REPORT ON

ENGLISH UNDERWRITING AND DISTRIBUTION

METHODS AND PRACTICES

By

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Sources:

The principal sources of information on which this report is based were made available through the courtesy of Ambassador Joseph P. Kennedy by introductions to stock exchange officials, bankers, brokers, underwriters, and others engaged in the business of issuing and distributing securities in London. In addition, representatives of insurance companies and investment and financial trusts were conferred with, as were representative members of the investing public.

At the back of this report is a digest of the principal sources from which the facts and impressions on which it is based were gathered, together with a list of such published information as was found available.

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INTRODUCTION

Purpose of Report:

The purpose of this report is to outline English underwriting and distribution methods and practices, and to provide specific information requested on certain particular aspects thereof.

Scope of Study:

English underwriting and distribution centers in London and extends over Great Britain from that point. London sets the standard for practices throughout the country. Thus it was found possible to cover the English system by a study of the methods and practices that prevail in London. Moreover, those particular aspects of the system on which this report is designed to shed light were found to be more readily available for study in London than elsewhere. Therefore, the study from which this report is written was confined to the background, growth and present organization of issuing and distributing as practiced in and from the city of London.

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Of the kind of security that they are willing to hold as an investment.

<u>Comparison with American System:</u>

In comparing English methods and practices with those in America, two salient points of contrast stand out. First, the English system is simpler and more direct, and probably less expensive in the long run to both borrower and investor. Second, it is primarily a buying proposition rather than a selling proposition.

Geographical differences have much to do with the relative simplicity and directness of the English system. Thus an issue offered in English papers is before most English investors at their breakfast tables on the morning of the offering, and has covered the whole country by noon. It then proceeds promptly to open, and closes even more promptly.

English issues can be handled in such a way that the business is over and done with and both the issuer and the underwriter know where they stand within a week.

In England, the investing public applies for new issues offered by prospectus and newspaper advertising, while in America investment bankers approach the public and sell securities. This contrast in sales methods has its origin in the fact that America, as a young nation with great resources to develop, needed to build up a large security buying public and did so by means of salesmen, advertising, and a distribution system which has come to include banking, purchasing and distributing syndicates, each taking compensation in the form of a profit. In England, an investment class arose during the Industrial Revolution when England became a creditor nation, and domestic savings have exceeded domestic requirements ever since. The result is that in England there is usually only one purchase and sale coupled with a direct approach to a carefully chosen list of retail distributors who are offered a commission for the sale of part of the issue.

Beyond these two main points of contrast are others worth considering. Market support, or “pegging,” is not practiced in England to anything like the extent that at times has prevailed in America, where, as a result of salesmanship with its accent on appreciation and speculative possibilities, more attention is paid to price fluctuations. In England, where there are many more experienced security buyers and where the majority of them are investors, price fluctuations are less disturbing since securities are bought more particularly for income. Thus, as has been pointed out earlier in this report, the best issuing houses allow their issues to reach price levels on their merits without artificial support.

Except in the case of the largest issues, English issuing houses generally handle them alone with their list of sub-underwriters. American investment bankers more frequently join together, due in part to the fact that American industrial units are considerably larger than those in England.

The London Stock Exchange is often used as a means of primary distribution, whereas this use is not often made of American exchanges which usually appear in the later stages of financing, except in the case of issues of rights and of blocks of existing securities.

English issuing houses do not have to pay for issues until a fortnight or so after the securities are issued, and in some cases they pay only as installments of the subscription price are paid by subscribers over a period of several months. This is in contrast to the American method of not delivering securities to the investment bankers until the issuer receives payment. This presumably makes necessary in America more banding together and bank borrowing to obtain necessary funds than might otherwise be the case.

The big English deposit banks have steadily avoided sponsoring capital issues because of the risk entailed of locking up funds. American banks took a different view up until 1933. Since then, the disassociation that has taken place between American deposit banks and their subsidiary security companies has done much to remove this point of contrast.

The English organization and practice of syndicates differs in many respects from that in America. As has been pointed out above, English syndicates are formed to a large extent of the issuing house together with its sub-underwriters, insurance companies, investment trusts, banks, and wealthy investors. A governing motive with many such syndicate members is to obtain large blocks of securities at less than the issue price, whereas in American practice, investors do not participate in syndicates. English syndicates are dissolved very promptly, usually when lists are closed and the allotment is completed. Nor is there any obligation on English syndicate members to hold such securities as they may receive in allotment, although in practice they are usually in no hurry to dispose of them. They realize that investors are likely to reason that if a house of good reputation has paid a certain price for an issue it is a buy at a slight discount, and that if they wait they will eventually find a buyer at the issue price or perhaps a slight concession. The fact that investment trusts and insurance companies play such an indispensable part in underwriting English issues acts somewhat as a safeguard. An issuing house or its broker takes a company's offer of securities to 15 or 20 such institutions. If they are interested, the business is done. If they do not like the issue, it usually stops there. As has been mentioned above, market support has had a much more prominent place in American than in English syndicate practice.

