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Client Briefing
February 2011

OFT subscribes to self help remedies for underwriting markets

Summary

On 27 January 2011, the Office of Fair Trading (OFT) published its report on the market for equity underwriting and associated services, and its provisional decision not to refer the market for a detailed investigation by the Competition Commission.

Its main conclusion was that the significant increases in fees for such services since the advent of the financial crisis do not appear to have been caused by excessive concentration among investment banks in the provision of equity underwriting and corporate broking services. Moreover, potential conflicts between the interests of institutional shareholders and investment banks, and those of companies raising equity capital do not raise significant concerns in practice. Rather, the OFT's analysis suggests that fee increases can be traced to certain inefficiencies in the way that fees are negotiated by companies, and insufficient pressure from shareholders to lower underwriting costs.

The OFT concluded that regulatory solutions (such as mandatory publication of fee break downs) are not called for, but that there are a number of possible solutions that companies and institutional shareholders may opt to pursue to drive greater competition.

Background

As reported in our client briefing of June 2010, the OFT's decision to conduct a market study into equity underwriting was promoted by perceived company and institutional shareholder dissatisfaction with recent increases in underwriting fees and discounts on rights issues, in particular since the advent of the financial crisis. The market study examined the provision of equity underwriting services for equity issues carried out by FTSE 350 listed firms over the last ten years, including rights issues, placings and other types of follow-on offer, but not Initial Public Offerings (IPOs).

The report's conclusions

The OFT found that average fees rose to more than 3% in 2009 and average discounts on rights issues rose to nearly 40%, compared with the typical fees of 2- 2.5% and discounts of around 30% in the period from 2003 to 2007. Sub-underwriting fees also rose following the onset of the financial crisis and recession, clustering around 1.75% during 2009. While the OFT accepted that such increases can be explained, at least in part, by increased volatility and risk in 2009, subsequent reductions in risk and stock market volatility do not appear to have fed through to lower prices (notwithstanding indications from the limited number of issues in 2010 of a reduction in underwriting fees). The OFT also identified a trend towards greater "clustering" of fees and discounts.

No excessive market concentration

The OFT's report concludes that, in practice, other forms of capital raising, such as internal or debt finance, tend to provide little or no competitive constraint on the equity underwriting market, and that the option of issuing non-underwritten "deeply discounted" shares has been little used since 1999. However, even

Key Issues

No proposed reference of equity underwriting markets to the Competition Commission

Increased fees and discounts not caused by excessive concentration nor conflicts of interest

Ineffective negotiation of fees by companies best resolved by self-help measures, not regulation

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considered in isolation, the OFT found that the equity underwriting market is not particularly concentrated, with the top three underwriters (Bank of America/Merrill Lynch, Deutsche Bank, and Morgan Stanley) together accounting for 35-40% of supply in 2010. In addition, the OFT found no evidence of anticompetitive agreements or unilateral conduct that might be in breach of the competition rules.

Inefficient price formation

Notwithstanding the lack of concentration, the OFT identified a number of ways in which it considers that competition for equity underwriting appointments is lacking. In particular, it concluded that:

- companies prioritise speed, confidentiality and the successful take-up of new shares ahead of pricing of underwriting services. They therefore often award mandates to their existing corporate brokers and advisers with little or no competition taking place at the time of the transaction. Holding a competitive tender for underwriting services is perceived to increase the risk of a market sensitive leak of information. Once work on an issue has begun, it is rarely feasible to remove or replace an underwriter, meaning that companies are typically in a weak position when negotiating fees and discounts;
- institutional shareholders appear to have had little success in persuading companies to act on their concerns regarding fees and discounts. In the OFT's eyes, they could do more (see below);
- there appear to be significant barriers to entering the market, such as the costs of building a reputation and relationships with potential clients;
- as most companies raise capital infrequently, there are asymmetries in information and experience which make it difficult for companies to assess whether they are purchasing services cost effectively; and
- the disclosure of overall fees and discounts in prospectuses tends to result in the perception that there is a general "going rate", rather than stimulating effective negotiation on the basis of the risks and costs associated with the transaction in question.

No concerns regarding conflicting interests

While the OFT identified certain theoretical areas of conflict of interest between companies and underwriters – for example in respect of pricing the issue, or hedging risk by underwriters in a way that affects a company's share price – it found that, in practice these do not appear to raise significant concerns. In particular, the OFT notes that underwriters are under a general legal obligation to identify and manage conflicts of interest fairly, and that companies raising equity are aware of the potential for conflicts and take steps to address them.

As regards potential conflicts caused by institutional shareholders' twin roles as investors and as potential sub-underwriters, the OFT found that these investors do not have strong incentives to press for higher sub-underwriting fees, and that there is limited evidence of them doing so.

The OFT's proposed next steps

The most important outcome of the report is the OFT's provisional decision not to refer the market to the Competition Commission for a detailed investigation. It takes the view that the identified market inefficiencies can be tackled most effectively by companies and shareholders doing more to achieve cost effective outcomes, rather than by the imposition of regulatory measures following a costly inquiry. Comments on its decision not to refer are invited by 11 March 2011.

The steps that the OFT recommends companies and institutional investors to consider include:

- requesting a breakdown of underwriters' proposed fees into constituent components, so that each element of the total fee can be negotiated. However, the OFT held back from pursuing mandatory public disclosure of underwriting fee break-downs, on the basis that such disclosure could also make it easier for investment banks to align their prices;
- awarding and agreeing fees for different aspects of the work at different times;
- holding tenders in which all investment banks with which an existing relationship is held (including corporate brokers and lenders) compete for certain elements of the underwriting work. The OFT notes, however, that there may be potential disadvantages which would need to be taken into account;
- increase the number of banks that companies have relationships with, so increasing the pool of potential providers and creating greater competitive tension;
- greater pressure from institutional investors on companies to reduce fees, through regular discussions with company executives;
- commitment by institutional investors (where possible) to sub-underwriting issues before they are announced, to reduce the risk borne by the underwriter and (the OFT hopes) the resulting underwriting fee paid by the company; and
- institutional investors indicating a willingness to accept lower sub-underwriting fees, with a view to applying pressure for primary underwriters to reduce their fees in turn.

Comment

The OFT's careful weighing of the substantial costs of a market investigation reference against the outcomes that might realistically be achieved is to be welcomed.

Subject to final confirmation of the OFT's decision, investment banks will be relieved to have avoided the threat of a burdensome inquiry. In contrast, institutional investors may be less pleased with the suggestion that the price increases are partly due to a lack of shareholder pressure on investee companies. That disapproval may yet, however, be tempered if the recent signs of lower prices that the OFT identifies in its report prove to be the start of a sustained return to historically lower prices.

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