for his invitation to participate in RIFI and for the opportunity to comment on the fees charged for capital raising and associated investment banking services. Standard Life Investments is one of the UK's leading institutional investors and sub-underwriters. As at 31<sup>st</sup> June 2010 it had £143bn of assets under management. The majority of these assets comprise UK listed securities. It thus has a strong incentive to ensure that the costs incurred by UK companies when they raise equity capital are competitive and that their impact on shareholder value is minimised.

In March 2010 Lord Myners challenged institutional investors to review the UK equity underwriting process. In light of the persistence of the high fees associated with the raising of equity capital during the period in 2008/09 when market conditions were far less benign, the question remains pertinent. We hope that our submission will inform the debate on this matter. We also hope that it will augment the suggestions made by the Rights Issue Review Group in November 2008 to make the raising of equity capital more efficient and orderly. We answer the questions raised by RIFI as follows:

### Changes in market practice

As with Placings and Open Offers, Rights issues are a common technique for the raising of fresh equity capital by UK companies. However, secondary offerings of equity are a relatively infrequent occurrence for UK companies individually. The decision to raise additional equity rather than additional debt will be determined by the relative costs of each and the structure of the company's balance sheet at the moment such an issue is contemplated. Critically, offerings that are underwritten provide company management with the certainty that the money will be raised whatever the market conditions. For the investor however, an additional consideration is the opportunity cost of providing further capital in this way. These considerations are as relevant to the decision to sub-underwrite an issue as to the decision to take up the entitlement to new shares. Yet while the market determines the price at which new shares will be issued, the costs of underwriting appear not to be subject to the same market forces. In effect, underwriters are inefficiently rewarded for the risks that they are taking.

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For companies seeking to raise equity capital, this inefficiency is less marked at the level at which an issue is sub-underwritten. Ironically, at the point when the MMC investigated the role of underwriters of share issues in the UK in the late nineteen-nineties, fees were already falling. This was the result of the introduction of tendering in sub-underwriting which led to a steady decline of the 2% fee rate that generally prevailed before.

The decline of the cost of debt relative to equity meant that secondary offerings of equity were far less common between 2000 and 2008. However, the rapid rise of risk premia associated with the reduced availability of credit from early 2008 coincided with a phase in which a more significant number of companies sought re-financing. The resultant rise in the cost of capital and the diminished capacity of the market to both underwrite and sub-underwrite saw a marked increase in the fees associated with secondary offerings of equity. The most recent rights issues have seen fees close to 4%, irrespective of whether the issue was for a plain-vanilla refinancing or an altogether more complex and risky deal. Yet while overall fees have increased, the proportion allocated to sub-underwriters has remained static, again suggesting that companies are achieving greater economies at the point at which lead underwriters lay off their risks.

Another change over the past fifteen years has been the sharp rise in the size of the discount at which new shares are priced in a rights issue. This trend predated the "credit crunch" and is associated with the change in the cost of equity relative to debt over the period. For investors that take up their entitlement to new shares in full, this discount is illusory as it has long been accepted that earnings, assets and dividends should be adjusted to take account of the bonus element of a rights issue. However, the discount has greater significance for the marginal investor who might wish to purchase rights for sale by an existing shareholder.

There has been some debate as to the extent to which the size of the discount reduces the risk of failure of a rights issue, thus mitigating the need for underwriting. Indeed, there is evidence that the contrary is true; when Cookson chose to issue new shares in 2002 at a near 50% discount without underwriting, the market price traded below the new issue price and the funds were put in jeopardy. It would seem that shareholder's interests are better served by the payment of a fee that guarantees that the monies will be received by the company.

#### Underwriting Capacity

Underwriting is a regulated activity subject to the rules of the Financial Services and Markets Act of 2000, the FSA Handbook and MIFID which require that underwriters act in accordance with the best interests of their clients. Underwriters may also be subject to statutory as well as internal restrictions on the amount of capital that they make available for this purpose. But while regulatory change may have contributed to the current level of underwriting fees, the correlation is not obvious.