Finally, additional points of contrast appear in the respective attitudes of English and American investors: first, toward securities and second, toward the institutions that issue them. These differences in view have had an important effect on underwriting and distribution methods and practices in the two countries. English security buyers are by and large less speculatively inclined than Americans. They buy more for yield and future appreciation, and are not so much concerned over intermediate price fluctuations. The American temperament inclines more toward quick profits and quick discouragement if prices decline. To the English investor the "good name" of the house making an issue is most important. He has come to believe in history, to judge closely by past conduct and performance, and to follow and take up issues by houses of established reputation because he has found that what they put out is almost always good. Such houses, in turn, seek to justify this confidence by conducting their affairs in a way that places character ahead of capacity.

Summary:

The English system of underwriting and distributing securities came into existence during the 18th century, as the demand for capital, growing out of expanding trade and the Industrial Revolution, became more insistent. Notwithstanding these early beginnings, it was not until 1900 that the practice of underwriting was recognized legally in England.

As the English system developed, a fundamental difference between the English method of supplying capital and that of other countries emerged. English industrialists of the 19th century were self-reliant and self-sufficient, in so far as capital needs were concerned. They used their banks for short term needs only and the banks, for their part, while willing to supplement a borrower's capital, came to make it a rule not to furnish capital on any permanent basis. Thus, the energies of English banks have come to flow into two main channels, the creation and circulation of checks and of short term bills

While the banking systems of most other countries became dominant in the organization of their capital markets, private merchant banks, attracted to London because of its commanding position as the world's greatest money market, assumed the role of issuing houses. At first they were the intermediaries which investigated foreign demand for money and presented it to the public.

As the 19th century drew to a close, industry in England underwent a change, becoming more large scale and international. In so doing, it outgrew its self-sufficiency in the matter of capital requirements, and the merchant banks were drawn more and more into the financing of industry by presenting industrial issues to the public.

Underwriting grew rapidly in importance as an adjunct to this expansion in industrial issues, after it became recognized and legalized in 1900. Issues grew larger every year and the issuing house became more indispensable as an intermediary between the company requiring capital and the public supplying it.

English issuing and underwriting virtually came to a standstill during the World War. After it, there was a great growth of public interest in Stock Exchange affairs, and with

rapid expansion in issuing of securities came abuses which resulted in a new Companies Act in 1929. At about the same time the requirements of the London Stock Exchange having to do with admitting new issues to dealing were overhauled and made more stringent.

Issuing and distributing in England today rests in the hands of four main types of issuing agencies – the merchant banks, the finance houses, stockbroking firms, and syndicates. The first three dominate the market.

Similarly there are four main methods of issuing and distributing securities in London: Issue by prospectus, offer for sale, private placing or stock exchange introduction, and offer to share holders. The majority of the business is done by the first two methods.

The principal types of securities floated on the London market are – gilt edge (government, colonial, municipal, and public utility), industrial and speculative.

There is no definite underwriting market as such in London. Each of the good issuing houses has its own list of underwriters composed, in order of importance, of insurance companies, investment trusts, finance companies, brokers, and wealthy investors, many of whom appear on several such lists.

The personnel of English underwriting may be divided into main underwriters, stock brokers, and sub-underwriters. A principal characteristic of their activities is that there is no sales force as such, and that securities go directly from the underwriter to the eventual holder, who in many cases is one of the underwriting group.

The main essentials to the successful handling of the routine of an English public issue may be summed up as – first, the ability to determine at any moment the total amount thus far applied for. Second, the ability to trace quickly particular applications in connection with withdrawls. Third, the ready identification of "stags." Fourth, the rapid issue of letters of allotment and regret after closing the lists. Fifth, the ability to effectively split subscriptions and, finally, the rapid preparation and mailing of checks.

The cost of new capital in England varies from 3 1/2% to as high as 13%, depending on the type of issue and its background.

Investment intermediaries are of paramount importance in the English system. In order of their importance, they are: insurance companies, investment trusts, finance companies, banks, and pension funds. Their importance arises from the fact that they are not only the principal sub-underwriters, but also are rapidly growing in importance as eventual holders of first-class securities.

