UK seeks to relax shareholder preemption rights

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A leading investment advisor to the British government is due to publish a report, this month, on whether the UK should relax its rules on shareholders' preemption rights to help biotech companies raise cash by issuing new shares without the need for approval of existing shareholders. The British debate spearheads emerging discussions in Europe, where biotech lobbyists have started to push governing bodies of the European Union (EU) to harmonize and relax laws on preemption rights.

'Preemption rights' are, in principle, an important line of defense for shareholders who fear managers may sell large chunks of their company. Directors who want to issue new shares at a discount, whether on the market or to private investors, to quickly raise cash from outside investors first have to offer those shares to existing shareholders. This way, shareholders' wealth or control over the company cannot be diluted against their will. In practice, companies often ask shareholders to waive their preemption rights to have more flexibility in raising cash. But the extent to which they can do that is severely limited by government laws and private agreements.

Paul Myners, the chairman of London-based retail company Marks & Spencer and a government advisor, was mandated by the UK Department of Trade and Industry to investigate whether preemption rights 'create obstacles to the raising of finance by public companies for research and development.' His conclusions, to be published in a new report at the end of this month, could boost the case the biotech industry has been making for years.

In particular, industry insiders have complained that the guidelines are too strict. These affect especially companies that need to raise large amounts cash, for example, when their products reach clinical trials. Although, under European laws, shareholders can set aside their preemption rights for five years, stricter rules known as 'preemption guidelines' were introduced in the UK in 1987. Since then, British shareholders will only waive their preemption rights to future share-offerings not exceeding 5% of the company's value or 7.5% over a period of three years. Moreover, outside investors cannot receive discounts bigger than 5% of the current share price.

Raising large amounts in bearish stock markets requires more flexibility, according to industry insiders. "We would like institutional investors [in the UK] to amend the guidelines, and to prepare shareholders to approve setting aside preemption rights up to 20%, just as in the United States," says John Aston, CFO at British therapeutic antibody producer Cambridge Antibody Technology and chair of the British BioIndustry Association's Finance Committee. Offering the discounted shares to existing shareholders before offering them to private investors would not only take too much time, but could even trigger a disastrous collapse of the stock price, industry insiders fear.

Thus far, however, institutional investors in the UK have been wary of waiving more preemption rights. Recent corporate governing scandals have prompted calls for more shareholder involvement, not less. According to the Association of British Insurers and the National Association of Pension Funds (NAPF), the country's two largest investor organizations, both London-based, existing shareholders can judge better than new investors whether issuing new shares is sound company policy.

In contrast, in the United States, most state laws allow companies to deny their shareholders preemption rights indefinitely. Stricter rules are set only by the stock exchange. The Nasdaq, for instance, allows listed companies to sell new shares worth up to 20% of the company's market value without asking shareholders' approval. In 2003, many US-listed companies issued additional shares against cash from private investors by issuing over 1,400 'private issues of public equities' (PIPEs), thus raising $18 billion in total, according to data from the New York City-based investment company Citigroup. In Europe, in part because of preemption rights, such PIPEs are extremely rare.

Myners' soon-to-be-published conclusions will be closely read in the rest of Europe. Although the urge to change the rules is more stringent in the UK due to the greater maturity of the British biotech sector, a move on making preemption rights more flexible could prove crucial for the development of the European biotech sector. The EU, which has been attempting to harmonize and simplify the financial rules across its market, is planning a preliminary study, due after 2006, on creating an alternative Europe-wide capital system (see *Nat. Biotechnol.* **21**, 1417, 2003).

Whether the EU will follow the UK by changing the preemption rights regulations is not clear. Brussels has made only slow progress on the issue so far. Indeed, on October 29, the European Commission presented a proposal to amend the '*Second Company Law Directive*' in order to scrap the requirement to give shareholders documentation on the reasons for waiving their preemption rights, but only in cases where shares are issued at no discount.

But the proposal "does not address the core issues," says Adeline Farrelly, spokesperson for Brussels-based EuropaBio, the European bioindustry association. In practice, European laws would still amount to a prohibition on offering discounts to outside investors discretely, effectively erasing the possibility of using PIPEs, says Philippe Pouletty, vice chair of EuropaBio. He adds, "You are not protecting existing shareholders by preventing their companies from reaching their full potential."

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Paul Myners, chairman of British retailer Marks & Spencer and a frequent government advisor on investment issues was mandated by the UK government to investigate whether preemption rights interfere with the way public companies finance R&D.

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