One feature of the market place which is likely to have had an impact on the pricing of underwriting capacity is the abandonment of the informal "queue" system by which secondary offerings used to come to the marketplace. The consequential bunching of offers during periods of heightened issuance will logically place a strain on available underwriting capacity and its cost. This was, for example, particularly apparent in 2009 when many issues were announced, often within days of one another. In March 2009 the market held an underwriting exposure of over £23bn as the likes of Xstrata, HSBC and a number of property companies launched rights issues.

An additional factor has been the steady decline of the institutional ownership of UK shares, which previously provided a much larger natural constituency for the placing of underwriting. While a more disaggregated shareholder base may have contributed to a higher level of risk taken by lead underwriters, it has certainly contributed to the loss of pricing power within the fee structure by sub-underwriters. This might be expected to have led to a fall in the overall level of the fee; in fact, as has been seen, lead underwriters have taken a larger share of an increasing fee.

Lastly, institutional investors, hedge funds and other principals now sign undertakings that prevent them from selling short the shares of the issuer as part of the underwriting agreements. This has reduced the appetite of hedge funds to sub-underwrite and should logically lead to a return of pricing power to the residual pool of sub-underwriters. The more secondary offerings are underwritten by existing owners of the shares of the issuer, the lower the risk taken by the lead underwriters. This should also lead to a re-balancing of fees in favour of sub-underwriters.

#### Transparency

Both companies and their shareholders would benefit from greater transparency of the fees associated with the secondary offer of equity capital. Lead underwriters that have a long-standing advisory relationship with the issuing client have a strong incentive to realise the costs associated with this relationship within the fees levied for a rights issue. Companies may also have an incentive to accept these fees in return for a lower cost of access to other forms of capital such as lines of credit.

Companies need to carefully consider the impact of costs that arise from a secondary offering on shareholder value. Standard Life Investments receives no financial benefits from the sub-underwriting process. To the extent that its clients are beneficial owners of the shares of the issuer, they will receive benefit from the distribution of sub-underwriting fees among Standard Life Investments wider client base.

Companies also need to give attention to the governance aspects of secondary offers of equity. Increased disclosures about the company's process for evaluating the cost and allocation of capital would improve accountability and lower the perception of risk associated with such an issue. Audit and Risk Committees could usefully incorporate details of these considerations as part of the governance reporting process.

#### Relations with corporate advisors

As an institutional investor, Standard Life Investments recognises the important role of corporate advisors and lead underwriters in the preparation of key documentation, the provision of specialist advice and in the distribution of the risks associated with a rights issue. However, the importance of the advisor and the lead underwriters in the pricing of an issue should not be overestimated; in practice much of the due diligence that informs the evaluation of the worth of a company in the market place is done by those who are invited to sub-underwrite. Greater recognition needs to be given to this in the allocation of fees in the rights process.

Companies that have a concentrated shareholder base should also consider the option of approaching investors directly when seeking to raise additional equity capital; this would relieve some of the requirement for primary underwriting and lower the overall costs associated with the offering.

Standard Life Investments supported the proposal of the Rights Issue Review Group to shorten the rights issue timetable. Logically, any shortening of the period in which underwriting capital is at risk should lower the fees associated with the provision of that capital. Similarly, the period in which an investor is "taken over the wall" should also be kept to a minimum period necessary to ensure an orderly and efficient market for a secondary offer.

Conclusion

There is much evidence to suggest a basic asymmetry between the risks to underwriters and sub-underwriters and the fees that are paid to each for the taking of the risks associated with rights issues. The rewards available to advisors and lead underwriters are disproportionate to those available to other providers of risk capital. It would also appear that the general increase in fees associated with rights issues is imperfectly correlated with the risks associated with these transactions and therefore degrades shareholder value.

As an institutional investor which receives no financial benefit from sub-underwriting, Standard Life Investments would support a return of competitive tension to the costs arising from the advising and underwriting of secondary offerings of equity. We would welcome a return of the tendering method of underwriting. We would also urge corporate buyers of investment banking services to consider more critically the economies that they are achieving within the present system and to examine ways that the associated costs can be minimised for shareholders.

Yours sincerely

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