The two main points of contrast between English and American methods and practices in underwriting and distribution are that the English system is simpler and more direct, and that it is primarily a buying proposition rather than a selling proposition. Other important differences are those in geography, in sales methods, in market support, in syndicate practices, and in the respective attitudes of English and American investors, all as set forth in the section immediately preceding this summary.

P A R T II

PARTICULAR ASPECTS

At the outset of this report its purpose was stated as being to outline English underwriting and distribution methods and practices, and to provide specific information requested on certain particular aspects thereof. A general outline of the English system has been set forth above.

As to those particular aspects of the English system on which specific information has been requested, nine principal points have been raised. Following each is a brief digest of the information requested.

> 1. "The types of persons who compose the British investment market for new securities; i.e., the relative importance of (a) the public, indicating the roles of the small, medium and large investors; and (b) insurance companies, banks, investment trusts and finance companies."

In giving this information it is necessary to emphasize again the fact that in London a direct appeal is made to the investing public both large and small, and that no intermediate wholesaler is used, such as is found in the American selling group system. The result is that the English issuing agent must deal with a large number of individual applications direct from the investing public since it does not employ brokerage houses to acquire the stock and retail it throughout the country. Thus, since an appeal is made to the public in the widest sense, the public is ultimately the most important factor in the English investment market for new securities. It is generally thought that the relative importance of the small, medium and large investor is in the order named.

However, the institutions such as insurance companies, investment trusts, financial houses, banks, pension funds, etc., through which a large part of the public investment finds expression, are absolutely essential to the English underwriting market, and the success or failure of an issue depends largely on their reception of it. In fact, with certain issuing houses of the merchant-banker type, in the case of issues of high grade bonds, for example, insurance companies and investment trusts are said to put up at least 40% of the money subscribed, the other 66% coming from the general public either direct or through banks or stock brokers.

Among the professional investors, relative importance is determined by the character of the security being offered. In the case of strictly gilt edge offerings, the insurance companies and banks play the most important roles, the banks acting both for themselves and on behalf of the public. In the case of grade "B" gilt edge securities and first-class industrial debentures, the insurance companies and the investment trusts play the leading roles, followed by the finance companies on behalf of the public. The investment trusts' participation in issues of this type is in direct proportion to the size of their yield.

Where good preference or ordinary shares are concerned, the public plays the leading role, followed by the investment trusts; then, to a limited extent, the insurance companies; and after the insurance companies, the finance companies, again on behalf of the public.

In the case of speculative issues, such as mining and oil stocks, the general public, either directly or through its brokers, are virtually the sole subscribers. It is generally thought that the more speculative the security the greater the number of small investors, because the small investor tends to lack the knowledge to differentiate between good and bad securities, and also because the small investor seems more readily attracted by a promised 10% yield than is the more experienced large investor.

> 2. "The extent to which the insurance companies, banks, investment trusts and finance companies participate as underwriters or sub-underwriters in the distribution of new securities."

Generally speaking, insurance companies, banks, and investment trusts do not act as main underwriters. Most of the main underwriting is done by issuing houses, finance companies, and brokers.

As to sub-underwriting, it is done principally by investment trusts, insurance companies, finance companies, banks, and pension funds, etc. Gilt edge issues are sub-underwritten principally by insurance companies who only sub-underwrite that which they would be willing to keep, and banks, on behalf of their customers. Investment trusts are the most active sub-underwriters in the industrial field, followed by insurance companies, banks for the account of customers, and wealthy individuals. The placing of sub-underwriting, apart from the amount the issuing house retains for itself or for its own close associates, is usually entrusted to a firm of stockbrokers who act as brokers to the issue and by whom the application to the Stock Exchange for permission to deal is made. These brokers usually reserve a portion of the sub-underwriting for their own important clients.

In connection with underwriting and sub-underwriting it should be noted that in England the only obligation of the underwriter is to take up and pay for his pro rata share of any securities not applied for by the general public when the lists are closed. Thus, he is not an underwriter in the wider sense of the word.

> 3. "The operations and techniques of the financial houses and trusts (such as the British Shareholders Trust) with particular reference to their part in the underwriting and distribution of securities."

The operations and techniques of financial houses and trusts are the same as those of any other class of English underwriters. Their importance has increased greatly since 1930. That period has seen a big increase in issues handled by such houses and also by stockbrokers. As for the part that they play, they are always underwriters.

The British Shareholders Trust does much the same thing as an issuing house, that is, it takes the original risk and then sub-underwrites with the aid of brokers. They do not often take major risks, usually going to good brokers to find out if the issue in question can surely be sub-underwritten. The B.S.T. is the kind of company that managing directors of industrial companies are likely to consult as to financing. In effect, they are bankers or financial advisers. The difference between such houses and the regular issuing houses like the merchant-bank or acceptance houses is more in type than in technique. Specifically, the B.S.T. usually issues a good grade of the newer industrial issues, this because most of the old line companies have their own connections. It should be clearly borne in mind that financial trusts and investment trusts are entirely distinct. The former are operated for the purpose to turning over their funds in such a way as to make a profit. The latter are operated primarily to produce income from investment. The B.S.T. is an example of the former.

> 4. "The extent to which underwriters and other engage in stabilizing or other operations for the purposes of supporting the market in new securities during the process of distribution, indicating any variations according to the particular method of distribution (i.e., offer for sale, offer by prospectus, Stock Exchange introduction, and private placement). What market technique is employed by the stabilizer, and are there any rules, or customs, written or unwritten, limiting his operations?"

The experience of English underwriters has apparently led them to believe that stabilizing does not pay in the long run. Therefore, stabilizing usually does not take place. Occasionally an issuing house may feel it to be its duty to support the market because of its underwriters or its own reputation. But the characteristic attitude toward supporting a market is that if the issue meets with poor reception the underwriters, having presumably exercised their best judgment in undertaking their commitments, are expected to work out their own situations. This does not mean that issuing houses do not endeavor to assist the market in securities which they bring out by seeking to supply jobbers with stock or in some other way. Moreover, at times issuing houses have called their underwriters together and invited them to form a pool. But the point is that this course is the exception rather than the rule, for ordinarily the issuing house neither seeks to support or influence the market, nor are there any restrictions placed upon sub-underwriters either as to the time of their selling or as to price.

In the case of certain types of issues, principally issues of mining shares, prior support is usually given to the market in similar securities, presumably by the finance house having connections with the mining company making the issue. In fact, this type of prior support is said to have been resorted to at times by the British Treasury in anticipation of new Government issues.

Also, a temporary fall, due, for example, to heavy selling by stags, may be checked by buying by the issuing house and the brokers to the issue either for their own account or by recommendations to their clients. Similarly, a violent temporary rise, if thought to be unjustified, may be checked by arranging for additional sales by persons connected with the issuing house who have taken up large allotments. But, as has been stated, these practices are exceptional, and the good houses interfere with their issues as little as possible.

As for the market technique employed, there is no special technique other than to deal as the requirements of the situation demand. There is no difference in the methods of stabilizing or supporting the market according to variations in methods of distribution, and finally, there are no rules or customs, written or unwritten, limiting operations in this field except the general belief that they do not pay in the long run and that the position of both the securities issued and the issuing house is sounder when stabilizing and market support are not resorted to.

5. “Whether or not it is true, as has been reported, that the tactic approval of the London Stock Exchange is a necessary condition for almost all types of distribution in the English market.”

Not only the tacit but the specific approval of the London Stock Exchange is necessary in the case of any security for which a market is required, and a market is generally considered to be absolutely essential to any form of English distribution of new securities. For this reason no English issuing agent would think of making an offering if it knew that the Stock Exchange would not grant permission to deal. Withholding permission to deal amounts to Stock Exchange disapproval, and so strong is the Stock Exchange's veto power that, as a practical matter, refusal of permission to deal will kill any issue.

An official form of application for permission to deal is attached to the original of this report. All of the relevant documents which have to be submitted with this form receive close and careful scrutiny by a special department of the Stock Exchange, because the granting or withholding of permission to deal is the only control that the Stock Exchange has over securities to be issued on the London capital market. Once an issue of securities has been made, even though permission to deal therein has been granted, the Stock Exchange may suspend the quotation of prices in the issue if it believes that dealing facilities are being improperly used. This deprives the manipulator of one of his principal weapons, namely, the publicity attached to official records of dealing, but by then much harm to the interests of the public may have been done. Every application is considered by the Stock Exchange on its own merits, and all in its power is done to insure that only securities of reasonably sound concerns with a reasonable chance of success shall enjoy the dealing facilities that the Stock Exchange affords.

6. "Some information relating to 'offers to shareholders only,' for comparison with American methods of offering to stockholders by means of rights, with particular reference to such points as: whether or not negotiable rights are used, the extent to which the offering price represents a discount from the market price, etc."

It is common practice among English companies to give shareholders negotiable rights, because that is an easy way of financing the expansion of a company that finds its earning power increased. Application must be made to the stock exchange for permission to deal in such rights, and the stock exchange insists that rights be issued in proportion and that a form be provided for renunciation. English rights are always negotiable. These rights may be in the form of a preference offer to stockholders, in case of public issues, or they may be issued only to the stockholders where no issue of securities to the public is involved. The differential between the offering price and the market price varies considerably, according to the extent to which a company may wish to give its shareholders a bonus, since this is a way of doing so and at the same time avoiding income taxes. If the company's objective is to receive the maximum price, it may offer rights practically up to the market price and arrange to have the issue underwritten. Underwriting is frequently resorted to in connection with the issue of rights. When underwriting is not resorted to, a differential of something like 2/6d. on a share selling at 30/- would be about the minimum considered feasible in the case of a high-class industrial share. Obviously the offering price is always below the market price and usually at a sufficient discount to induce the stockholders to subscribe. English law does not permit a company to issue these shares at a discount from their par value unless it has accumulated reserves which can be capitalized. It should be borne in mind that there is no such thing as "no par" shares in England.

> 7. "The methods by which secondary distributions are effected, with particular reference to: the types of firms or organizations participating in such operations, the use of options, the extent of market operations, and requirements with respect to disclosure. Is the approval of the London Stock Exchange required for such operations? How frequent and voluminous have secondary distributions been in recent years?"

There is no such things as secondary distribution in England as it is understood in America. The nearest thing to secondary distribution is when a firm of brokers goes to a group of sub-underwriters with an issue and stipulates that it has the right to take back 50% of the amount allotted for the purpose of making a market when the market opens. This is a precaution only resorted to under unusual circumstances. Another approach to secondary distribution may occur when a big investment trust receives more of an allotment than it wants for its portfolio. It may then seek means of liquidating it as a secondary offering by placing it privately. In the case of issuing securities by the method of private placing, there is a possibility of something like secondary distribution through the medium of the stock exchange and its jobbers. But nowhere in English practice is there such a thing as originating another offering in some other provincial city.

> 8. "Statistical information concerning average banking compensation (commissions to underwriters, sub-underwriters, etc.) and average costs of flotation and distribution other than banking compensation."

The general question of the cost of new capital in England has been dealt with above on pages 39-41. The "spread," as it is called, depends on the nature of the issue and may vary considerably from a high-class debenture to a share in a new and obscure speculative venture. For the kind of high-grade issue which the foremost English houses would sponsor, the average spread might be somewhat as follows, although there are no statistics available showing the total commissions earned by issuing houses:

Issuing House for arranging the issue and underwriting it	3/4%
Sub-underwriting	1 1/2%
Stockbrokers for placing the sub-underwriting	1/4%
Brokerage on allotments	1/4%
Advertising Prospectus in the newspapers, printing, legal expenses, etc.	3/4%
	3 1/2%

*On a large issue this would be much less.

> 9. "General information on the financing of small local industrial enterprises. Such matters as the development of industrial banks in England as a result of the recommendations of the MacMillan Committee, including the operation of some of the new firms which have apparently gone into this type of business. In this connection, some material would be helpful on the extent to which financing is centralized in London and the effects of such centralization upon the ability of local enterprises to raise funds."

The financing of small local industrial enterprises continues to be a problem, and possibly a defect, of the English system. The problem has grown through several generations and has its origin when not so much was thought of securities. Men bought other businesses when they had excess funds. There were no investment trusts or death duties and no good stock market. Within the last 50 years, these things have developed and liquidity has become a prime consideration. The effect of the investment institutions is to collect savings of the public and to make them less available for the kind of risk bearing that is involved in new enterprises. Investment institutions and banks confine their business to new issues by old companies, municipal enterprises, government loans, mortgages, and so forth. Generally speaking, they will have little to do with new enterprises.

The MacMillan Committee recommended that certain steps be taken to bridge this gap in the English capital market and, as a result, several companies have been formed, such as Credit For Industry. But these efforts have not been successful, since they have largely resulted in tying up the funds of the companies organized to finance small enterprises. At present, as in the past, small English enterprises must rely on local money for their growth until they are large enough to come to the Stock Exchange and the London capital market.

As to the centralization of English financing in London, it is highly centralized there. Provincial cities finance their small companies through their banks and through private money friendly to the enterprise to be financed, but – as was stated at the introduction to this report – “English underwriting and distributing centers in London and extends over Great Britain from that point. London sets the standard for practices throughout the country.”